

Public Finance

BUDGET REFORM IN FRANCE: TOWARDS A NEW MANAGERIAL APPROACH

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Abstract

As part of the new budgetary reform, the Constitutional bylaw of August 1st, 2001 on budget acts introduced new rules and methods for preparing and implementing the state budget. The main purpose is to move from a resource-based to a results-based logic. Indeed, debate will focus on the objectives and the effectiveness of public expenditures. The paper aims to highlight the main aspects of the new managerial approach adopted by French administration within the framework of budgetary reform and the expected difficulties that would be encountered in its implementation. In the new budgetary system, appropriations may be freely apportioned among the so-called Programmes. Programme managers have to be fully dedicated to their goals and be accountable for their management acts via results indicators and target values so as to make public spending more efficient. Therefore, under such framework, the budgetary reform poses a number of questions about the manner of implementing the performance-related aspects of the Constitutional bylaw on public policies. This reform, effectively operational in 2006, calls for a different administrative organisation based on clearer relations between both players engaged in forwarding policies and those managing activities. Another issue raised by the reform is the need to alleviate regulations.

Keywords : *Budget reform ; mission ; programme budget ; globalisation ; performance goals.*

1. Introduction

At a time when the government's call for reforms has differently been understood by the French people, and when the financial and budgetary situation requires a strict control of expenditure, it seems more urgent to provide a meaning to the reform and explain the constraints, and the management model which is the best suitable.

Like any other complex entity, the state always needs to evolve. Indeed, it doesn't risk, for lack of adaptation, to disappear, but a failure to achieve its objectives will give rise to a society crisis. Therefore, the political crisis and the question of optimizing public finance management call for a better transparency.

This requires a real revolution in behaviour ; it supposes a change from a resource-based logic, also called a logic of control, to a results-based approach, called now a logic of evaluation.

As part of the new budgetary reform, the Constitutional bylaw of August 1st, 2001 on budget acts (*Loi organique relative aux lois de finances, LOLF*) introduced new rules and methods for preparing and implementing the state budget. Under the new rules, the parliament provides ministers with overall budgets for setting objectives and defining indicators for measuring results.

The purpose of defining performance goals and measuring results is to make public spending more efficient at two levels :

- in the budget decision making process at governmental and parliamentary level ;
- in the management of internal units themselves.

The speed of this reform, and the consensus around which it was agreed constitute a political event; it will allow the emergence of a cultural change, which consists of many other advances in the state's management method.

We need to know how the constitutional bylaw complies with different transformations of the organisational and regulatory model. In other words, will the new constitutional bylaw enable the government to move from a resource-based budget to a budget designed to reflect the results of government action? The answer to this question depends on the implementation procedures, most of which still need to be worked out.

2. A new budgetary architecture for greater transparency

The aim of budget reform is to move public management from resource-based to a results-based approach. At present, state budget appropriations to ministers are divided into about 850 chapters organised by category of expenditure.

In 2006, the state budget will be drawn on the basis of a results-based approach. It will be decided by end purpose in the form of overall budgets, the amount of which will generally be larger than that of current budget chapters. The information joined to the budget act will provide an account of the results expected and obtained.

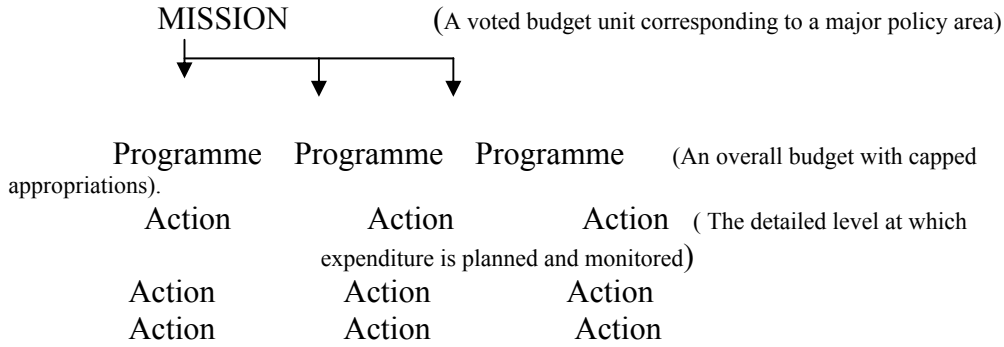
2.1 A Programme Budget based on political objectives

Under such reform, the Programme budget is organised around the purpose of expenditure. It has three levels (*Fig. 1*) :

- Forty missions correspond to the state's major public policy : the parliament approves the budget act at mission level. The emphasis can be placed on the aim of public policy. Each mission contains a set of programmes which need to be appropriated. Different ministries can be in charge of the programmes. The parliament may modify the allocation of expenditures between programmes within a mission proposed by the government.
- 150 programmes describing the responsibility for policy implementation. Each programme is subdivided into sub-programmes (actions), and is confided to a programme coordinator appointed by the minister concerned. Programme coordinators receive a fungible overall budget which enables them to choose the best-suited resources to achieve the objectives defined. A programme is a single-purpose appropriation unit .
- About 500 actions describe the programmes more detailed. The actions give the managers the information about the use of the budget resources. At this level, an expenditure is planned as it is incurred, specially for guidance purposes. By describing the budget at the objective's level, the state's missions and public service goals become fully transparent.

For each programme a strategy, objectives, performance indicators, and targets are defined. The programme coordinator uses the managerial flexibility, within the framework of the allocated resources, to steer public management according to objectives defined.

Fig. 1. A Programme budget based on a three-tier structure.



Source : Un nouveau cadre budgétaire pour réformer l'Etat, Ministry of the Economy, Finance and Industry, Department of Budgetary Reform, 2004.

2.2. Globalisation and greater autonomy for a more reactive administration

In the new budgetary system, appropriations may be freely apportioned among the programmes. Their breakdown according to the type of expenditure is purely indicative. This globalisation will make management more flexible because programme managers will be able to reallocate appropriations between types of expenditure. Personnel expenditure is the only exception to such globalisation. Because of its long term effect on public finance, it cannot be topped by other appropriations. The system will operate on a commitment accounting basis, which will make much more clearer the multiyear programme management.

In exchange of the high degree of autonomy they have, managers have to be committed to their goals and be accountable for their acts via results indicators. In order to measure the management performance, three criteria are used : social and economic effectiveness, the quality of service, and efficiency (*Fig. 2*)

Through an Annual Performance Plan (APP) appended to the budget act, ministers and programmes managers have to make a commitment to reach specific results. The APP will state programme appropriations, the performance indicators, the expected results and related tax expenditure. Financial data and performance measurements are included. They give more information and better assessment on the efficiency of the public policy.

Once the budget has been executed, performance results of management and expenditure acts are included in an Annual Performance Report (APR) appended to the Budget Review Act. The APR is built on the same model as the APP to make it easier to compare authorisations with execution.

Fig. 2. The three lines of performance analysis

	Goal	Sample goal	Sample indicator
Citizen	Social and economic effectiveness	Health : cut breast cancer screening time	Average time elapsing before breast cancers are detected
User	Quality of services provided	Police : cut police intervention time	Average time between police being alerted and their arrival on the scene
Taxpayer	Efficiency	Roads : reduce maintenance costs	Average maintenance cost per kilometre

Source : Un nouveau cadre budgétaire pour réformer l'Etat, Ministry of the Economy, Finance and Industry, Department of Budgetary Reform, 2004.

3. Budget Reform and the challenges of the reform of the public management model

As any other reform which aims at changing the reality of behaviours, and not only the rules of law, the public finance reform of 1st August is particularly based on the challenges of the transformation of budgetary, organisational and regulatory models.

At the budgetary level, in order to judge the results and derive the consequences from the choice of actions, it is necessary for us to clarify the relationship between the objectives defined and the resources used to achieve them. The budgetary architecture based on the programme is a compromise between two requirements : identifying the policies and defining the activities that they include.

Hence, the Constitutional- by law shows clearly an intention to keep performance plans within a rigorous framework. However, the confirmation of this intention depends on two factors : the quality and as well

as the accuracy of the norms that will be defined in order to frame the content of the information associated with the programmes; in addition, the quality of controls that will be carried out.

The Constitutional- by law doesn't say anything about the processes of information control in relation to the performance of the programmes. This field is entrusted to finance commissions as well as to regulation authorities.

The budget reform success depends tightly on an evolution of management style within the administration. With regard to this question, it is normal that the Constitutional- by law doesn't say anything, but, it is placed in the procedures of its implementation. This evolution is based on a reform of the organisational model as well as the regulatory framework.

3.1. Budget reform and the organisational model change

The French model of administration is fundamentally based on one particular organisation, which ensures that all the authorities and initiatives result from a unique center: within a unique actor which is the state, the prerogatives take a hierarchical direction from the summit of state to those in charge of their implementation. This administrative model is no more suited to the new management system introduced which calls for a participative approach between the different actors involved in the decision – making process. Also, the actual administrative model prevents the autonomy of management, especially for those who are charged with the implementation of public policies.

The budget reform reveals that this organisation is outdated. It distinguishes two major roles of the state. The first one consists of supervising policies, defining programmes and setting up objectives, while the second role is related to programmes implementation and resources management. As for the managers, they have a large spectrum of freedom of action and initiatives.

The overall budget puts in concrete form this sphere of autonomous responsibility, which is necessary to provide to public managers.

However, many features of state organisation impede this evolution. On the one hand, within the central administrations, the functions of supervising policies and those of managing activities are mixed. Under such conditions, the confusion between roles make it hard to define the concept of command. On the other hand, and at the decentralized level, every service

will find it difficult to gather the necessary competences for an autonomous management. The management unit is rather a service network.

3.2. Budget reform and the transformation of the regulatory model

The functioning of administrations is based on the application and control of detailed and universal legal rules. All fields of state's action take place within a regulatory provision (laws, decrees, etc). So, is this compatible with the intention to implement a management model based on results ?

Confronted with many regulations, and a great number of controls, the public manager, will merely respect and implement the provisions of these regulations and forget the indications of programme.

The main challenge is to emphasize a concrete and measurable definition of performance goals, beside a reduced regulation adapted to the actual context. The major effort consists, thus, in realizing the transition from a resource- based to result-based approach.

4. Conclusion

The new Constitutional bylaw constitutes the basis of a concrete public finance reform. Therefore, it is considered only as a foundation: many rules should still be specified without which the new framework will remain formal.

Indeed, the budget reform, effectively operational in 2006, calls for a different administrative organisation based on much more clearer relations between those engaged in designing policies and those in charge of their implementation and follow up actions. Another issue, raised by the reform, is the need to alleviate the current regulations, which are still reflecting a resource-based logic.

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INTRODUCTION OF MEDIUM TERM EXPENDITURE FRAMEWORK (MTEF) IN TURKISH BUDGETARY SYSTEM¹

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Abstract

Turkish financial management system has undergone a long lasting reform process for years. Finally a new organic law (Public Financial Management and Control Law) was passed in late 2003 and its full implementation will start in 2006. The new law requires introduction of MTEF for next three years in all general government agencies. Although the new law captures necessary provisions for MTEF, implementation of the new system rises some questions and causes some concerns for the agencies in terms of well working implementation of the new system since it is a system newly introduced. So, 2006 budget will be the first one to start for MTEF. This paper first covers the disadvantages and advantages of the former and new Turkish financial management system. It also analyses MTEF, more importantly policy formulation process within the context of international best practices. It then lays out new Turkish MTEF system and also deals with some potential problems that Turkish authorities will be challenged with. The paper ends with recommendations on how best to implement the new MTEF system in Turkey.

Keywords: *Medium Term Expenditure Framework, Turkish Budgetary System, policy formulation.*

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1. Introduction

The economic and financial problems experienced in the today's economies have created pressure towards an increase in budget expenditures; increasing pressures undoubtedly caused the governments to increase taxes and resort to borrowing. These developments brought along with the questioning of the public financial management systems of countries and therefore the reform efforts. In order to bring a solution to their problems, the countries tended to change their public financial management systems that constitute the focal point of the problem; within this scope, they have undertaken significant structural changes towards ensuring effective, efficient and economic use of public resources.

Also in Turkey, the economic structure has rapidly deteriorated starting from the beginning of 1970s, several interventions made to capture stability has proved fruitless when combined with fluctuations in the political structure. Turkey constantly struggled with high inflation, public deficit, instable growth, high interest and deterioration of income distribution, could not bring radical solutions to its problems other than short term recoveries and could not capture the stability it seeks. Meanwhile, the lifespan of the economic stability packages that were not supported with structural reforms were short termed. Although improvements in economic and financial situation have been recorded, the system has not lost its feature of being easily distorted.

Therefore, the problems arising from the public financial management system and following thought that the public resources have not used in an effective, efficient and economic way have accelerated the reform efforts. As a matter of fact, the reform efforts in Turkey have usually arisen in the aftermath of economic and financial crises. Right after the economic crisis experienced in April 1994, it was concluded that it was necessary to undertake some changes in the public financial management system and to this end, working commissions were set up composing of representatives from key economic agencies. The commissions made their studies, prepared their reports and submitted to then the government. However, with lack of sufficient political will supporting the reform efforts, these efforts were inconclusive. The second step in the public financial management reform, consequent to the significant economic problems experienced in the economy, started with the new economic program introduced in the year 2000 and has accelerated following the economic and financial crisis undergone in 2001. Within this scope, the quasi-fiscal transactions of the state have been set in order, the budgetary and extra-budgetary funds as well

as special accounts outside the budget, which were great problems for long years, were eliminated leaving out some exceptions, the provisions allowing agencies to add appropriation within the year without the authorization of the parliament have been abolished, state borrowing and the procurement system have been brought under discipline through framework laws. The most radical and comprehensive change in the public financial management system has been realized with the adoption of the Public Financial Management and Control Law numbered 5018 at the end of the year 2003. By abolishing the Public Accounting Law numbered 1050 which was in implementation for approximately eighty years but unable to meet the requirements of the best international practices in today's world, the new public financial management approach has been introduced with Law numbered 5018. This new law brings important changes to the fundamental principles of public finance and utilization of public resources.

The significant changes brought by the new public financial management concept can be listed as; strengthening of the generality and unity principles of budget in execution, highlighting financial transparency, accountability in the utilization of public resources as well as performance based budgeting and MTEF, introduction of the mechanisms necessary for the effective, economic and efficient utilization of public resources and one of the principles of modern public financial management, giving freedom to the managers in the line agencies beforehand and strengthening the ex post audit by increasing its efficiency.

In this paper, firstly the content of the changes undergone in the public financial management systems in the world and the problems experienced in Turkey during the period of implementation of the Law numbered 1050 and in the following period and new practices that are brought will be explained. Afterwards, the introduction of MTEF in Turkey which is one of the important practices brought by the Law numbered 5018 in terms of efficient, effective and economic use of public resources will be discussed. The paper will end with a short conclusion part.

2. Recent Developments in Public Financial Management System

2.1 The World

Significant arrangements are being undertaken in several countries in the area of public financial management in recent years. The established economic, social and cultural structure of every country may set different forms to the public management and public financial management systems. However, in the world, the public financial management reforms have some common characteristics; public financial management reforms are realized to affect three fundamental elements. These are; overall financial discipline, distribution and utilization of resources according to strategic priorities and ensuring effectiveness and efficiency in the provision of public services. The budget reforms continuing for centuries to realize these focused on reformulating three basic functions of the public. These are; control of public resources, medium term resource allocation and management of resources².

Realization of the institutional arrangements necessary for fiscal discipline is important in terms of the outcome of budget implementation. In this context, allocation of public resources should be in line with the expenditure ceilings and the agencies have no any authorization to exceed the appropriations set by the budget except for the supplementary budget approved by the Parliament. The most fundamental element of the fiscal discipline concept is that the budgets are formed by taking into account the available resources. Actually, together with the budgetary restrictions introduced in the public financial management system and the flexibilities given to the public agencies in the realization of public services will play an important role in the realization of the goals mentioned above, and at the same time they will pave the way for change in public financial management. The second aim of the reforms made in the public financial management system are the arrangements made towards taking into account the program efficiency and strategic priorities of the government and hence the agency in the allocation of public resources. In allocation of resources, taking into account the national priorities determined by the government is a requirement

² THE WORLD BANK. *Public Expenditure Management Handbook*, Washington D.C.: The World Bank, 1999, pp. 17; ZEVENBERGEN, J. *Budgetary Reforms in Transition Countries: The Role of Capacity Building-Summary and Main Conclusions. (Special Report Prepared for OECD Budget Officials Meeting)*. Rooterdam, 2004. pp. 1.

of accountability. Because, resource allocation is basically a political issue. In this regard, in the policy formulation process which is the first stage of the budgeting process, the areas which will be allocated public resources among the priorities of the government are identified by also using the efficiency analyses. The third element is increasing the performance of public sector, in other words, the efficiency. Provision of public services with the most possible cost is an issue that occupies the agenda of many countries in the world including developed countries. On this issue, particularly developed countries have made significant progress and they have changed their public financial management systems towards this direction.

On the other hand, OECD has reached the conclusion that the performance about the fiscal discipline is closely related and the countries which generally have budgetary surplus are those that reform their budgeting process and implement modern budgetary systems³. In this framework, five basic institutional arrangements are recommended in the budgetary system in order to control the public expenditure efficiently. These are; MTEF, prudent economic assumptions, top-down allocation of public resources, departure from input oriented resource allocation towards output oriented resource allocation, highlighting financial transparency and accountability.

MTEF is basically the most important tool of establishing policy, plan and budget link. Determination of policies independent from available resources and budgets is the result of a decision-making mechanism away from efficiency. This also shows that policies are not identified according to available resources or strategic priorities⁴. An efficient budgeting requires efficient balancing between needs and resources. MTEF contributes to increasing predictability and reliability of budgets by establishing the link between policy and budget.

On the other hand, over-optimistic economic assumptions and unnecessary increase of public expenditures bring together resource allocation to inefficient budget practices. The old practice that used to be applied in resource allocation to public agencies was to receive appropriation requests from the agencies, examine these requests one by one, make negotiations with the relevant agency and to identify the appropriation to be allocated in term expenditure areas. Among many drawbacks of this system, the most important drawbacks that it does not reflect the priorities of the government. However, this practice is now abandoned in many countries.

³ BLÖNDAL, J. R. Budget Reform in OECD Member Countries: Common Trends. *OECD Journal on Budgeting*. 2003, vol. 2, no. 4, pp. 7 – 14.

⁴ THE WORLD BANK. *Ibid.* pp. 32.

Instead, the top down appropriation allocation is implemented, where the government predetermines the total appropriation to be allocated in the relevant year and also puts a ceiling for the appropriations to be allocated to public agencies, the resource distribution for the activities and projects to be carried out within the predetermined ceilings is made by the public agencies without the intervention of the Ministry of Finance.

However, it is possible to encounter views opposing to this approach; it is underlined that the ministries of finance should somehow be involved in the distribution or redistribution process of public resources in the budgets of relevant public administrations in terms of the financial objectives and political priorities of the government⁵.

On the other hand, there is a common understanding that departure from input oriented resource allocation to output oriented resource allocation, in other words caring about what is done in the public sector rather than how the public activities are performed, will increase efficiency in the utilization of resources. Besides, transparency and accountability are regarded as significant tools for the governments to give assurance to the parliaments and the people that they have efficiently used the public funds entrusted them.

As can be observed, generally the same methods and tools are being used in the reformation of public financial management systems in the world. The arrangements focus on financial discipline and highlighting efficiency and effectiveness in the allocation and utilization of public resources. To this end, innovations are made in the national budget systems, international best practices emerge. Now, through the budget reforms, the governments take the necessary steps not to have the public budgets, which have a significant position in the economy in terms of magnitude and quality, to be the sole cause of economic and financial crises.

2.2 In Turkey

2.2.1 Period before the Law numbered 5018

In Turkey, the Parliament's right to approve the national budget has been recognized with the 1924 Constitution and the first arrangement related

⁵ SCHICK, A. Does Budgeting Have a Future?. *OECD Journal on Budgeting*. 2002, vol. 2, no. 2, pp. 28.

to public financial management system in the Republic period has been realized with the Law numbered 1050 adopted in the year 1927. The Law numbered 1050 which is the constitution of the public financial management system has been implemented in Turkey for almost eighty years since 1927 with a few amendments. During this term, significant changes have been undergone in the public financial management and control systems in the world and international best practices have emerged. In Turkey, in the same period of time, the number of public administrations has gradually increased and significant changes have occurred in terms of their quality and organizational forms as well as in terms of quality and quantity in the production of public goods. Besides these, the changes in the world have brought by the appearance of great changes in the approaches in the area of public financial management system in Turkey.

The criticisms concerning the period when the Law numbered 1050 was implemented can be summarized as follows; rather than a single budget, emergence of different budgets (extra budgetary funds, revolving funds, etc.); failure of the budget system to establish the policy-plan-budget relationship; not making strategic plans for agencies; failure to perform functional analysis of the state and therefore lack of clear duty definition of the public agencies; performance of audit in the Turkish budget system basically in terms of compliance audit; neglecting the efficient economic and effective use of resources; taking into account only the expenditures incurred in the previous year for the allocation of appropriations; lack of defining managerial responsibilities in a clear way; magnitude of the appropriations recorded throughout the year, although not included in the budgeted appropriations, without parliament's approval, on the grounds of powers vested by some laws, the Law No 1050 being the dominant; failure of the registry and control system of state's assets to reach a sufficient efficiency level and that fact that the state does not have the full set of information on its commitments; not budgeting the tax exceptions, discounts and exemption created by the state through incentive policies⁶

These drawbacks that are mentioned have accelerated the restructuring of public financial management system especially in recent years. Consequent to these studies, the Law No 5018 has been adopted to

⁶ DPT. *Sekizinci Beş Yıllık Kalkınma Planı Kamu Mali Yönetiminin Yeniden Yapılandırılması ve Mali Saydamlık Özel İhtisas Komisyonu Raporu*, Ankara: DPT, 2000, pp. 28-82. ARCAGÖK, M. S., YÖRÜK, B., ORAL, E., KORKMAZ, U. Kamu Mali Yönetimi ve Kontrol Kanununda Öngörülen Düzenlemeler. *Bütçe Dünyası Dergisi*. 2004, İlkbahar, no. 18, pp. 3-4.

replace the Law No 1050 and it has been foreseen that the 2006 budget will be prepared in accordance with this approach.

2.2.2 Changes to the Public Financial Management System with Law No 5018

The Law No 5018 that constitutes the financial pillar of the public management reform has been adopted by the Parliament on 10 December 2003. Law No 5018 takes a new approach on the structure and functioning of our financial management and control system and regulates the fundamental principles of these issues, and determines how the transactions for the preparation, implementation and control transactions of public budgets will be carried out as well as accounting and reporting of financial transactions.

The changes brought and the issues aimed with this Law that has the objective of the establishment of a new public financial management system can be stated as follows:

- ◆ It is ensured that all revenues and expenditures of public agencies are included in the budgets and it is aimed to prevent obtaining revenues and incurring expenditures from outside the budget.
- ◆ A close connection has been established for policy-plan-budget⁷. Strategic planning and performance based budgeting have been fundamental pillars of the new system. Besides, special provisions for the purpose of ensuring efficiency in budget preparation and implementation process and MTEF is introduced.
- ◆ The duties, powers and responsibilities of public administrations in the budget process are rearranged. Within this scope, the power-responsibility balance in public financial management is re-established and the problem of responsibility without powers and irresponsibility with powers is overcome. The duties of performing ex ante control and ex post internal audit have been transferred to the relevant public administrations and it has been stipulated that they will undertake a new structuring in this regard.
- ◆ The duty of giving visa to commitments and contract drafts still performed ex ante by the Ministry of Finance is abolished. Within his

⁷ ARCAGÖK, M. S., YÖRÜK, B., ORAL, E., KORKMAZ, U. Ibid. pp. 6.

scope, transaction of giving visa on utilization of appropriation and transaction of registering contracts performed by the Court of Accounts has been ended as of 2005. Therefore, through reducing ex ante controls, the necessary environment for swift provision of public services is prepared.

- ◆ Through paving the way for specialising in audit, establishment of an internal audit system that has certain rules and standards, constantly functioning and that will take place within the relevant public administration is targeted. Appointment of internal auditors is provided for in order to ensure the performance of auditing activity operating within a determined system and to perform ex post internal audit. As a requirement of the newly adopted system, strengthening of ex post auditing activity is required.
- ◆ In the public sector, the obligation to use the same accounting system has been introduced. In all public agencies within the scope of general government, common accounting and reporting standards as well as chart of accounts shall be implemented. Furthermore, the Ministry of Finance has been delegated to prepare and announce publicly the financial statistics⁸. Implementation of a new budget classification in accordance with the International Monetary Fund Government Finance Statistics (GFS) is introduced.
- ◆ Tax expenditures chart renounced due to tax exemption, exception and reductions as well as similar implementations shall be added to budget laws.

To summarize all that have been explained above, this Law; ensures budget unity, highlights effective, economic and efficient utilization of public resources as well as financial transparency and accountability and allows for wide initiative power to the public agencies for decision making and implementation.

⁸ MALİYE BAKANLIĞI MUHASEBAT GENEL MÜDÜRLÜĞÜ. *Devlet Muhasebesinde Reform Çalışmaları: Nakit Esasından Tahakkuk Esasına*. Ankara: Maliye Bakanlığı Muhasebat Genel Müdürlüğü, 2002, pp. 32.

3. New Approach in the Utilization of Public Resources: Medium Term Expenditure Framework (MTEF)

The main objective of fiscal policy is to increase economic welfare. Fiscal policy employs three elements in order to realize this. These are; the allocation of public resources, redistribution of welfare and income and regulation of economic activities. Budget, which is an important instrument for the implementation of fiscal policy, has its own effect on the other elements, mainly on the allocation of public resources, directly and/or indirectly. It is possible to see how budgeting process affects the aforementioned instruments. The first in this process is policy formulation (making). Afterwards, a budget that is suitable for the outcoming policy is prepared and implemented, and the process ends with the evaluation and auditing of the implementation. The rationale of the budgeting process is exercising the authority granted by citizens to the government, and the government should be able to give account of what it does and what it produces as it exercises this authority.

As regards the historical development process, whereas budgets used to be prepared based on input sources such as money, human and accounting; a new budgeting approach became prominent in budgeting in OECD countries especially in the last twenty years and public budgeting and administration started to develop in an output-outcome oriented rather than input oriented manner.

In the traditional public management approach, accountability takes place in the form of conforming to legislation; consequently managers do not encounter any problems as long as they comply with the rules. In the new public management approach, what the managers do is more important than how they do it⁹. Thus, being outcome-oriented in rendering public services and evaluating the success of the managers based on the output and outcome generated by public activity, find wide implementation today.

On the other hand, the main problem encountered in the budgeting process in many countries is downplaying the importance of strategic decisions, namely absence of certain strategic rules while the budget implementation is strict and centralist. In other words, the loose policy making process is endeavoured to be balanced by means of over-strict budget implementation rules. The reason why the strategic decision-making process

⁹ BLÖNDAL, J. R. Ibid. pp. 18.

is weak is because the policy making process is distributed among different public agencies. Therefore, an efficient coordination mechanism is needed within the government for an efficient strategic management. In fact a centralist and strict policy making process and decentralist and flexible implementation processes are desirable for an efficient MTEF process¹⁰.

MTEF is implemented in order to provide information on the medium terms strategies to be implemented by the governments in terms of public financing. Therefore, MTEF is an instrument that provides information on the areas where the public expenditure will be directed to in the medium term. MTEF sets expenditure ceilings for central government and agency level to accomplish fiscal discipline and to allocate public resources in line with the strategic priorities of the governments within these ceilings. However, agency level ceilings might be shifted from one agency to the another if necessary, provided that overall ceiling for the budget will not be exceeded. Strategic priorities are determined for two steps, first on national level and next on agency level. The agencies' priorities should be more detailed compared to the national one. Strategic priorities should also cover macroeconomic framework (inflation, growth, export, import, budget deficit, public debt stock), otherwise setting priorities itself will not make sense for well working MTEF. The agencies should be careful that their priorities are to comply with the national priorities. Consequently, MTEF finds wide implementation around the world in recent years, for overcoming challenges encountered in the budget systems.

3.1 Definition of MTEF

MTEF is defined as a budget approach where the annual budget process is evaluated with a multi year approach, especially such as multi year forecasting of expenditures or a multi year fiscal strategy, and where the policy-plan-budget link is realized¹¹. Disconnection between policy-plan-budget causes budgets to give negative economic outcomes especially in developing countries. In many countries, these three elements operate independently from each other. Therefore, budgeting is seen as an instrument for the central agencies to meet the appropriation requests of agencies in the pertaining year. However, budgeting should be seen as an activity that is based on policy. An efficient decision making process should ensure that the

¹⁰ THE WORLD BANK. Ibid. pp. 24.

¹¹ KIZILTAŞ, E. Çok Yıllı Bütçeleme Sistemi, *Bütçe Dünyası Dergisi*, 2003, Sonbahar, no. 16, pp. 13. ARSLAN, M. Orta Vadeli Harcama Sistemi (Çok Yıllı Bütçeleme) ve Türkiye'ye Uygulanabilirliği. *Sayıştay Dergisi*. 2004, no. 54, pp. 11.

link of policy making and planning with budgeting is established and it should also require them to be limited by the available resource level and priorities. Otherwise, budgeting process turns into an activity which is no more than a challenge to save the day. Consequently, predictability in budgeting process will enable public agencies to plan and manage their resources in the medium term. In consequence, MTEF also brings about the control of public expenditures and efficient utilization of resources and thus the resource allocation process is eliminated from uncertainty.

MTEF process generally covers the budget year to be prepared for the coming year and sent to the parliament for approval and the following two years. In terms of time, the same approach has been followed in the Law No 5018. This process basically has been founded over three structures. The first one of these is the top-down estimation of total resources that can be allocated for public expenditures in coherence with the macroeconomic structure; the second one is bottom-up estimation of the costs of the activities and projects that are underway and that are to be put into practice shortly; and the third one is a process that compares total resources with these costs¹². The most important innovation brought by such a practice is drawing up of the framework of the size of the service to be rendered as per the available resources, in other words existence of a very close link between decision making mechanism and the available resource package and as a natural outcome of this, distribution of resources according to determined strategic priorities.

Thanks to MTEF, budget resources are mobilized in a way to cover a period longer than one year for realizing the strategic priorities which cover more than a year, which are determined by politicians and which reflect the choice of the electorates so to speak; therefore, medium term policies are formulated and these policies are integrated into the budget process. Thereby, a transition has been foreseen from the budgeting system based on traditional cash management to a budgeting system based on expenditure management¹³. As a natural outcome of the given information, planning and handling the expenditure areas in the budget with a medium term approach is required. For instance, welfare payment to those older than 65 or agricultural subsidies to farmers are not policies that differ from year to year. Lately, the agriculture strategy to be implemented in the coming five years has been declared by the Ministry of Agriculture and Rural Affairs in Turkey. Therefore, the best way

¹² YILMAZ, H. H. Kamu Mali Yönetiminin Yeniden Yapılandırılması: Dünya Bankası Orta Vadeli Harcama Sistemi. Ankara: DPT, 1999, pp. 16.

¹³ YILMAZ, H. H. Ibid. pp. 19.

to formulate this declared agricultural strategy within the budget is to take up the issue with a medium term approach.

3.2 *The Objectives of MTEF*

There are many reasons MTEF has been given place in budgeting process in recent years. It is possible to enumerate these as follows:

- ◆ It makes it obligatory for the governments to determine their medium term goals and objectives clearly. Thus, it is ensured that the public resources to be raised in the medium term are allocated between and across the sectors. So it improves predictability of funding for line agencies and is sort of budget planning given policy choices¹⁴,
- ◆ It sets out major policy directions, fiscal aggregates and the sectoral resource allocation¹⁵,
- ◆ It enables the redistribution of resources among the budgets of public agencies and/or within the budgets of public agencies so that the changes which took place in the government's priorities are included into the next year budgets¹⁶. So efficiency in the allocation and utilization of public resources is encouraged¹⁷. However, minimizing the redistribution of resources in the budget execution is also important because the frequent repetition of such a practice might cause budgets not to reflect the real priorities or might cause a deviation from fiscal/political discipline¹⁸,
- ◆ By way of establishing a consistent resource-expenditure balance, it ensures fiscal discipline and contributes to the enhancement of the macroeconomic balance¹⁹,

¹⁴ SWAROOP, V. *Medium Term Expenditure Framework: What is it?*. Washington, D.C.: PREM Week Thematic Session, 21 November 2000, pp. 4.

¹⁵ KOWN, O. B., YOUNGSUN K. *Introducing a Medium-Term Expenditure Framework: The Korean Experience*, Ankara: Symposium on Strengthening Budget Preparation Process, 5 May 2005, pp. 4.

¹⁶ SCHICK, A. Opportunity, Strategy and Tactics in Reforming Public Management. *OECD Journal on Budgeting*. 2002, vol. 2, no. 3, pp. 27.

¹⁷ KIZILTAŞ, E. *Ibid.* pp. 18.

¹⁸ THE WORLD BANK. *Ibid.* pp. 22.

¹⁹ WILDAVSKY, A. Controlling Public Expenditure: The Theory of Expenditure Limitation. *OECD Journal on Budgeting*, 2003, vol. 2, no. 4, pp. 40.

- ◆ It provides necessary information to the political decision makers on the possible costs of the political priorities of the government and of new programs and projects that are put into implementation²⁰.
- ◆ It ensures the continuity of programs that are being implemented as a result of the increased predictability in the allocation of public resources for certain policies. Furthermore it assists the establishment of the necessary incentive mechanisms for the effective and efficient utilization of the public resources as a result of the budget constraints introduced and the flexibilities provided to public agencies²¹.

MTEF approach has certain disadvantages although it ensures, by way of realistic analyses, the allocation of the limited public resources to the areas where they can be effective and efficient. It is possible to enumerate these disadvantages as follows:

- ◆ Future oriented estimations in MTEF practice might appear as earned rights by the agencies, and this might prevent the top down revision of the expenditures in case a need arises for the correction of the estimates made beforehand,
- ◆ Over optimistic multi year estimations might lead to continuation of unnecessary public services and might form an upward pressure over the budget expenditures,
- ◆ If multi year estimations are made in a way to include real increases, expenditures might automatically increase in the inflationist periods, these increases taking place independently from the developments in the budget revenues might make it difficult to ensure fiscal discipline²². There are also claims that this situation might inhibit rendering public services at a required level, furthermore, that the position of the public and private sectors in the economy might change against the favor of public sector²³.

However, it is within the bounds of possibility to eliminate the enumerated disadvantages of MTEF using multi year budget estimations

²⁰ BLÖNDAL, J. R. Ibid. pp. 11.

²¹ YILMAZ, H. H. Ibid. pp. 22.

²² BLÖNDAL, J. R. Ibid. pp. 12.

²³ WILDAVSKY, A. Ibid. pp. 40.

which are prepared on the basis of economic presumptions determined realistically as well as nominally and which are not responsive to inflationist increases.

We should bear in mind that MTEF may fail due to the some circumstances encountered such as macroeconomic instability, weak financial management system, lack of enough administrative capacity and fiscal discipline and introducing new programs with no resources available²⁴. If successfully applied, it would improve macroeconomic balance by developing a multi year resource framework.

Therefore, budgets are the most important instruments used by governments to realize the services committed by them to citizens. This also indicates that budgets are important texts which reflect political choices. However, it is not possible to limit the commitments of the governments to a year, besides they have a nature of covering many years. Therefore the budget systems should take account of the economic activities and commitments that exceed a year and that are related to budget. For this reason, budgeting should be thought together with the planning process and establishment of the plan-budget link becomes inevitable for an efficient budget process. Consequently it will be possible for this kind of a budget, which is not disconnected from other periods, to generate policies.

3.3 Policy Making, Planning and Budget Relationship

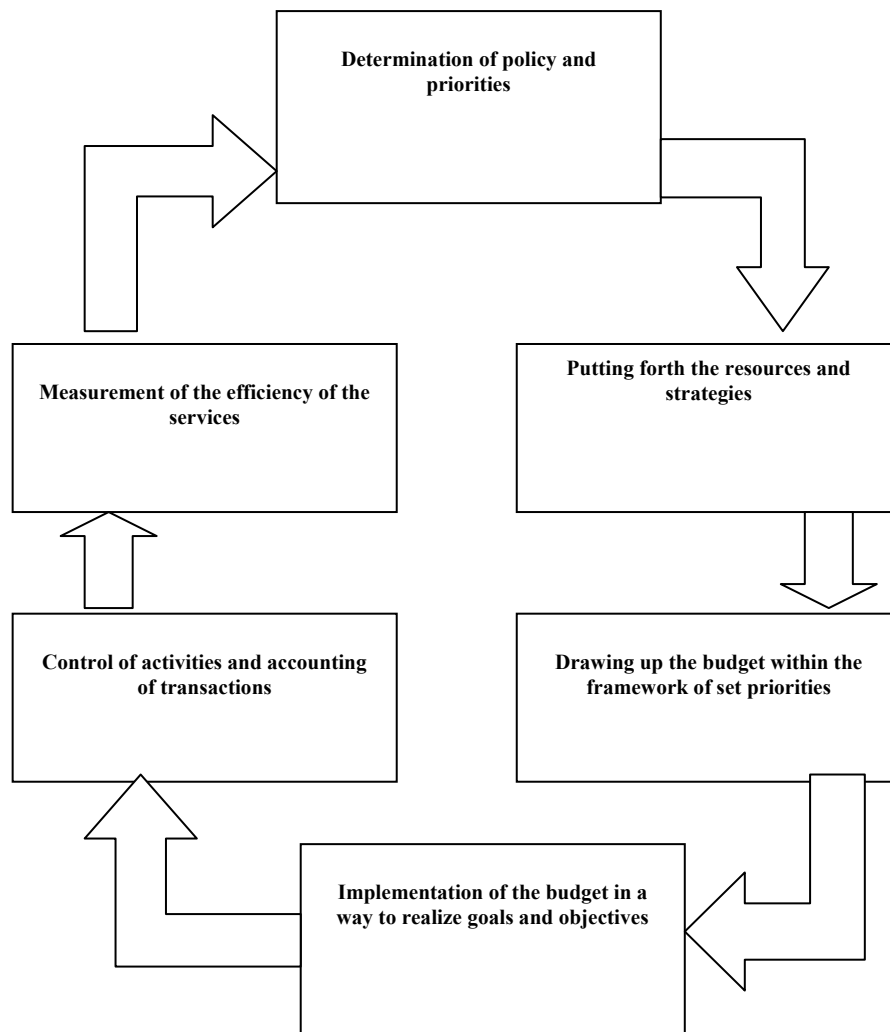
Medium term approach facilitates the allocation and realization of public resources in compliance with the resource-expenditure balance and considering the determined priorities. Therefore we can state that from the two most important objectives of the medium term approach, the first one is setting the fiscal objectives and the second one is distributing the resources as per strategic priorities within the framework of the said objectives.

Figure 1 indicates the process that is necessary for the establishment of the link between efficient policy making, planning and budgeting. First and foremost, the process starts with the government determining on its policies and priorities as per sectors. In the following stage, goals and strategies as well as available resources oriented towards realizing these policies and priorities will be put forth. As the third stage, preparing a budget as per certain sectors in conformity with the determined policies, goals and available resources will be required. In this stage, what amount of resources

²⁴ PEARSON, M. *Medium Term Expenditure Frameworks. (Briefing Paper)*. UK: DFID Health Systems Resource Centre, 2002, pp. 4.

will be distributed to which expenditure areas will be determined. Budget implementation, which includes the collection of revenues for the realization of determined public activities and the mobilization of the necessary personnel and resources, comes up as the next stage. Monitoring of the activities and keeping of the necessary accounting records are required in the fifth stage. The process will have been completed with the evaluation of the efficiency of the activities and auditing of the implementation and at the same time with the acquisition of the necessary experience for the policies to be implemented in the future.

Figure 1-Policy Making, Planning and Budget Relationship



Source: THE WORLD BANK. Public Expenditure Management Handbook, Washington D.C.: The World Bank, 1999, pp. 32.

Resource allocation process in the developing countries faces important problems due to uncertainties experienced and it prevents proper planning oriented towards future. For example, over-optimistic estimation of budget revenues might lead to an uncertainty in terms of resource levels and might inhibit efficient planning oriented towards future.

The budget process does not take into account the possible problems to be encountered in the coming years and the multi year budgets are not binding or the set objectives are not taken seriously, the government operates in order to carry out the given duties only, as in the case of classical budget approach, rather than to use public resources for the realization of certain goals and objectives. For this reason, especially in the developing countries the policy-plan-budget link is required to be strengthened²⁵.

3.4 Introduction of MTEF in Turkey

MTEF is a newly introduced approach in Turkish financial management system. One of the deficiencies Turkish budgetary system had in the past is the lack of prudent macroeconomic framework and assumptions in estimating revenues and expenditures for coming years. More importantly, revenue and expenditure estimations were not compatible with the existing macroeconomic framework. So MTEF for Turkey shall be prepared in a rolling structure, capture some more flexibilities in case of changing priorities and circumstances within the year. MTEF should also be in detail and comprehensive enough to link with national priorities set forth in medium term program and fiscal plan as required by the new Law, No 5018.

MTEF should be handled as a process and roles and responsibilities of key central agencies (Ministry of Finance and Undersecretary of State Planning Organization) as well as public agencies should be defined within this process. In reference to the Law No 5018, we see that no clear and simple process relating to MTEF has been set forth. As for the MTEF practices across the world, the most important element of MTEF is that the priorities of the government are determined by the council of ministers and the priorities at the level of administrations are determined by the ministries together with the agencies strategic plans. First stage in MTEF is the determination of the macroeconomic framework. Macroeconomic framework will at the same time facilitate the estimation of expenditures pertaining to

²⁵ IŞIK, H. Kamu Harcamalarında Performansa Dayalı Bütçe Yönetimi ve Denetimi ile Türkiye’de Uygulanabilirliği, Ankara: Devlet Bütçe Uzmanlığı Araştırma Raporu, 2003, pp. 73-74.

the next three years. Therefore it is required to ensure mutual harmony by means of combining economic estimates and financial objectives; and consequently to estimate the macroeconomic framework for the next three years employing different methods of analysis. Furthermore, it is required that the costs of current and new policies are identified and effects of these policies on economic balances are estimated. For example, economic forecast office operating independently in the Netherlands is obliged to assist the ruling government and the opposition especially in the calculation of the costs of new policies as well as in the estimation of the effects of these policies on economic balances.

Medium Term Program to be prepared pursuant to Article 16 of the law No 5018 could be functional in this respect. Thus this program could be taken as the starting point of MTEF. The Council of ministers that will convene by the end of May will adopt the medium term program prepared by State Planning Organization in a way to cover macro economic policies, principles, targets and main economic magnitudes as indicators (sectoral priorities, growth, inflation, exchange rate, payment balance, interest, etc.) in line with requirements of the development plans, strategic plans and general economic conditions and the Program will be published on the Official Gazette within the same time period.

The second stage in MTEF is the revision of sectors. In this stage goals and activities of a sector/ministry should be revised and the costs of these goals and activities should be calculated and information on their outputs and outcomes should be obtained. As a result, the programs and subprograms that will ensure the realization of these goals and activities should be prioritized taking account of the available resources. As regards Article 16 of the Law No 5018, this stage has not been given any place. However in Article 9 of the Law, strategic plans are mentioned and this stage will be realized by the strategic plans of the administrations. Nevertheless, as mentioned just a while ago, the fact that multi year budgeting process is not given in a certain order in the Law has the potential to cause complications in practice. What is more, the fact that MTEF will be introduced with 2006 budget while only certain administrations are piloted in terms strategic planning, indicates that this stage will not be given place in the budgeting process at least for a while.

The third stage should entail negotiations of the Ministry of Finance and State Planning Organization with the sectoral ministries. In this stage negotiations take place on the outputs of the sectoral study conducted in the

previous stage. Similarly, law No 5018 provides no certain calendar for these negotiations.

The fourth stage is the determination of expenditure ceilings of the sectors/ministries for the coming three years. Expenditure ceilings are set bearing in mind the priorities determined in the previous stages and the macroeconomic structure. In other words, a detailed framework on the sectoral and institutional distribution of the expenditures is formed. Furthermore, targets relating to the total revenues of the coming three years are determined. However, the final decision about the expenditure ceilings of sectors/ministries and total revenues will be taken the Council of Ministers.

In stage five, expenditure ceilings of sectors/ministries will be approved by the Council of Ministers. The most important stage in MTEF is this stage where the expenditure areas for which the public resources will be allocated in the medium term are transformed into a government declaration by the council of ministers by staying within the boundaries of available resources. This stage is not a simple stage where budget ceilings are determined only. It is a stage where the medium term priorities of the government and thus its policies as well as the economic role of the state are reflected to the budgeting process.

According to the Law No 5018, medium term fiscal strategy, which includes total revenue and expenditure estimates relating to the coming three years, the target balance, the borrowing status if any and appropriation ceilings of the public administration, shall be prepared by the Ministry of Finance in compliance with the medium term program and shall be approved by the High Planning Council in the first half of June. However, the Law No 5018 has brought a structure that does not comply with this general rule mentioned above. This is because the medium term fiscal strategy will be adopted by the High Planning Council instead of the Council of Ministers. Therefore a policy declaration which many ministers are not involved in, in other words, a resource allocation process which might not be agreed upon by the members of the cabinet will be brought about.

In the final stage, public agencies are required to prepare their budgets for the coming three years taking account of the sectoral/institutional priorities and ceilings. However, in the budget preparation stage the Ministry of Finance and State Planning Organization is required to check how much the budget proposals sent by the institutions comply with the sectoral/institutional ceilings and priorities set forth by the medium term program and fiscal strategy. It would provide an important contribution for

the realization of policy and budget link if they talked with the representatives of the sectors/institutions on ruling out the inconsistencies if any, thereby ensuring consistency.

There is no doubt that a successful and sustainable public financial management reform reveals the need for strengthening of the institutions involved in the budget process and the realization of the institutional arrangements other than the budget. Because realizing the transformation does not depend on setting the necessary rules only. It also depends on a public financial management system whose authorities and responsibilities are well defined, an internal control mechanism that operates efficiently together with the necessary mentality change in the public institutions and the public sector personnel with sufficient capacity. On the other hand, presentation of information on time and in a reliable manner and monitoring and evaluation capacity of the administrations thereof will play an important role. Furthermore, external audit is an important element. For this reason, administrative capacity building in public agencies and creating necessary infrastructure to this end is essential. Transfer of the public financial management system, which has been the duty of the ministry for many years in our country, to the public agencies from now on, as a requirement of the Law No 5018, should be seen as a very important and fundamental mentality change.

4. Conclusion

A transformation need in public financial management system has become prominent in a rapidly changing world, based on the methodology approach brought by globalization and information society. Reconstruction need appeared not only in the public financial management systems but also in the public administration approach and the transition from an industrial society to an information society revealed the difficulty of adaptation of public administrations to the changing conditions within the existing patterns. As a consequence of this, the new public administration approach came out and public administrations in many countries initiated a change in their approach and implementation.

Public administration systems have undergone change in parallel with the new public administration approach and activities carried out towards reconstruction hastened in recent years. A need for transformation especially appeared in developing countries rather than in developed countries;

however, transformation activities carried out in public financial management systems became prominent more in developed countries. As a consequence of this, with the efforts of international organizations too, international examples of the best practices were opened up and the developing countries have been affected by the wind of transformation too.

The need for transformation appeared especially after the economic crises in our country and the problems encountered by the Public financial management system have been among the issues which have always been a matter of discussion. And the idea became prominent that a budgeting system, which is founded over an audit system that is fragmented, that operates on strict principles and procedures and that is not intense or efficient; and which adopts an input oriented budgeting approach that does not include fiscal transparency and accountability in itself, that does not provide initiatives to administrations, can no longer be continued²⁶.

One of the important approaches brought by the new financial management approach has become MTEF. Reflecting the governmental policies to the planning and budget process is the most important tool for providing resource-expenditure balance in the public sector. A decision making process prepared without taking account of the available resources might cause deviation from fiscal discipline and accumulation of economic problems. For this reason, MTEF is seen as an important element for ensuring discipline in the utilization of resources. Therefore, efficiency and effectiveness in the allocation and utilization of public resources have been highlighted and policy, plan and budget link has been endeavoured to be strengthened, through the Law No 5018, and necessary legal infrastructure for performance based budgeting and MTEF has been created within this context.

So MTEF may pave the way to evaluate the outcome of the policies adopted and to finance the provision of public and semi-public goods. MTEF should not be as detail as the budget but should capture certain sectors and sub-sectors in terms of resource allocation and output-outcome of the programs. However, we should not expect beyond the capability of MTEF such as solving all service delivery problems because there are other crucial factors that the public service delivery is affected. In conclusion, MTEF is important approach to provide the expenditure areas that the government is diverting to and ensure predictability and reliability of government policies.

²⁶ BAŞBAKANLIK. Kamuda Yeniden Yapılanma:1:Değişimin Yönetimi İçin Yönetimde Değişim, Ankara: Başbakanlık, 2003, pp. 131.

It is believed that the predictability and reliability of the budgetary system is necessary for every one of us in a contemporary society.

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TAX HAVENS VERSUS TAX HELLS¹

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Abstract

This paper analyzes some aspects concerning tax havens and their existence in the context of globalization. The tax havens are a consequence of the existence of the tax hells. Also, the paper presents development of tax havens by comparing with a few developed countries and reveals the impact of expansion of tax havens and how they influence the economic activity in the other countries – non-haven countries. The ability to avoid taxes by using tax havens seems to be favorable for economic activity, especially for the countries in the same region. A few types of firms which are establish tax haven operations are presented, and what purposes do these operations serve. In conclusion, many of developed countries fight against the tax havens, but other are in competition with tax haven adopting the flat tax rate on corporate income.

Keywords: *tax havens, tax competition, offshore companies*

¹ I would like to thank Lawyer Titi Mureşan (Alba-Iulia) for his important contribution on realization of this paper.

1. Introduction

Tax havens are one of the most important subjects for an international entrepreneur or investor, yet few understand and use them properly. One group discounts them as hiding holes for dirty money, which is not a legitimate use for tax havens. Others think they are only for banking money after you have made it. Not true either. Money grows much faster if a tax haven is part of your business planning, and almost any international business has an opportunity to use tax havens.

Called a “*paradis fiscal*” by the French, a “*rifugio fiscal*” by the Italians, and a “*Steuereroase*” by the Germans, it obviously means a place where the “fiscal grass is greener than in your own particular backyard”. But an effective tax haven is not determined simply by geography; it all depends on what particular asset or transaction you are trying to defend from the tax collector. Simply stated, a tax haven is any country whose laws, regulations, traditions, and, in some cases, treaty arrangements make it possible for one to reduce his overall tax burden.

This paper presents some aspect regarding the tax haven concept and his proliferation directly linked by tax hells. Tax hells can be defined as the country with a very high level of taxation and an increasing tax burden. There is no tax haven without tax hell, thus the tax haven is a consequence of the increasing tax burden for companies and individuals. In this context the tax haven is a proper way to escape from the tax burden of tax hells, it is a way of international tax avoidance.

Also, the paper presents development of tax havens by comparing with a few developed countries and reveals the impact of expansion of tax havens and how they influence the economic activity in the other countries – non-haven countries. The ability to avoid taxes by using tax havens seems to be favorable for economic activity, especially for the countries in the same region. A few types of firms which are establish tax haven operations are presented, and what purposes do these operations serve. In conclusion, many of developed countries fight against the tax havens, but other are in competition with tax haven adopting the flat tax rate on corporate income.

2. Tax hells – the effect of social-economical development

The growth of social-economic role of the state supposes, in the first place, financial resources at his disposal, resources that are coming from taxes paid by citizens. In this context the level of taxation is increasing,

especially after the Big Crisis from 1929-1933, moment that represents a big turn of point for the idea of state interventionism promoted by Keynes.

The state interventionism in economy has positive effects through social-economical development, but also negative effects when it affects the individual liberty –the situation of centralized economies in the communist countries. If in the 1702, Vauban appreciates the level of taxation at 10% in the now days there are countries where the rate of taxation it is about 50% from GDP.² In these countries the level of burden of taxation it is justified through the welfare and social protection programs for population, reason for that are known as tax hells.

Hansen and Kessler (1999) analysis a few states concerning the geographical area and the tax rate on income and concluded that is double connection between the level of development, geographical area and tax rate. The countries with a high level of development and with a large area are characterized by high tax rates comparative with the countries more and less developed but very small like we can see from the Table 1 (the analysis take in consideration only the tax rate on income).

Hansen and Kessler (1999) reveal another regularity, in the tax policies. Despite many cultural and historical differences between the nations in the sample, one observes not only those taxes are high in large and modest sized countries, but also that rates are surprisingly similar within the two groups. Given the displayed figures, one immediately wonders whether the geography of a country is related to its pattern of taxation.³

Central point of argumentation is oriented to an international integration. Diminishing transportation costs and the removal of political barriers to mobility have increased trade and exchange of productive factors in the last decades. For example, in the European Union the process has advanced to the point where all formal constraints to mobility have been abandoned. This development has also greatly improved the mobility of households across states or national borders.

Decision of migration is based on local fiscal policy, but the migration of households determines fiscal policies through the interplay of two basic effects:

² Tulai, C., 2003, *Finanțele publice și fiscalitatea*, Printing House Casa Cărții de Știință, Cluj-Napoca, 2003, p. 292

³ Hansen, N. A., Kessler, A. S., 1999, *Financial Management Analysis of Tax H(e)avens and Tax Hells: Focus on Residence Pprinciple of Taxation*, Journal of Financial Management & Analysis; Jul-Dec 1999; 12, 2; ABI\INFORM Global, p. 54

1. residential choices determine tax rates through a process in which a jurisdiction's inhabitants select their local policies, and
2. tax and welfare policies in each country influence residential decisions.⁴

More precisely households with different incomes differ in their policy preferences: as a natural implication of their earning characteristics, high income households prefer to live in countries with low taxation and low income households are rather interested in generous public spending than in low income tax rates because they prefer to live in countries with large welfare programs financed by substantial taxation – tax hells. Thus individual preferences imply a self-selection process which leads to the segregation of households across countries according to income classes.⁵

In 1956 Tiebout reveals a segregation of populations by political preferences, point that the main and determinant factor for migration is the preference for the public goods.

There is a mechanism which stops the extensive migration to the tax haven – the limited land which determines a very high price for property, thus only the wealthiest households can buy it.

In the specialized literature there are similar results – low taxes in small countries and high taxes in large countries based on tax competition for attracting more capital, especially for increasing base of taxation, what is known as “tax base effect”. The differentiation of tax policy based on segregation of populations by level of income is called “politico-geographical effect”.⁶

But in the present, many countries with tax hells reputation, because tax competition had permitted to establish a real “fiscal oasis” on their territories, for example in SUA: Delaware, Wyoming, New York, Nevada, Utah.

3. The concept of tax haven

Despite the fact that tax haven phenomenon is by no means a recent occurrence and multilateral struggle against it spans more than 70 years, there is, as yet, no clear understanding of the nature of the phenomenon.

The term “tax haven” has been loosely defined to include *any country having a low or zero rate of tax on all or certain categories of income, and*

⁴ Hansen, N. A., Kessler, A.S., 1999, Ibid.

⁵ Hansen, N. A., Kessler, A.S., 1999, Ibid.

⁶ Hansen, N. A., Kessler, A.S., 1999, Ibid.

*offering a certain level of banking or commercial secrecy.*⁷ Applied literally, however, this definition would sweep in many industrialized countries not generally considered tax havens including the United States (the U.S. does not tax interest on bank deposits of foreigners).

The Modern Dictionary for the Legal Professions states the following: *tax haven is a tax shelter in a foreign country that is preferable to other countries because of that country's educated labor force, modern commerce system, advanced equipment and technology, good transportation, and good climate.*⁸

Black's Law Dictionary makes a different emphasis when defining the tax havens as: "*A country that imposes little or no tax on the profits from transactions carried on in that country*"⁹. Sometimes, within the same definition several criteria interfere with each other and even the common division of tax haven on the basis of, for example, their policies towards income taxation turns out to be by no means universal. Thus, some of the researches identify the following groupings:¹⁰

- The so-called "classical" tax havens or "no-income tax havens";
- Tax havens with no tax on income from foreign sources;
- Tax havens with special (privileged) tax regime;
- Treaty tax havens

The term "tax haven" suggests that a jurisdiction allows foreigners tax saving. This saving can take place in three ways. Activity can take place in the haven; activity can be assigned to the haven for fiscal purposes, regardless of reality; or the haven can mask reality through secrecy. Tax havens may therefore *produce* goods and services, they may *shift* claims among jurisdictions, or they may *hide* claims; frequently they do a bit of two or all three.

Therefore, the term tax havens is used to indicate any tax practice of a state or a jurisdiction related to the establishment, for any purpose, of a more privileged tax regime in comparison with other states or jurisdictions. The first uses of this term date back at least to 1950s. Back then it had a positive

⁷ Gordon, Richard, 1981, *The Gordon Report – Tax Havens and Their Use by United States Tax Payers – An Overview*, A Report to the Commissioner of Internal Revenue

⁸ Gerry W. Beyer, *Modern Dictionary for the Legal Profession*, 2nd ed. William S. Hein & Co., Inc., Buffalo, New York, 1996), p. 751.

⁹ Bryan A. Garner, *Black's Law Dictionary*, 7th ed. (West Group, 2001), p. 1474

¹⁰ Mykola Orlov, 2004, *The Concept of Tax Haven: A Legal Analysis*, *International Tax Review*, INTERTAX, Volume 32, Issue 2 Kluwer Law International

meaning of escape from the otherwise drastic tax regimes of the developed countries. However, gradually, the term acquired a marked negative connotation of the erosion of tax bases of countries and unfair tax competition. Of late this has been aggravated by the added implications of money laundering and assistance to international terrorism.¹¹

There are three main ways for the escape of the burdensome taxation imposed by welfare state through the movement of the income and property:

Temporally: that is, from one *time period* to another; for example, from one year into another, in anticipation of either an increase (or decrease) in tax rates and burdens.

Geographically: that is, from one *location* (or tax jurisdiction) within a country to another, or between countries, or from one corporate form to another.

Subterraneously: that is, from the above-ground (taxable) economy to the underground (untaxed) economy usually when it is become difficult or impossible to move temporally or geographically.

Tax havens represent a *geographic* form of escape from tax burdens.¹²

When viewing tax havens in a political context it becomes natural to differentiate between tax privileges within otherwise “normal” tax systems and tax havens as tax systems. Tax haven is not synonymous with an absence of neither taxes nor a tax system. Tax havens describe a *type or family of states*¹³. Without a political criterion it is not possible to differentiate between tax incentives and tax systems.

Examples of Tax Havens:

- The United Kingdom is a tax haven for people of foreign domicile, even if they are UK resident (*residence* and *domicile* being separate legal concepts in the UK), in that they pay no tax on foreign income not remitted to the UK. Similar arrangements are to be found in a few other countries including Ireland.

¹¹ Mykola Orlov, 2004, Ibid.

¹² Salsman, Richard, M., 2002, *Capital on Strike: The Tax Haven Controversy*, Part One, The Capitalist Advisor,

¹³ Haslerud, Gjermund, 2004, *The Growth of Tax Havens – A Theoretical Perspective and an Empirical Analysis*, <http://www.sgir.org/conference2004/papers/Haslerud>

- Switzerland is a tax haven for foreigners who become resident after negotiating the amount of their income subject to taxation with the canton in which they intend to live.
- Monaco does not levy a personal income tax and nor does Andorra. The Bahamas levies neither personal income nor capital gains tax, nor are there inheritance taxes.
- In the various Channel Islands, and in the Isle of Man, no tax is paid by corporations or individuals on foreign income and gains. Non-residents are not taxed on local income.

In Table 1 it is presented the tax havens list according Diamonds (2001), OECD (2000) and Hines & Rice (1994).

Table 1 Lists of tax havens

<i>Tax havens</i>	Diamonds (2001)	OECD Tax Haven List (2000) *	Hines & Rice Tax Haven List (1994)
<i>Andorra</i>	x	P	x
<i>Anguilla</i>	x	P	x
<i>Antigua & Barbuda</i>	x	P	x
<i>Aruba</i>	x	P	
<i>Austria</i>	x		
<i>Bahamas</i>	x	P	x
<i>Bahrain</i>	x	P	x
<i>Barbados</i>	x	P	x
<i>Belize</i>	x	P	x
<i>Bermuda</i>	x	C	x
<i>British Virgin Islands</i>	x	P	x
<i>Brunei</i>	x		
<i>Campione</i>	x		
<i>Cayman Islands</i>	x	C	x
<i>Cook Islands</i>	x	P	x
<i>Costa Rica</i>	x		
<i>Cyprus</i>	x	C	x
<i>Djibouti</i>	x		
<i>Dominica</i>	x	P	x
<i>Gibraltar</i>		P	x
<i>Grand Britain</i>	x		
<i>Greece</i>	x		
<i>Grenada</i>	x	P	x
<i>Guernsey (Chan. Is.)</i>	x	P	x
<i>Hong Kong</i>	x		x
<i>Hungary</i>	x		
<i>Iceland</i>	x		
<i>Ireland</i>	x		x
<i>Isle of Man</i>	x	P	x
<i>Jamaica</i>	x		
<i>Jersey (Channel Is.)</i>	x	P	x

<i>Jordan</i>	x		x
<i>Labuan</i>	x		
<i>Lebanon</i>	x		x
<i>Liberia</i>	x	P	x
<i>Liechtenstein</i>	x	P	x
<i>Luxembourg</i>	x		x
<i>Macau</i>	x		x
<i>Madeira (Portugal)</i>	x		
<i>Maldives</i>		P	x
<i>Malta</i>	x	C	x
<i>Marshall Islands</i>	x	P	x
<i>Mauritius</i>	x	C	
<i>Monaco</i>	x	P	x
<i>Montserrat</i>	x	P	x
<i>Nauru</i>	x	P	
<i>Netherlands</i>	x		
<i>Netherlands Antilles</i>	x	P	x
<i>Nevis</i>			
<i>Niue</i>	x	P	
<i>Oman</i>	x		
<i>Philippine</i>	x		
<i>Panama</i>	x	P	x
<i>Samoa</i>	x	P	
<i>San Marino</i>	x	C	
<i>Seychelles</i>	x	P	
<i>St. Kitts & Nevis</i>	x	P	x
<i>St. Lucia</i>	x	P	x
<i>St. Martin</i>			x
<i>St. Vincent & Grenad.</i>	x	P	x
<i>Singapore</i>	x		
<i>Switzerland</i>	x		x
<i>Thailand</i>	x		
<i>Tonga</i>		P	
<i>Turks & Caicos</i>	x	P	x
<i>Uruguay</i>	x		
<i>US Virgin Islands</i>		P	
<i>Vanuatu</i>	x	P	x
<i>Venezuela</i>	x		
Total	63	41	40

Note: *P = potentially harmful, C = cooperative

Source: Diamond, W.H., Diamond, D.B., 2001, *Tax Havens of the World*, Vol. 1, 2 and 3, Overseas Press and Consultants.

OECD, 2000, *Towards Global Tax Co-operation: Progress Identifying and Eliminating Harmful Tax Practices*.

James R. Hines & Eric M. Rice, 1994, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109.1 Q. J. OF ECON 149 (Feb. 1994)

4. History of Tax Haven

To understand the logic behind the development of tax havens and their proliferation, it is necessary to trace the history of the respective policies and the rationale for the respective practices. Tax havens are not a modern invention. The use of tax haven policies were often used by states to further their goals, even, as it happens in world politics, to the detriment of their neighbors.

To put tax havens in proper perspective we have to go back 3500 years to the Book of Joshua, even to the Books of Moses, where the Lord ordered the Children of Israel to set aside cities of refuge where a person could gain asylum from the punitive laws of Moses. Recently, Hawaiian kings on the big island of Hawaii, set aside a city of refuge.¹⁴

A tax haven is somewhat similar. It is a kind of economic sanctuary, a modern city of refuge for those oppressed with the fiscal laws of their homeland. People can bring their wealth to a tax haven and avoid government confiscations by tax or exchange controls, or just plain confiscations like Castro and other totalitarian rulers have done. These oppressive acts by their governments are as much an evil to them, as those oppressed politically.¹⁵

Tax havens, or something like them, have been used for centuries. While some tax havens have evolved through a history of laissez-faire economic policies, others, particularly those specializing in attracting corporations, have been created as a matter of deliberate government policy. People have been looking for ways to avoid taxes for many years. Likewise, governments have been using tax incentives to attract or maintain business for many years.

For example, the ancient city of Athens imposed a tax on merchants of two percent of the value of exports and imports. Merchants would detour twenty miles to avoid these duties. The small neighboring islands became safe havens in which to hide merchandise to be smuggled into the country at a later date. In the middle ages, the City of London (as well as other jurisdictions) exempted Hanseatic traders resident in London from all taxes.¹⁶

In the fifteenth century, Flanders (now Belgium) was a thriving international commercial center. Its government imposed few restrictions on

¹⁴ Adams, C., 2003, *A Historian Looks at Tax Haven*,

<http://www.freedomandprosperity.org/>

¹⁵ Adams, C., 2003, *Ibid*.

¹⁶ Gordon, Richard, 1981, *The Gordon Report – Tax Havens and Their Use by United States Tax Payers – An Overview*, A Report to the Commissioner of Internal Revenue

domestic or foreign exchange and freed much trade from duties. English merchants supplied the needed raw materials, preferring to sell wool to Belgium rather than to England where they would incur numerous duties.¹⁷

Today, most major havens are also offshore financial centers (centers for international borrowing and lending in non-local currency). But tax haven is not the same thing with offshore financial center, even if some of the tax havens in fact, are offshore centers. The offshore financial centers suppose the high financial techniques which are developing progressively on some types of structures and products giving a comparative advantage on world market level.

Historically, the type of tax haven practices adopted by the states and jurisdictions at different periods of time depended on the features of the tax systems in the respective period of time. Thus, until the beginning of the twentieth century with the mass introduction of income taxation, the majority of tax havens focused mainly on granting relief from import and excise duties.

Admittedly, tax haven practices were used not only in the competition between states. Since the Middle Ages, tax privileges have been actively used for achieving certain developmental objectives.

5. Determinants factors for tax havens proliferation

The political and economic catalysts that influenced the growth of the tax havens industry in the last decades are:

- *political and economic instability;*
- *market globalization and deregulation;*
- *the internationalization of business;*
- *the lifting of trade barriers;*
- *a trend towards steady global economic growth;*
- *a global relaxation of foreign exchange controls.*

In addition to political and economic catalysts there are also global tax related catalysts that continue to influence the growth of the offshore industry. These include:

- ❖ high tax regime with an increasing tax burden for companies and individuals;

¹⁷ Gordon, R. 1981, Ibid.

- ❖ tax competition and migration;
- ❖ fiscal harmonization;
- ❖ opportunities of utilizing double taxation treaties.

By simply stating that tax haven proliferation was as a consequence of rising taxation in the industrialized world. The same factors that explain an increasing private sector demand for less regulated and taxed jurisdictions are used to explain tax haven developments. They do not separate between the growing the use of tax havens, and the growing number of tax havens. As a consequence the theories cannot differentiate and explain why certain states become tax havens. Haslerud (2004) through a statistical test of the neoclassical perspective laid the ground for further analyses. Tax haven developments were explored in light of size, colonial heritage and rule of law. Logistic regression was used and all factors were significant at the 1973 model. The analysis showed that tax haven developments can be understood by historical, structural and institutional factors.¹⁸

In contrast to other states, tax havens have distinguished themselves by enacting legislation that provides corporations and individuals with anonymity and shelter from their home governments. Lacking adequate mechanisms of "internal profit generation," these so-called paper financial centers have learned to take advantage of what *The Economist* scornfully describes as their main asset: the right to write the laws. But in so doing, tax havens are like the sovereign equivalent of parking lot proprietors: they could not care less about the business of their customers only that they pay for parking their vehicles there. Likewise, tax havens are unconcerned with the true nature of the companies residing within their borders. Those using tax havens rarely relocate to them; instead they pay for the privilege of "renting" a residence there. That is, they take advantage of the juridical facilities offered to them for what is euphemistically called "effective international tax strategy," which is another way of saying avoiding or evading taxes.¹⁹ But with increasing numbers of tax havens and those who use them, the principles of supply and demand appear to regulate the cost of license fees and the character of the legal protection that tax havens offer. In other words, tax havens are introducing choice and marginal utility into issues of residency and sovereignty.

¹⁸ Haslerud, Gjermund, 2004, *The Growth of Tax Havens – A Theoretical Perspective and an Empirical Analysis*, available at <http://www.sgir.org/conference2004/papers/> Haslerud

¹⁹ Palan Ronen, 2002, *Tax Havens and the Commercialization of State Sovereignty*, International Organization 56.1, pag. 151-176,

6. The main features of the tax havens

Tax havens are generally characterized by the low or zero tax on income, high standards of financial, including banking, and commercial secrecy; no or liberal currency controls; developed infrastructure; available professional help of, first of all, lawyers, auditors, accountants and financial analysts; and lower standards for the regulation of financial institutions, in particular banks and insurance companies, stable government, equitable treatment of foreigners, existence of free trade zones, local consumer and labour markets, investment incentives or self-promotion

Low Tax

Many of the jurisdictions that are considered tax havens do impose taxes. All, however, either impose no income tax on all or certain categories of income, or impose a tax which is low when compared to the tax imposed by the countries whose resident taxpayers use them.

Some jurisdictions do not impose income taxes, or impose very low rates of tax. In the Caribbean, the Bahamas, Bermuda, the Cayman Islands, and the Turks and Caicos do not impose any income or wealth taxes. In some cases the tax situation may be part of a policy to attract banking, trust or corporation business. In other cases it may exist because they country never found the need to impose tax.

Often low tax rates are considered an evil. However, many tax havens are small less-developed countries whose residents are generally poor. In many cases, the small population of the country makes an income tax system impractical. Instead, the country will establish a license or fee system for generating revenue. Instead of imposing an income tax, fees can be charged for bank licenses, commercial charters, and the like. Administration costs of collecting those revenues are kept to a minimum.

Often jurisdictions, while imposing significant domestic taxes, impose low rates on certain income from foreign sources, a tax system used by a number of developed high tax countries (such as France) as well as by some tax havens. Panama is an example. Accordingly, a local corporation can be formed and managed in the tax haven with no tax being paid to the tax haven on its income from other jurisdictions.

Some tax havens impose low rates of tax on income from specific types of business. Some jurisdictions, for example, offer special tax regimes to holding companies, making them especially useful as financial centers or suits for holding companies.

Secrecy

By definition, all of the jurisdictions with which we are concerned, afford some level of secrecy or confidentiality, afford some level of secrecy or confidentiality to persons transacting business, particularly with banks. This secrecy has its origin in either the common law or in statutory law.

Common law secrecy is found in those jurisdictions which were or still are British Colonies. It derives from the finding of an implied contract between a banker and his customer that the banker will treat all of his customer's affairs as confidential. If violated, an action for damages for breach of contract lies against the banker.

Some level of secrecy is a characteristic common to both tax havens and non-tax havens. Most countries do impose some level of protection for banking or commercial information.

Relative Importance of Banking

Banking tends to be more important to the economy of a tax haven than it is to the economy of a non-tax haven. Most tax havens follow a policy of encouraging offshore banking business. This is done by distinguishing between resident and nonresident banking activity. Generally, nonresident activity will not have reserve requirements, will be taxed differently (if at all), and will not be subject to foreign exchange or other controls.

The banking industry has a significant effect on the economy of the tax haven. Financial business yields revenues in the form of fees and modest taxes on financial institutions. The tax haven also benefits from employment of personnel and rental of facilities.

Availability of Modern Communications: many of the countries considered tax havens have excellent communications facilities.

Lack of Currency Controls

Many tax havens have a dual currency control system, which distinguishes between residents and non-residents, and between local currency and foreign currency. As a general rule, residents are subject to the currency controls; non-residents are not. However, non-residents will normally be subject to controls with respect to local currency. A company, formed in the tax haven, which is beneficially owned by non-residents and which conducts most of its business outside the tax haven, is generally treated as non-resident for exchange control purposes. Accordingly, a foreign person can form a tax haven company to do business in other jurisdictions. It will not be subject to the tax havens' exchange controls as long as it is

dealing in currency of other jurisdictions and is not doing business in the tax haven.

These rules are adapted to facilitate the use of the tax haven by a person wishing to establish a tax haven corporation to do business in other jurisdictions.

Tax Treaties: it is important for a tax haven to have an extensive network of tax treaties to be attractive for potential users.

7. Types of tax havens

Kudrle and Eden (2003) classified tax havens from the substantial activity which these are developed:²⁰

- **“Production” haven:** where a jurisdiction’s tax attraction induces a significant change in real haven value added, Ireland, until it recently changed its laws, was cited as the prime example. Although some complain that jurisdictions with generally low taxation should be called “havens” because they attract real foreign activity, most observers look only at discrimination: are foreigners treated differently from otherwise similar domestic persons and businesses? If they are not, then one is simply looking at a low tax state.
- **“Headquarters” havens:** lower corporate taxes by providing tax advantages to firms that incorporate in that jurisdiction, wherever their shareholders are located. Examples usually offered are Belgium and Singapore.
- **“Sham” havens:** host low corporate-tax financial intermediaries that may be little more than an address for investment activity directed from elsewhere. Nearly all of the Caribbean and Pacific tax havens fall into this category. Some sham havens have also emerged as headquarters havens. The low value-added activity may not be a subsidiary of a foreign firm but independent and legally based in the haven despite negligible local ownership. Some Liberian and Panamanian

²⁰ Robert T. Kudrle, Lorraine Eden, 2003, *The Campaign Against Tax Havens: Will It Last? Will it Work?* Stanford Journal of Law, Business, and Finance

shipping firms and some Bermudan insurance companies serve as examples. In addition, there is the rapidly rising phenomenon of “corporate inversions,” in which corporations based in high-income countries simply shift their declared nationality to a sham haven.

Types of tax havens by aims

In terms of the targeted types of taxation, tax havens can be divided into:

1. income tax havens offering complete or partial shelter from income taxation: individual income tax, corporate income tax or capital gains tax;
2. import duties (excise) tax havens;
3. estate tax havens;

4. tax havens with privileged regimes for the taxation of certain forms of activities, for example ‘flags of convenience’, tax haven for captive insurance companies or IBC regimes.²¹ It should be noted that one state or jurisdiction, in its tax haven practices, may target several types of taxation, for example Panama is known as a ‘flag of convenience’ state .

At the same time, tax havens may also be limited to a particular type of tax relief, e.g. the US is generally considered to be a tax haven for income earned on the deposits of non-residents in US banks.

Approached from a different angle, tax havens can be further categorized in terms of the taxpayers that use them:

- *havens for individuals* (Cayman Islands is one of the most favored);
- *corporate havens* for companies like captive insurance companies, banks, holding companies etc.

A **corporate haven** is a jurisdiction with laws friendly to corporations thereby encouraging them to choose that jurisdiction as a legal domicile. Within the United States, Delaware is considered the pre-eminent corporate haven. However it is facing competition from Nevada and Wyoming. While Delaware through its developed legal system and laws protecting shareholder rights is geared toward the large complex public corporation, Nevada and

²¹ Mykola Orlov, 2004, The Concept of Tax Haven: A Legal Analysis, International Tax Review, INTERTAX, Volume 32, Issue 2 Kluwer Law International

Wyoming are more attractive to the small privately-held corporation. Delaware law tends to protect the rights of shareholders, and Nevada and Wyoming tend to favor management.

Corporate havens include British crown colonies such as Bermuda, Cayman Islands. Increasingly, U.S. corporations are using these havens, either by incorporating subsidiary corporations in these locations or by moving their corporate domicile there.

- havens for trusts (Luxembourg, Liechtenstein;)
- offshore financial centers;
- free economic zones;
- ‘flags of convenience’, etc.

8. Offshore companies

An **offshore company** is one which does not conduct substantial business in its country of incorporation. They are sometimes known as non-resident companies.

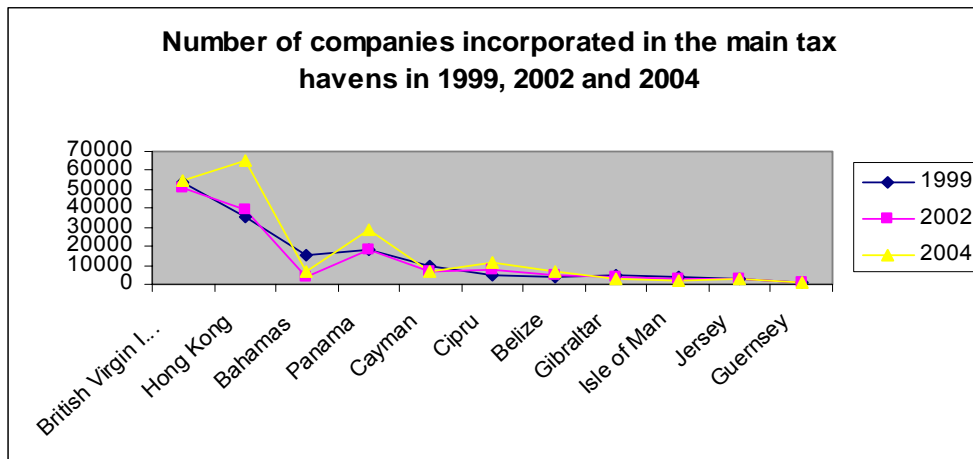
Theoretical, anywhere in the world it can be set up an offshore company, but not everywhere it is possible to obtain fiscal advantages, because a company will not be exempted from taxes because is an offshore company, it must be an offshore set up in a tax haven.

The main reason for establish an offshore company in a tax haven is the minimization of taxation and reducing of burden taxation, also a good management of the risk and an important costs reduction.

Offshore companies can be set up as Limited Liability Company (LLC), International Business Corporation (IBC – specific for the jurisdiction of British Crown), trust, exempted company, non-resident company. These companies can develop any kind of activity without restrictions. Only, for banking and insurances activities it is necessary a special approval.

Basically, an LLC allows for the flexibility of a partnership structure within the framework of limited liability, such as that granted to corporations. Another advantage of an LLC over a limited partnership is that the formalities required for creating and registering LLCs are much simpler than the requirements most states place on forming corporations; often they are no more complex than creating a corporate structure.

Figure 1 Number of companies incorporated in the main tax havens in 1999, 2002, 2004

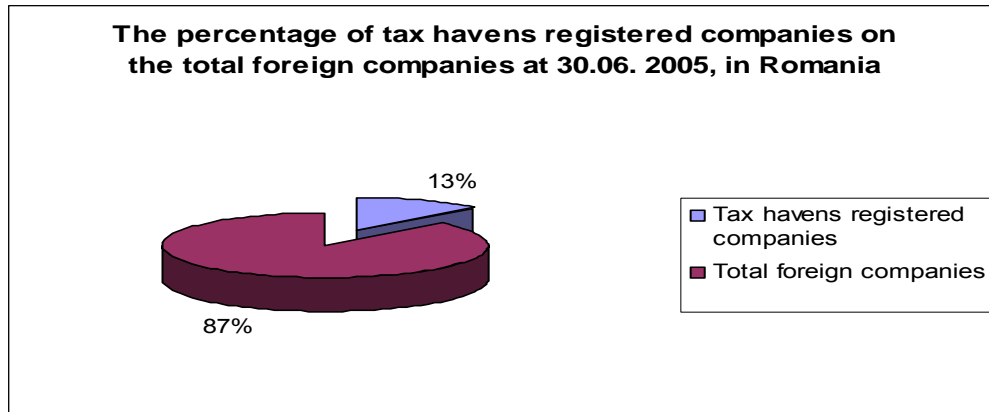


Source: Author's calculation based on statistical data provides by National Commercial Office

The figure 1 reveal the evolution of the main tax havens regarding the number of companies inregistered on their territories. British Virgin Islands was on the first position with 54361 incorporeted companies, but in 2004 Hong Kong is on the first position with 65558 incorporeted companies.

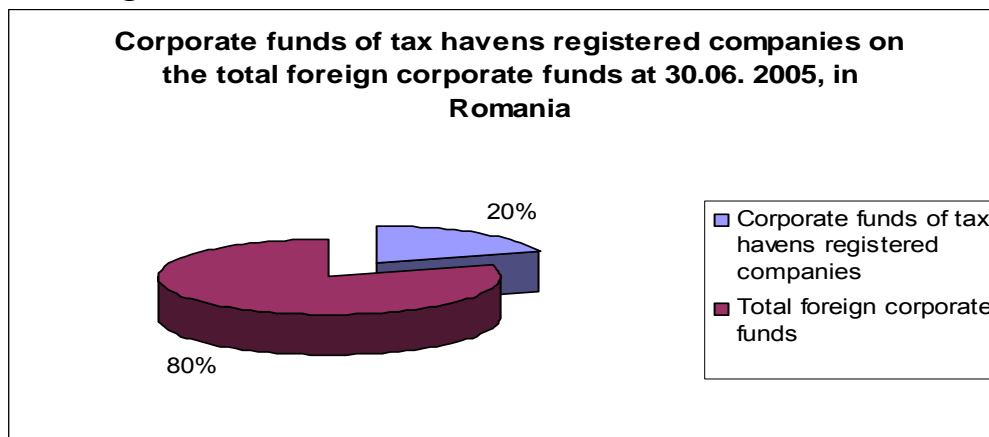
In Romania, the tax burden for companies and individuals was very high until recently. Beginning with this year, was introduced a flat tax rate – 16% for income (of companies and individuals), thus we can consider that Romania it is almost a “tax haven”, but this is far from reality. Many companies which are operating in Romania coming from tax havens. Figure 2 indicates that 13% of the foreign companies are from tax havens, and the percentage of corporate funds of this companies in total foreign corporate funds is much bigger 20% (figure 3).

Figure 2



Source: Author's calculation based on statistical data provides by National Commercial Office

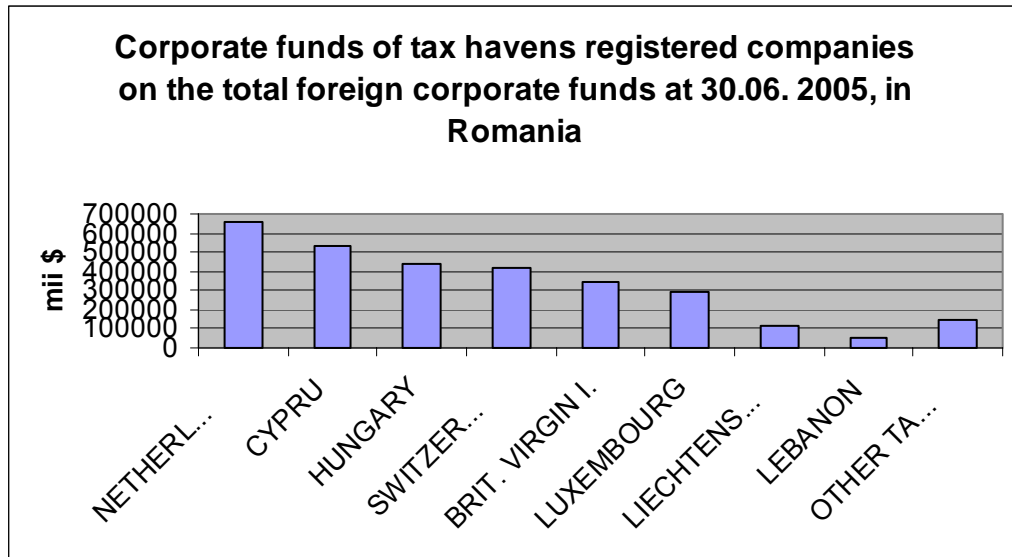
Figure 3



Source: Author's calculation based on statistical data provides by National Commercial Office

The most important part of corporate funds is provided by Netherlands Antilles, Cyprus, Hungary, Switzerland, British Virgin Islands, Luxembourg and Liechtenstein (Fig.4).

Figure 4



Source: Author's calculation based on statistical data provides by National Commercial Office

9. The growth of tax havens

According to some estimates, as much as half of the world's stock of money either resides in tax havens or passes through them.²²

Palan (2002) explain the growth of tax havens in recent decades through increasing regulation and taxation in the post-war OECD economies. Also, he suggests that haven activity is a "state strategy" for economic development in the context of the globalization.

James R. Hines, in a National Bureau of Economic Research (NBER) paper co-authored by Mihir Desai and Fritz Foley of Harvard Business School, found that "haven activity does not appear to divert activity from non-havens." In fact, their calculations indicate that "firms establishing tax haven operations expand, rather than contract, their foreign activities in nearby countries."²³ When firms can reduce their tax burden by means of affiliates in tax haven countries, the authors argue, sales and investment in nearby nonhaven nations increase. A one percent greater likelihood of

²² Palan Ronen, 2002, *Tax Havens and the Comercialization of State Sovereignty*, International Organization 56.1, p. 151-176,

²³ Desai, M. A., Foley, C. F., Hines, J. R. Jr., 2004, *Economic Effects of Regional Tax Havens*, National Bureau of Economic Research, available at <http://www.nber.org/papers/w10806>

establishing a tax haven affiliate is associated with 0.5 to 0.7 percent greater sales and investment growth by non-haven affiliates, implying a complementary relationship between haven and nonhaven activity. The ability to avoid taxes by using tax haven affiliates therefore appears to facilitate economic activity in non-haven countries within regions.²⁴

But don't the haven countries shortchange their own citizens by offering such favorable conditions for multinational corporations? In another NBER working paper, Hines suggests they don't. Per capita real GDP in tax haven countries grew at an average annual rate of 3.3 percent between 1982 and 1999, which compares favorably to the world average of 1.4 percent. Tax haven governments appear to be adequately funded, with an average 25 percent ratio of government to GDP that exceeds the 20 percent ratio for the world as a whole, though the small populations and relative affluence of these countries would normally be associated with even larger governments.²⁵ Table 2 presents a ranking of the countries based on GNI per capita. As we can see on the two first positions are Bermuda and Luxembourg (both tax havens).

Table 2 GNI per capita 2003, Atlas method and PPP

<i>Rank.</i>	<i>Economy</i>	Atlas methodology - US \$-	<i>Rank.</i>	<i>Economy</i>	Purchasing power parity PPP -international \$-
1	Bermuda	.. a	1	Luxembourg	54,430
2	Luxembourg	43,940	2	Bermuda	.. a
3	Norway	43,350	3	United States	37,500
4	Switzerland	39,880	4	Norway	37,300
5	United States	37,610	5	Liechtenstein	.. a
6	Liechtenstein	.. a	6	Channel Is.	.. a
7	Japan	34,510	7	Switzerland	32,030
8	Denmark	33,750	8	Denmark	31,210
9	Channel Islands	.. a	9	Ireland	30,450
10	Iceland	30,810	10	Iceland	30,140
11	Sweden	28,840	11	Canada	29,740
12	United Kingdom	28,350	12	Austria	29,610
13	Finland	27,020	13	San Marino	.. a
14	Ireland	26,960	14	Cayman Is.	.. a
15	San Marino	.. a	15	Belgium	28,930
16	Austria	26,720	16	Hong Kong	28,810
17	Cayman Islands	.. a	17	Japan	28,620
18	Netherlands	26,310	18	Netherlands	28,600

²⁴ Desai, M. A., Foley, C. F., Hines, J. R. Jr., 2004, Ibid.

²⁵ Hines, J.R. Jr., 2004, *Do Tax Haven Flourish?*, National Bureau of Economic Research, available at <http://www.nber.org/papers/w10936>

19	Belgium	25,820	19	Monaco	.. a
20	Monaco	.. a	20	Australia	28,290
21	Hong Kong	25,430	21	United Kingdom	27,650
22	Germany	25,250	22	France	27,460
23	France	24,770 b	22	Germany	27,460
24	Canada	23,930	24	Finland	27,100
27	Australia	21,650	25	Italy	26,760
28	Italy	21,560	26	Sweden	26,620
29	Singapore	21,230	30	Singapore	24,180
35	Spain	16,990	33	Macao, China	<i>21,920 a</i>
37	Kuwait	<i>16,340 a</i>	35	Spain	22,020
38	Israel	<i>16,020 a</i>	36	United Arab Emirates	<i>21,040 a, c</i>
40	New Zealand	15,870	38	New Zealand	21,120
41	Bahamas, The	<i>15,110 a</i>	41	Greece	19,920
43	Macao, China	<i>14,600 a</i>	42	Cyprus	19,530
45	Greece	13,720	43	Slovenia	19,240
47	Cyprus	<i>12,320 a</i>	45	Israel	19,200
49	Portugal	12,130	46	Malta	<i>17,870 a</i>
50	Korea, Rep.	12,020	47	Kuwait	<i>17,870 a, c</i>
51	Slovenia	11,830	49	Portugal	17,980
52	Bahrain	<i>11,260 a</i>	50	Korea, Rep.	17,930
53	Puerto Rico	<i>10,950 a</i>	52	Bahrain	<i>16,170 a</i>
54	Malta	<i>9,260 a</i>	53	Puerto Rico	<i>16,320 a, c</i>
55	Barbados	9,270	54	Bahamas, The	<i>16,140 a</i>
56	Antigua & Barbuda	9,160	55	Seychelles	15,960
57	Saudi Arabia	<i>8,530 a</i>	56	Czech Republic	15,650
59	Oman	<i>7,830 a</i>	57	Barbados	15,060
61	Palau	7,500	58	Hungary	13,780

Source: World Development Indicators database, World Bank, September 2004

Notes: .. Not available.

GNI is gross national income (gross national product)

PPP is purchasing power parity.

Figures in italics are for 2002 or 2001.

a. 2003 data not available; ranking is approximate.

c. Estimate is based on regression; other PPP figures are extrapolated from the latest International Comparison Programme benchmark estimates.

From this ranking made by World Bank we can pointed that “tax haven strategy” is very efficient specially for microstates, which have no other sources of revenues except the tourism and the “tax haven strategy”.

10. Conclusion

As long as welfare states exist and expand there will be pressure to raise taxes. That's why there's been an intensifying assault lately by high-tax governments (including the U.S.) on the world's low-tax nations. A coordinated campaign organized by the Organization for Economic Development (OECD), European Union (EU), the World Bank, the International Monetary Fund (IMF), the U.N., the World Trade Organization (WTO), the U.S. Treasury Department and the U.S. Congress has targeted what are referred to as the harmful tax practices of low-tax nations, territories and jurisdictions – tax havens.

However tax havens are used for sheltering illegal money and also for legitimate business because of their peculiar characteristics such as secrecy, lack of exchange control, good banking, communication and transport structure, tax advantages end up being their major attraction both to wealthy individuals and large corporations.

As long as economic agents have become more sensitive to differences in effective tax rates and capital gained mobility within the process of growing integration of world's economies, capital tends to flow from high to low tax countries, mainly to those regarded as classical tax havens. Thus, tax havens have imposed an unfair tax competition for international capital, not only by means of reducing tax rates, but also introducing changes or distortions in the tax bases, which is less visible than low tax rates. Even some studies demonstrate that impact of tax haven is positive, developed countries try and fight for stopping the proliferation of tax haven. OECD issues a few reports in this context (1998 *Harmful Tax Competition: An Emerging Global Issue*, 2000 *Towards Global Tax Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices*), but many of developed countries are veritable tax haven (United Kingdom, United States).

Tax havens will continue to exist and even in the globalization context their proliferation it is hard to stop because neither international authority has any right to affect the state sovereignty.

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ASSESSMENT OF SOCIO-ECONOMIC TRENDS IN THE SLOVAK REPUBLIC IN THE CONTEXT OF TAX REFORM

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Abstract

Recently accepted tax reform is one of the most important initiatives of Slovak government towards creating a highly competitive and non-distortive market environment in Slovakia. In its Policy Statement, the government undertook to reduce income tax rates and to analyse the possibility of implementing a flat-rate tax. In fact, the actual reform goes even beyond these original ambitious objectives. Its ultimate goal is to transform the Slovak tax system into the most competitive one in the entire EU and OECD area. Assessment of the tax reform in Slovak Republic represents complicated issue from both professional and political point of view. Indisputably, there are positive effects, such as simplification of tax system, higher degree of transparency and creation of business-friendly environment. However, we can't notice also negative impacts. The resources of the society are being redistributed to higher income groups.

Keywords: *Tax reform, direct taxes, indirect taxes, VAT, GDP*

1. Introduction

Recently accepted tax reform is one of the most important initiatives of Slovak government towards creating a highly competitive and non-distortive market environment in Slovakia. In its Policy Statement, the government undertook to reduce income tax rates and to analyse the possibility of implementing a flat-rate tax. In fact, the actual reform goes even beyond these original ambitious objectives. Its ultimate goal is to transform the Slovak tax system into the most competitive one in the entire EU and OECD area.

Assessment of the tax reform in Slovak Republic represents complicated issue from both professional and political point of view. Indisputably, there are positive effects, such as simplification of tax system, higher degree of transparency and creation of business-friendly environment. However, we can't notice also negative impacts. The resources of the society are being redistributed to higher income groups.

2. Macro-economic trends in Slovak Republic between January 1, 2001 and December 31, 2004

The trend of basic macro-economic indicators, indicating the development in Slovak Republic, is specified in the table below:

Indicator	2004	2003	2002	2001	Difference
1. GDP in constant prices in bill. SKK	827	783	750	713	+114
2. Unemployment rate in %	13,1	15,6	17,5	18,6	-5,5
3. Increase of consumer prices	5,9	9,3	3,4	6,5	- 0,60
4. Average monthly wage in SKK (1 Euro = 38,5 SKK)	15.825	14.365	13.511	12.365	+ 3.460
5. Nominal Wage Index in %	110,2	106,3	109,3	108,2	+ 2,00
6. Real Wage Index in % *	102,5	98,0	105,8	101,0	+ 1,50

Source: www.nbs.sk
www.statistics.sk

* Real Wage Index is counted as Nominal Wage Index divided by Index of consumer prices

Basic socio-economic problems in the Slovak Republic are concentrated in the following areas:

2. high unemployment rate despite the high rate of GDP growth
3. low GDP per capita (in 2004 it reached 153 580 SKK, i.e. approx. 3 989 Euro)
4. low average monthly wage (average monthly wage in 2004 was approx. 411 Euro)
5. tax reform impact on households (relatively high tax burden on middle and low-income earners)
6. distribution of sources to higher income groups after the implementation of tax reform in Slovak Republic (January 1, 2004)

3. Main principals and objectives of tax reform in Slovak Republic

Recently accepted tax reform is one of the most important initiatives of Slovak government towards creating a highly competitive and non-distortive market environment in Slovakia. In its Policy Statement, the government undertook to reduce income tax rates and to analyse the possibility of implementing a flat-rate tax. In fact, the actual reform goes even beyond these original ambitious objectives. Its ultimate goal is to transform the Slovak tax system into the most competitive one in the entire EU and OECD area.

By a competitive tax system, the government does not merely mean low degree of taxation – far from it. The Slovak tax system should be competitive mainly because of the unusually high degree of its efficiency, transparency and non-distortiveness.

Designed as fiscally neutral, the reform is intended to achieve the following broad objectives:

1. creation of a business and investment friendly environment for both individuals and companies
2. elimination of existing weaknesses and distortionary effects of the tax law
3. achievement of a high degree of tax fairness by taxing all types and amounts of income equally

These goals should be achieved by a careful implementation of several simple **principles on which the tax reform is based:**

1. shifting of the tax burden from direct toward indirect taxes, from taxing of production towards taxing of consumption
2. introduction of low standard tax rates and elimination of all exceptions, exemptions and special regimes
3. introduction of flat tax rate in personal income tax, replacing the regime with different tax brackets
4. elimination of distortive roles of tax policy as instruments for achieving non-fiscal goals
5. elimination, as much as possible, of double taxation of income

3.1 Implementation of flat tax rate

In the area of direct income taxation, the tax reform concentrates on the implementation of the flat-rate tax. In accordance with the principle of **taxing all incomes of individuals and corporations equally**, only **one linear percentage rate of 19%** has been applied since January 1, 2004. The new legislation eliminated the 21 different types of taxation of direct income that were in force in Slovakia until January 1, 2004, including five different personal income tax rates (10%, 20%, 28%, 35% and 38%). This radical change has several major advantages. First, the flat-rate tax still maintains the progressive nature of effective tax rates faced by individuals with different amounts of income. All personal income of up to 1.6 times the poverty line will be exempt from taxation. As a result, the effective tax rate for individuals below this threshold will be null. However, the average tax rate will start increasing once the individual surpasses this threshold. Hence, the introduction of flat tax on direct income will have no negative impact on low-income earners, negligible impact in the medium range of income distribution and a positive impact on people with the highest incomes. Second, the existence of single marginal tax rate for all income above the standard exemption sharply decreases the distortive effect of personal income taxation and limits the economic disincentives associated with it. This should increase labour productivity both in the short and long term, as it encourages higher work effort at any given point in time, as well more investments in human capital.

Effective January 1, 2004, the **corporate income tax rate was reduced to 19%** from the previous rate of 25%. At the same time, the new tax system follows the principle of taxing the investment and capital gains income only once as it is transferred from the corporate to the personal level. Thus,

dividend taxation has been cancelled and investment income will be taxed only once, at the level of corporate profits.

3.2. Radical simplification on the tax law

The Income Tax Act also radically simplifies the taxation of both individual and corporate income. In order to achieve the highest possible degree of tax transparency and to minimise economic distortions, the new tax law eliminates virtually all exceptions, exemptions and special regimes. In the area of personal income taxation, many exceptions, exemptions, deductions, etc. were established in the past with various non-fiscal goals in mind, for instance in the area of social policy. However, these measures usually generate significant negative side-effects, such as economic inefficiencies and distortions. The tax reform was coordinated with the social insurance reform, pension reform and healthcare system reform. Virtually all tax deductions and exemptions that were originally intended to achieve non-fiscal policy goals were replaced by targeted measures in the relevant policy areas. For instance, the child allowance was cancelled and a new form of targeted social compensations and entitlements was introduced, which should ensure a fairer distribution of income particularly benefiting low-income families with children. Exceptions and exemptions, including tax holidays, tax brakes, individual tax bases, and special tax rates were eliminated from the corporate tax law as well. Lump-sum taxes for entrepreneurs were cancelled and a regime of deductible lump-sum expenditures was introduced. The simplification of the tax law dramatically improves its transparency and business-friendliness. It eliminates one of the main business barriers identified in Slovakia by business surveys – the excessive complexity and frequent changes in the tax law. Thus, the implementation of the tax reform should positively affect the business environment in the medium-term and long-term and should serve as a major stimulus for further inflow of foreign direct investment. Moreover, the government expects that the low corporate tax rates and high transparency of corporate and investment tax laws should sharply reduce the scope for tax evasion and tax avoidance. As a result, tax collection should improve in medium and long-term in spite of decreased nominal tax rates.

In Income Tax Act (valid in 2003) **21** different income tax rates and 443 types of income were presented. Each type of income had to be assigned to particular tax rate. This was one of the reasons why was the Income Tax Act

so complicated. In case of flat tax rate there is only one tax rate introduced and any complications are avoided.

In Income Tax Act valid in 2003, for example, these rates could be recognised: 1 % - rent from financial lease, 2 % - lump-sum income tax from income up to 500.000, 2,25 % - lump-sum income tax from income up to 1.000.000, 2,5 % - lump-sum income tax from income up to 1.500.000, 2,75 % - lump-sum income tax from income up to 2.000.000, 10 % - social fund income, 15 % - income from shares, revenues from participations in limited liability company.

3.3 Unification of VAT rates

The immediate result of the introduction of relatively low flat-rate direct tax would be a lower absolute amount of collected direct taxes. The lost revenue is therefore compensated by increased indirect tax revenues generated by higher indirect tax rates introduced as a part of the reform. Prior to the reform, Slovakia had a standard value added tax (VAT) rate of 20% and a reduced rate of 14%. As a part of the reform, the reduced VAT was cancelled entirely and a **unified 19% rate was introduced for all goods and services** as of January 1, 2004. In addition to generating increased tax revenues, the unification of VAT rates will also eliminate important economic distortions and inefficiencies associated with taxing of the consumption of various goods differently. The existence of reduced VAT rates was usually being justified by non-fiscal arguments. Reduced VAT rates were supposed to lead towards the achievement of non-fiscal policy goals. They were expected to generate lower prices, leading to better access of low income groups to basic food and other selected goods, or to increased consumption of goods deemed to be socially desirable. However, there is plentiful evidence casting serious doubt on whether reduced VAT rates truly support the fulfilment of such objectives in spite of the inefficiencies which they introduce. As a result, the Slovak government decided to replace these inefficient fiscal policy instruments with targeted instruments directly in the relevant policy areas, such as social policy and health care.

The tax reform also includes amendments to acts on excise duty on mineral oils, tobacco and tobacco products, and beer, which came into effect on August 1, 2003.

The amendments increased excise duty rates on these types of products. The increased excise taxes on tobacco products harmonised the Slovak tax law with EU regulations earlier than was expected in Slovakia's accession

treaty with the European Union. A new act on excise taxes on spirits also introduced stricter conditions for spirit producers and tax warehouses, which should prevent tax evasion and increase tax collection.

3.4 Elimination of other forms of taxation

Real estate transfer tax, donation tax and inheritance tax were also cancelled as a part of the tax reform. Donation tax and inheritance tax was eliminated as of January 1, 2004. With the elimination of the donation tax, donations are no longer recognised as tax-deductible expenditures. The real estate transfer tax was eliminated as of January 1, 2005.

The tax reform was followed by fiscal decentralisation, which includes significant changes in the structure of local taxes concerning real estate tax, road tax and local fees. In principle, the fiscal decentralisation significantly strengthens the fiscal competences of municipalities in the field of local taxes. The successful realisation of the tax and customs administration reform closely depends on a smooth adjustment of the Slovak tax system to the principals of the tax system in the European Union. Some of the most important activities that are currently being realised include the e-DP project (input of tax declarations via the internet) and e-TAX project (Electronic taxation and electronic communication with tax subjects).

3.5 Fiscal impacts of the reform

The government paid serious attention to ensuring that the tax reform will not have a negative impact on its fiscal position. In order **to ensure a fiscally neutral outcome** in the first year after the reform, the government produced and commissioned five independent estimates of its fiscal impact. A highly precise estimation of these effects was difficult to make because of complications with estimating precise tax elasticity, due to the lack of detailed data on the structure and development of tax revenues of households. In order to mitigate the negative effects associated with this uncertainty, the government based the reform on the most conservative of these estimates, which was also more conservative than one of the International Monetary Fund. The development of tax revenues in 2004 confirmed that these estimates were correct. The collected tax revenues correspond to the expectations and direct taxes even slightly surpass the expectations.

The responses from companies and economists from Slovakia and abroad confirm that the fundamental tax reform concept created in the Slovak Republic is one of the most competitive tax systems in the entire EU and

OECD area. The contribution of individual types of taxes to GDP in 2002 and the estimated development in 2006 are specified in the table below.

% GDP	2002	2006
Income tax	6,9	5,0
Personal income tax	3,4	2,4
Corporate income tax	2,7	2,2
Withholding income tax	0,9	0,4
Value added tax	7,6	8,4
Excise taxes	3,1	3,2
Donation, inheritance, real estate transfer tax	0,2	0,0
Local taxes	0,6	0,7
Road tax	0,2	0,0
Other tax revenues	0,4	0,1
Total tax revenues	19,0	17,3

www.finance.gov.sk

The government plans to decrease tax burden in 2006 in comparison to 2002 by 1,7 % on condition of high rate of GDP growth. Contribution of personal and corporate income taxes to GDP should be smaller and contribution of value added tax should, on the other hand, be higher.

4. Assessment of tax reform effects

For the purpose of assessment of first tax reform effects we have chosen the basic indicators of taxation system effectiveness, i.e. direct and indirect taxes.

Comparison of individual indicators in the year 2004 and 2003 can be seen in the table below:

Indicator in bill. SKK	2004	2003	Difference
1. VAT in bill. SKK	99,6	83,4	+ 18,8
2. Excise taxes (on mineral oils, alcohol, tobacco)	43,4	38,0	+ 5,4
3. Personal and corporate income tax	55,8	61,0	- 5,2

Source: www.finance.gov.sk

There is a **basic economical assessment** of tax reform:

1. The expectations of government were met – the tax burden was directed from direct taxes to indirect taxes. Personal and corporate income tax revenues fell by 5,2 bill. SKK and value added tax and excise taxes rose by 24,2 bill. SKK in 2004 in comparison with 2003.
2. Tax reform in the first year of its introduction did not prove to be neutral as government supposed, as the excess taxation represent the amount of 19 bill. SKK.
3. Evidently, the positive effects of the reform on unemployment have not been observed yet. The unemployment fell by 2,5 % in 2004 in comparison to preceding year, the average fall being 1,83% for each of three preceding years.
4. The government presents the tax reform as a stimulus for direct foreign investments which reached the amount of 43 bill. SKK in 2004 (the government expects inflow of investments in the amount of 280,5 bill. SKK in the period of 2005 – 2008), in this context the professionals present the perspective of the investors not being interested in the amount of tax rate in the first place, but the qualification and price of labour in Slovakia.

5. Anticipated macro-economic trends in Slovak Republic in connection with entering the Eurocurrency market according to National Bank of Slovakia

To define the date when Slovakia is going to enter the Eurocurrency market (1.1.2009) was a **big challenge for the central bank as well as for**

the whole society. Monetary policy of National Bank of Slovakia (NBS) should ensure meeting the inflation target and Maastricht exchange rate criterion. That's why NBS clearly defined its monetary policy in medium long term, not in the form of expectations but in a form of binding goals. NBS defines its monetary policy as inflation targeting in terms of ERM II. Monetary Programme of NBS was elaborated in cooperation with Ministry of Finance and Slovak government.

Monetary Programme of NBS for the period till 2008 is **based on real macro-economic results of the Slovak Republic in 2004.** At the same time it reflects the most up-to-dated information and predictions regarding the trends of basic external factors, e.g. oil prices, exchange rate changes or expected economical growth in other countries of European Union.

Estimated trend of selected macro-economic indicators in the period of 2004 – 2008 is presented in the table below:

Indicator	2004	2005	2006	2007	2008
1. HICP*	6,2 – 6,5	3,5 +/-0,5	below 2,5	below 2,5	below 2,0
2. GDP in constant prices	5,3 – 5,7	4,5 – 5,3	4,7 – 5,7	6,0 – 7,2	4,0 – 5,2
3. Real wages	1,9	2,3 – 3,4	2,4 – 3,1	2,8 – 3,6	2,8 – 3,6
4. Share of public sector on GDP (including expenses on pension reform)	- 4,0	- 3,8	- 3,9	- 3,0	- 2,1

Source: www.nbs.sk

Note: HICP - Harmonised index of consumer prices

Macro-economic trend in Slovakia **in 2004** as a whole can be characterised by high GDP growth, higher deficit of current account of balance of payments, while the inflation was affected especially by its cost basis.

In 2005 and later on strong deflationary development of Slovak Crown is expected. The decrease of consumer prices in 2005 in comparison with 2004 should be based on less significant impact of increase of regulated prices and on the change of monetary policy of NBS that would concentrate primarily on identification and targeting of demand inflation.

Inflation development in 2005 – 2008 will be influenced by **administrative interventions** to economy to some extent, such as increase of tax on tobacco and tobacco products and introduction of tax on energy. These taxes should be increased in 2007 and 2008 and the estimated impact on inflation is 0,8% in 2007 and 1,1% in 2008.

Monetary Programme of NBS for the period till 2008 is based on **optimistic assumptions** of both public finance consolidation and economical growth.

Share of public sector on GDP (including the expenses on pension reform) is determined by individual phases of electoral cycle to the certain extent. In our opinion presented values of this indicator do not sufficiently take this correlation into consideration. We suppose that the indicator will worsen its position in 2006, when the elections will be held. Political influences after the elections in 2006 in Slovakia and their impact on indicator can not be predicted with high probability.

Although the acceptability of implemented reforms by inhabitants of Slovak republic is probably the highest possible, it would be good for Slovakia to ensure their positive fiscal results also after 2006, based on lower government consumption and higher activity of small and medium enterprises.

The development of political situation in European Union might be problematic as well, especially where European constitution, European monetary integration or meeting the Maastricht criteria by Germany or France is concerned.

NBS expects **high rate of GDP growth** in 2005 – 2008. Average rate of GDP growth in constant prices represents 5,32 %, while in 2007 it is expected to be 6,6%.

Presented GDP growth represents **ambitious estimation** that is based on assumption that the fundamental accelerating factor of economic growth in Slovak Republic in medium - long term will be the direct foreign investments to automobile industry. It is probable that due to increase of investment demand, import of production technologies will rise at first. That will lead to higher deficit of net export with negative influence on GDP growth. In the following period (probably in second half of 2006) NBS expects, in connection with the start of production in automobile companies PSA and

Kia – Hyundai, a significant increase of export of goods and services and the change of deficit of net export to surplus of balance of goods and services, with positive impact on economy growth.

This assumption is not free of the **risk**, which is also included in Monetary Programme of NBS and in prediction of macro-economical indicators. The risk arises from the fact that automobile industry build out of foreign investments is at present non-existing part of Slovak economy; and therefore the foreign investments as a accelerating factor of economical growth are very complicated to quantify, especially in connection with always changing economical environment. The assumption also reflects branch asymmetry of economical environment in Slovakia and too strong dependence on one industrial branch.

Convergence Programme defines **risks of GDP development** as follows:

1. Dynamics of final consumption of households will depend on particular **impact of implemented tax, pension and health care system reform** on development of gross available income of households.
2. Private consumption trend will be determined by actual real wages trend. Increase of expenses on consumption depends not only on real wages but also on preferences of consumer. NBS assumes that propensity to consume will be encouraged by wide offer of credit products of commercial banks as well as by positive trend of client interest rates.
3. The development of **final consumption of public administration** will depend on the level of meeting the planned deficit of public finance and on other factors.
4. Real level of investment demand will depend on constantly changing macro and micro-economic conditions in Slovakia, on economic development in neighbour countries and on expectations of domestic and foreign companies. The expectations of the companies will have an influence on willingness or unwillingness to realise investments in Slovak Republic.

The development of **labour productivity** should also be determined by inflow of direct foreign investments to automobile industry in 2006 and 2007. Inflow of direct foreign investments should create a solid base for non-inflationary growth of nominal and real wages. NBS assumes 5 to 6% growth of nominal wages in national economy that would be sustainable and acceptable. Assumed average growth of real wages would then be 3%.

The risks for inflation trend in the period of 2005 to 2008 are the following:

1. **Increase of prices of mineral resources.** The price of oil represents the main risk factor for consumer prices development. NBS assumes that price of oil will reach in average 40,8 USD for barrel in 2005; 36,8 USD for barrel in 2006; 34,6 USD for barrel in 2007 and 34,2 USD for barrel in 2008. More rapid growth of supply in comparison with demand is expected because of the fact that member states of OECD do not respect the quotas and restrictions. Considerable increase of oil production in non-member states and decrease of demand in China are also expected. Other risk factors affecting the price of oil are: conflict in Near East and Middle East, political instability in Russia, Venezuela and Nigeria, slow increase of capacities for oil producing in Iraq and continuous economical expansion in China.
2. **Development of exchange rate of SKK against EUR and USD.** The projection of inflation prepared by NBS is based on assumption of appreciation of balanced exchange rate in accordance with economy development. More significant depreciation of nominal exchange rate of SKK could endanger meeting the inflation target as it causes the increase of prices in trading sector.
3. **Increase of food prices.** Potential increase of food prices represents another risk. Food prices trend will be influenced by acceptance of principles of Common agricultural policy, by fertility of soil in following years and by impacts of implemented reform of Common agricultural policy. NBS assumes that acceptance of Common agricultural policy will have an impact on inflation in the amount of 0,3% in 2005.
4. **Regulated prices trend.** Certain amount of risk is connected with increase of regulated prices of energy and other commodities (for example in 2005 deregulation of prices of heat, transport, postage services and rent is expected). It is relatively hard to estimate possible secondarily effects in non-regulated part of the consumption basket. According to the data provided by NBS, deregulation of prices will have 1,6 % impact on inflation in 2005 (while the greatest impact is expected in connection with deregulation of gas prices – 0,5%). The impact of deregulated prices will gradually fall - to 0,4% in 2008.
5. **Changes in the area of excise taxes.** The impact of expected changes of excise tax rates on tobacco and tobacco products on inflation will be significant, approx. 0,8% in 2007 and 1,1% in 2008. NBS admits

that this represents a risk in regards to timing and extent of changes in the area of excise taxes, which are uncertain. Other risks can be seen in unexpected decisions of European Commission in the next period.

6. **Higher fiscal deficit in comparison with projected deficit.** Risk of higher fiscal deficit is defined in previous sections (the year of elections 2006, optimistic assumption of the economy growth, etc.)

6. Conclusion

Assessment of the tax reform in Slovak Republic represents complicated issue from both professional and political point of view. Indisputably, there are positive effects, such as simplification of tax system, higher degree of transparency and creation of business-friendly environment. However, we can not notice also negative impacts. The resources of the society are being redistributed to higher income groups.

Due to the insufficient competitiveness for example in the branch of distribution of petrol or banking, not much earning Slovak people are confronted with high level of prices of petrol, banking services or health care products.

Current government is being criticised by its political competitors for generous support of foreign investors (for example a state support in the amount of 5 bill. SKK has been approved for Peugeot Citroen Automobiles Slovakia or 5,4 bill. SKK for Kia), as there is a minimum state support of Slovak small and medium enterprises.

When presenting the ideas about future trends in Slovakia we used the information mentioned in Monetary Programme of NBS (central bank of the state, respected institution in Slovakia). Monetary Programme of NBS till 2008 is a very ambitious document, contents and orientation of which is influenced by the entering to European Union and later obligation to enter to European Economical and Monetary Union (Eurocurrency market).

The greatest challenge for NBS and a chance as well is to **obtain support of public** for meeting the targets of Monetary Programme till 2008. Formation of inflationary expectations in national economy represents a strong monetary instrument that has to be taken into consideration when making decisions on investments, savings and wages. Optimistic inflationary

expectations of public in combination with other monetary and fiscal measures of government and NBS may create favourable macro-economic environment for dynamic growth of Slovak economy and in the end increase standard of living of the inhabitants of the Slovak Republic.

In the period of nominal and real convergence of Slovak Republic with Eurocurrency market also several risks may occur. These have to be eliminated using reasonable and balanced monetary and fiscal policy by responsible institutions in the Slovak Republic.

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PRESENT AND FUTURE PROBLEMS OF ROMANIAN TAXATION SYSTEM AND FISCAL REFORM

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Abstract

After 1989, the Romanian taxation system has been subjected to major transformations. It has adapted to the requirements of the market economy by taking over the main taxes levied in the developed countries. In the present, Romanian taxation system meets to a great extent the requirements imposed by a competitive economy. However, there are still certain problems, both general problems, regarding the entire fiscal system and the way it functions, and specific problems regarding each and every tax. The present paper tackles about the general problems of the fiscal system as well as problems regarding the direct taxes, profit taxes, income taxes, problems connected with the main indirect taxes, value added taxes and excise duties. As far as the fiscal reform is concerned, the present paper analyses mainly the fiscal simplification implemented by the present government, as a means to reduce the taxation in the business environment, to encourage the private initiative and to achieve the economic growth by expanding the scope of the taxes as a result of expanding the official economic activities.

Keywords: *fiscal reform, fiscal policy, taxation system*

1. Introduction

After 1989, Romanian taxation system has been subjected to major transformations, adapting to the market economy by taking the main taxes levied in the developed countries. In the present, Romanian fiscal system meets to a great extent the requirements improved by a competitive economy. However, there are still certain problems, both general problems, regarding the entire fiscal system and every important tax. First, we will tackle about the general problems of the fiscal system.

2. General Problems of Romanian Taxation System

One first major problem which arises from the analysis of the evolution of the fiscal system after 1989 is the instability of the legal framework. In time, each of the main taxes has been subjected to repeated, more or less important changes. In fact, in many cases, the former settlements have been replaced by new ones, because of the repeated changes to which they have been subjected and which have made difficult the keeping under observation of the tax evolution and its levying.

One reason why the main taxes have been subjected to changes is the necessity to adapt them to the E.U. requirements. Another one is the necessity to have in view the practical experience of levying different taxes as well as their adaptation to economic circumstances. However, irrespective of the reasons, much instability of the legal framework in the fiscal field can not be justified, because it makes almost impossible long-term business plans, fails to attract the foreign investors and reduces the internal and external investments. Apart from this, the legal framework makes more difficult both for the tax payer and control authorities (because of the number and rapidity of changes) to know the content of the respective law and the way it is put into practice.

Another problem is the way in which the fiscal legislation is put into practice and the embezzlements. In Romania, only half of the taxes and contributions owed by the companies according to the data in the balance sheets are paid. In this case, there is a matter of nonobservance the fiscal legislation. The Romanian authorities have tolerated it and, some cases even supported it. There are various reasons why this happened but they all have in common the bad "habit" of the state-owned enterprises to pay their debits to the state only partially. The enterprises pay less than half of their debits because they are inefficient and because of the influence of the trade unions in the large state-owned companies which has been a real problem for all the

governments after 1989. Lately, this negative “habit” of unpaying the debits has extended to private firms.

Another reason which has made the applying of fiscal legislation difficult was the fact that Romanian authorities have derated or postponed the payment of debits for a large number of enterprises. In many cases, the tolerance for not paying the debits and derating or postponing the payment of debits has been influenced by the business and political circles, the politicians having in view to obtain extra-votes to find financing sources for their party, especially in election campaigns, and even to have some personal advantages. All these generate an uneven distribution taxation which has negative effects for the economic competition and makes private firms to turn their attention to subterranean economy.

A negative effect when putting the fiscal legislation into practice was generated by the fact that, usually, the laws and governmental order in the fiscal field are not very clear and can be subjected to interpretations and, sometimes the Ministry of Finances gives instructions which contradict or distort the settlements which they are supposed to interpret. In some cases, these instructions have a restrict circulation which makes them even more difficult to be understood by the tax payers and control authorities.

Another important problem Romanian taxation system has to face is the existence of a powerful subterranean economy. Taking into account various evaluations, the Romanian subterranean economy is 30-40% of the gross domestic product or even more which is a lot and has major fiscal consequences. Apart from all these controversies we must keep in mind the fact that this phenomenon is wide spread. It has been caused by the high level of taxation (especially that regarding the labour force) and its uneven distribution the legislative instability and the incorrect putting into practice of the fiscal legislation the corruption of the civil servants; the regress of the economic environment, etc.

Although there are voices that try to find the positive part of tax evasion (one of the arguments being that using this method one can risk capitals which, then, can be invested this contributing to economic growth) we must enlighten the negative effects it can have in economy. If the firms working in the field of the subterranean economy do not pay the taxes, the fiscal revenue (of the state) is reduced which makes necessary an increase of fiscality which, in its turn, will increase the numbers of the firms working in the field of the subterranean economy. This will diminish the fiscal revenue and generate a vicious circle. If the public expenses in Romania have significantly been reduced and many of them pay the public debit, a new diminishing of public expenses due to diminishing the fiscal revenue, will

jeopardize the very functioning of public institutions and the entire society. The most affected would be the socio-cultural expenses (education, health, culture) and those regarding the maintenance and the development of the infrastructure, which will affect the long-term economic and social development irremediably.

Therefore, urgent measures must be taken to reduce this. There have been voices which insisted to increase of the similar to those for crime. But we must have in view the fact that only enforcing coercive measures can not make this disappear. Other measures are needed, such as: reducing taxation and a more even distribution of it; drawing up a stable and clear legislative framework and its coherent putting into practice; the efficient use of some fiscal tools capable to discover the incomes obtained in subterranean economy and levy taxes in them.

A measure which could have important effects on fighting fiscal evasion and a better putting into practice of the legislation in the fiscal field would be the use of computerized data bases of the entire process of fiscal administration. At the same time, in order to fight the fiscal evasion a special attention must be paid to enhancing the fiscal control. This can be achieved by proper human and financial resources and new priorities for control. In this sense, we must have in view the professional training of the tax inspectors as well as applying modern criteria to select those tax payers that are to be controlled.

Without a fighting fiscal evasion which limits the range of the state's actions by embezzling funds it is impossible to rapidly achieve the goals for the accession in the E.U., as we have planned.

Other problems regarding the fiscal system as a whole are those connected to the amount of the taxes and the ratio between direct and indirect taxes.

As regards the amount of the taxes, as it was shown above, the Romanian fiscal system meets the requirements imposed by the European standards, especially those of the Eastern Europe, except the taxation of the labour force, case in which the amount is increased, due to the large social contributions. Being aware of this situation, the Romanian authorities took measures reducing the level of social funds from 60% to 57% in 2002. This continued in 2003, when level of social funds diminished with 5 percentages down to 52%. In 2004, it diminished down to 49.5%. The present government considers that since 2006 the contribution to social public funds will go on diminished so that in 2008 they will come to 39.5%. The contribution will significantly reduce in the case of the employer as compared to that of the employee.

As far as the ratio between direct and indirect taxes is concerned, the present government speculates that the indirect taxes will be the main source for the budget of the state. This makes the fiscal balance created by the Romanian fiscal system to be fragile. In order to solve this problem, the value of direct taxes when forms I the fiscal revenue must increase. This can be achieved only simultaneously with reducing the level of social contributions and increasing the tax base both by including of the economic growth in it and reducing the tax evasion.

It is normal that the organization / structure of the public financial resources vary from one country to another. But, in many developed countries most of the public financial resources are determined / influenced by direct taxes, in the case of developing countries. Romania is one of them, they are determined by indirect ones, especially consumption / expenditure taxes (value-added taxes, excise duties).

Only by solving all the above-mentioned problems, Romania may increase the level of the fiscal returns without increasing the value of the taxes, thus reducing the discrepancy between it and other countries in Eastern Europe which at similar taxation quotas get several extra percentages of fiscal revenues in gross domestic product.

3. Problems Regarding Direct Taxes

The system of levying taxes on legal entities incomes has undergone significant changes since the 1st of January 2000, when the taxation quota of the profit tax was reduced from 38% to 25%, as well as since the 1st of January 2004, when the present government decided to levy only one income tax. The taxation quota of 16% is wanted to be competitive as compared to the other states in order to attract direct foreign investments. Resorting to this measure, they fight against the fiscal evasion and encourage the economic activity.

In the present, the rate of the profit tax is only 16%, one of the lowest in Europe: in Hungary, it is 18%, in Croatia 20%, in Czech Republic 31%, Poland 27%, and Germany 39.58% and in Italy 38.25%

Starting from the 1st of July 2001, in the case of small companies, the profit tax has been replaced by a tax levied on their incomes, calculated with a quota of 1.5% from the incomes, irrespective of their source. The quota has increased with 3% starting with the 1st of January 2005. At the beginning all small companies, had to calculate the tax according to this quota. Later on, it was allowed to choose between the tax levied on small companies and the

profit tax which was not a very good idea, because of the possible fiscal evasion.

As far as the process of levying taxes on natural persons, incomes is concerned, an important step forward in the modernization of Romanian fiscal system is the introducing of the global income tax. In general levying this tax has many advantages as compared to levying taxes on incomes, each of them taken separately chancy these, mention can be made of:

- it contributes to fiscal balance; both the exact incomes of each individual and the personal situation of the tax payer are taken into account (which was not possible in the later above-mentioned case);
- it is more efficient by including in the tax base the income of a tax payer;
- it is an excellent way of fighting against fiscal evasion and criminal activation.

Up to the 1st of January 2005, for levying taxes on physical persons there were 5 taxation quotas which ranged between 18 and 40%. After the above-mentioned moment, a unique quota of 16% was introduced. This will has as main effect the significant reduction of the fiscal administration costs. The measure of reducing the taxation quota is similar to what has happened lately in the countries of the Central and Eastern Europe. Then, Russia has applied a unique 13% taxation quota of incomes Estonia and Latvia, also apply unique taxation quotas of 26% (the former) and 25% (the later). At the mine time, Croatia has three levels of taxation of 15.25% and 35%, Bulgaria – 4 quotas of 18, 24 28 and 29% and Czech – 5 of 15, 20, 25 and 32% in the present quota diminishing from 40% in 1982 to 32% in the present.

Another problem that arises when cones to levying the income tax in Romania is the fact no deductible expenses were provided from the taxable income. Granting these fiscal deductible expenses is a frequent in the developed countries and has a double function: on the one hand to bring to other to support certain economic branches by encouraging the consumption of the goods produced by them. The measure of granting much facility in Romania, too, would have positive effects on the receipts / returns resulting from this tax, as well as on the development of economy.

The most important problem of levying of the declared incomes is controlled. Normally, by controller the tax payers regularly and correlating the declared income mitt the level of the expenses in the same period, the undeclared incomes can be revealed if the value of the expenses exceeds that the incomes. In Romania, this control can not be made because the tax payers will say that the expenses that can not be justified by the level of the incomes are made due to the fortune acquired before the levying of this tax.

4. The Problems Regarding Indirect Taxes

The main indirect tax, the value added tax was introduced in Romania by law in July 1992 from the 1st of January 1993; it was enforced on the 1st of July 1993. Initially, Romania introduced a system with 2 quotas: a normal one of 18% and the zero quotas. A diminished quota, of 9 %, was added to these two ones, and it was applied to food, medication and medical equipment etc. In time the settlements regarding the value added tax have been subjected to many changes, the most important ones stipulating the diminishing of the number of products and services exempted by value added tax (VAT), the number and the value of the quotas, changed on the 1st of February 1998, the normal quota becoming 22% and the reduced one 11%. Starting from the 1st of January 2000, the normal quota has become 19% and the reduced one has been given up.

Latterly, value added tax has undergone significant changes having in view the harmonization with the provisions of the 6th Directive of the E.U. Comity Council. In this sense mention must be made of the fact that Romania not only has completed the harmonization measures which had 31st of December 2002 as deadline but also has completed in advance some of the commitments it has understood. This process of bringing Romania to a balance with various European provisions will go on. About 25 tax brackets that are not in accordance with the European standards in the respective field will have been eliminated up to 2006. At the same time, some exemptions stipulated in 6th Directive will be introduced in the Romania legislation, together with some special treatments for small entrepreneurs, agricultural producers and tourism companies.

As a result of the negotiations with the E.U. to temporarily close the 10th chapter "Taxation", Romania was all wed to keep the exemption VAT for the passengers transport for all kinds of transport: land, water, railway all these are to remain after Romania's accessions in the E.U. At the same time, E.U. also accepted the appliance of a taxation level of 3,500 € for VAT payer, in the condition in which this is of 5,000 € in the E.U. In the present Romania applies a taxation level of 5,000 € and will continue to do so up to its accession in the E.U. when it will go down to 3,500 €.

E.U. has also accepted the appliance of a reduced VAT quota (of minimum 5%) for the basic food, medication and flat building, but we must mention the fact that I.M.F. recommended the Romanian authorities to reject the introducing of a reduced VAT quota. The argument brought was the fact that this measure diminished significantly the efficiency of fiscal

administration, whose goal should be the VAT reimbursable in much many cases.

At the same time, it was enlightened the fact that the transfers for the homesteads with small incomes are superior to the possible social effects of a reduced VAT quota.

In the present in Romania there is a 19% standard quota and a 9% reduce one. Although the 2005-2008 governing programmer stipulates that, for a certain period of time, the present for VAT will be kept the positive effects of the tax relief on income and profit allowing a future level of 10% at the political level it is discussed the opportunity of increasing the 22% VAT normal quota and eliminating the reduced quota.

The main concern of the authorities is to bring the excise duties to the minimum E.U. quotas. As a result, the value of the excise duties has increased especially in the case of alcoholic drinks and cigarettes and this will go on in the future, too. Mention must be made of the fact that the European Commission has come to an agreement regarding a gradual and not a linear increase of the value of the excise duties. The gradual calendar has been adopted to increase the future incomes of the population so that the future price increase may be bearable. The same thing will happen mitt the excise duties for fuels.

5. Problems of Fiscal Policy

Fiscal policy is a part of the state's economic policy which comprises the totality of the settlements / regulation regarding the setting and levying the taxes, having as main goal the encouragement of the economic growth and diminishing the oscillations of economic cycles.

The role of the fiscal policy is to protect or encourage certain economic branches; in this way, the fiscal intervention has various goals such as:

- encouraging the companies to make investments in certain fields;
- increasing the quality and the competitiveness of products;
- encouraging the export and small producers;
- protecting the environment etc.

When making decisions of fiscal policy, public authorities must satisfy some conditions being confronted with a series of restrictions and claims which can have certain consequences on using tools of fiscal policy in connection with the stage of development of the respective economy, the economic relations with other states; the degree of international integration

etc. Then the enforcing of fiscal policy measures must face certain restrictions such as:

- dimensional restrictions (the fiscal policy is in accordance with the financial potential of the country);
- the development of financial market, of credit market as well as the extent the state's intervention in economy;
- structural restrictions, calculated according to the taxation base and the development of various components of public economy;
- institutional restriction, which correlate the fiscal policy with the way in which the central and territorial institutions with fiscal functions are organized as well as with the existence of private companies;
- informative restrictions, which have in view the rapidity (in due time) of necessary information referring to the tax base and to the correlation with the incomes obtained from the taxes at a certain moment;
- instrumental restrictions which are closely connected to the previous restrictions and refer to the existing fiscal structures and mechanisms which generate fiscal instruments / tools.

In this initial stage, the fiscal reform in Romania had in view a system of taxes capable to assure adequate budgetary incomes, equitably and not really influence the prices. But unfortunately, the fiscal policy of Romania authorities hasn't taken into account the socio-economic evolutions. Imposing austerity budgets and increasing the value of the taxes, levying new taxes have all hindered for a long time the development and gradually affected the purchasing / buying power and the consumption.

The main goal of Romania's present government in the field of the fiscal policy is to assure stimulating role of taxes, having in view the economic growth and development, the fiscal stability and the development of the middle classes. The fiscal policy is wanted to function rather in favor of the tax producers / creators rather than of the tax collectors and to rely on a real partnership between the state and the tax payers.

The efficiency of the taxation system is seen both in the way in which the taxes are collected for the state's budget's and return in the form of the quality of the public services, and in the way in which they assure the maintaining and extension of tax base. The reform of fiscal legislation has in view the continuous reduction of immunities and exception regarding the taxes, having in view the improvement of the transparency of the business environment, the improvement of competition and the extending of the tax base.

The keystone of the present government's fiscal policy in the tax relief as a means to induce a relaxation in the business environment, to

stimulate the private initiative and to make legal the subterranean economy. At the same time, the tax relief will contribute to the economic growth by extending the tax base as a result of the extension of the range of official economic activities (both at the entrepreneurial level and at the level of the jobs offered). The tax relief will make the business environment in Romania more flexible and predictable. The government promotes the tax relief mainly because an increased value of taxes would have negative effects on the unreal economy: the evolution and the reorganization of the internal offer are no longer flexible; there are no records of a part of economic activity.

For the 2004 fiscal year the tax quotas levied on incomes were between 18 and 40% and that levied on the taxable profit was 25%. According to the Order for the modifying and completing the Law No. 571/2003 concerning the Fiscal Code, promulgated by Adrian Nastase government which was to come into force on the 1st of January 2005, the income tax was levied with distinct annual quotas between 14-38% and the tax quota levied on the taxable profit was 19%.

According to the Emergency Order No. 138/30th December 2004 for modifying and completing the Law No. 571/2003 concerning the Fiscal Code promulgated by Tăriceanu government, the tax quota for determining the tax levied on the incomes obtained from independent activities, wages, demising the right of using certain goods, pensions, agricultural activities, prizes and other sources, is of 16% and it is levied on the taxable income corresponding to each source and category, and the profit tax quota levied on the taxable profit is also of 16%. In this way for the unique taxable quota it is necessary that the taxation of incomes should be equal with flat of the profits.

The modification of the fiscal policy was Tăriceanu governments, first measure and one of the priorities of the governing programmer. The fiscal reform was initially presented as tax relief, having in view the support of private entrepreneurs, the encouragement of foreign investments and of free initiative, which should contribute to the consolidation and development of market economy in Romania, which is one of the main requirements that Romania has to fulfill in the its process of accession to the E.U.

Some critics have considered the unique taxable quota a rash / hasty measure, not justified by an impact analysis, one which theaters the budgetary balance. It should be accompanied by the increase of the value of other taxes, by levying menu taxes, the increase of the utilities prices and reducing the budgetary expenses.

To fill the budgetary emptiness's generated by the tax relief, the Finance Ministry, as a result of its negotiations with the I.M.F., had to suggest unpopular fiscal measures:

- doubling the tax levied on the turnover of small companies;
- the social insurance contributions are no longer reduced;
- postponing the increase of the budgetary person's salaries;
- postponing one of the stages of recalculating the pensions;
- doubling the tax levied on the dividends from natural persons;
- the 10 times increase of the taxation of the bank interests and of the earnings obtained the capital market;
- the more drastic taxation of the earning from the real estate transactions and rents, etc.

The unique tax is the most frequent topic of discussion in the states that have recently been made E.U. members and requests for simplifying and reducing the value of taxes have become common all over the Europe. In such a complex system, instead of a complex set of taxation rules the state declares a limit and if it is surpassed them everybody pays a fixed tax their own incomes. Usually limit has a low value in order to encourage the citizens to pay their taxes, instead of trying to avoid paying them. Such a system is instead of the idea that taxes are levied on all incomes only once.

The unique tax used to be a rule in all industrialized states in the former half of the XIXth century. But, finally, the capitalist states were the ones which adopted such a progressive or gradual system of taxes. Since then, the idea of a unique tax has been "brought to life" several times, many countries adopting one variant or another of the unique tax. The modern "renaissance" of the unique tax levied on income was initiated by Estonia in 1991, followed by Latvia (1994), Lithuania (1994), Russia (2001), Serbia (2003) and Romania (2005). It seems that Hungary and Poland take into account the introduction of one version of the unique tax in the near future. Here are the advantages and the disadvantages of the unique taxation quota.

Arguments in Favor of the Unique Taxation Quota and Its Positive Effects

- the unique quota does not run counter of communitary acquis. Chapter 10 "Taxation" in communitary acquis has in view the indirect taxes (VAT, excise duties) and not the direct ones (the tax levied on income is not a part of the category). It is not necessary a harmonization of the taxes levied in those states that are members of the E.U.
- the unique quota encourages work and exposes illegal work. It encourages a second job.
- the unique quota eliminates the complicated and expensive procedure of the yearly forms of return for certain categories of tax payers.
- it is characterized by simplicity, transparency and efficiency in the raising / collecting process.

- it is a system suitable for those states with reduced administrative and fiscal discipline.
- it reduces the subterranean economy. It exposes a part of the “grey” and “black” economy.
- it simplifies the producers of calculating, collecting and controlling the taxes.
- the exceptions, the deductions and the special regimes are easier exploited by the wealthy and informed persons than by the poor.
- the equality between the rates of the taxes levied on income and profit will no longer artificially stimulate a factor of production in detriment of another.
- the social redistribution will be made only by means of the expense policies, not by means of those for collecting the incomes.
- the distinction between personal deductions is a progress, even in the case of levying the unique quota.
- the unique quota coincides with the regional evolution of the fiscal policy. Countries that have already introduced it or are about to introduce it: Estonia, Latvia, Russia, Ukraine, Slovakia, Poland, The Czech Republic, Hungary, and Slovenia.
- the reduced taxes will encourage the Romanian investments and will attract foreign investments, allowing the capitalization of Romanian companies which will become more competitive on the external market.
- the discouraging of speculative transactions and the encouraging of capital investment in productive business that creates jobs.

Arguments Against the Unique Taxation Quota and Its Negative Effects

- the lack of coherence in the case of governmental declarations and measures.
- the lack of consultancy with the associations of employers and trade unions regarding the modification of fiscal policy.
- the lack of stability and predictability of fiscal policy.
- diminishing the local budgets taken from the income tax.
- the entrepreneurs can no longer evaluate the effect of the new taxes introduced in order to diminish the effect of the unique quota on budget.
- fiscal equity and social justice require a distinctive, progressive taxation, one in accordance with contributive capacity given by the value of the respective fortune, income and consumption.
- the modification of the Fiscal Code was made by an emergency decree and not by law, and this modification had to be put into practice 6 months before its effects become visible.
- this fiscal policy decision was taken without consulting the World Bank, I.M.F. and E.U. The developed countries in the E.U. do not do

something like that. At the same time, this decision is not supported by a large part of the political class (the parliamentary opposition) and by the trade unions. The government and the opposition have conflicting fiscal policies. The introduction of the unique quota requires the modification of the state budget.

- the taxation the social divisions and is a real advantage only for 1% of the population.

- it increases the value of the tax levied on the interests on bank deposits and on the earnings from the capital market (capital investments).

- the increase of the price for utilities (electricity, gases etc.).

- doubling the value of the tax levied on the dividends of natural persons.

- reducing to one half the deduction in case of the incomes obtained from rents, the lack of profitability in the case of the business consisting in hiring out buildings, the temptation to hire out buildings illegally, without paying the respective taxes.

- doubling the tax levied on the turnover in the case of small enterprises.

- it increases the value of the excise duties imposed by the E.U. in the case of petrol, cigarettes, coffee and alcoholic drinks much sooner than it was established.

- postponing one of the stages of recalculating the pensions.

- increasing the value of the tax levied on the earnings from real estate transactions.

- the introduction of the unique quota might affect the process of reducing the inflation in 2005 by increasing the incomes of the population and the consumption. The increase of the product and service demand will generate inflation.

- the members of social assistance are more carefully selected and the social security benefit is reduced.

- the increase of the salaries of those paid by the state is stopped.

In order to be efficient, the tax relief must be accompanied by a strategy which has in view the improvement of the capacity of fiscal administration by:

- separating the fiscal administration from the fiscal policy;

- giving up on those policies having in view the exemption or rescheduling of the debts for the public budgets;

- considering the fiscal evasion an economic-financial offence and its punishment should be done with this fact;

- eliminating the policies of modification the fiscal norms by means of inferior laws;

- an increasing the administrative of those institutions which collect the taxes;
- assessing the fiscal control procedures and establishing strict ethical rules for fiscal control activity as the result of the good expiration between public authorities and businessmen.

6. Conclusion

We must keep in mind the fact that only applying the fiscal legislation correctly and coherently we can speak about an economic framework which will be one for all companies this being an advantage for those which are really efficient then contributing to the progress of economy. At the same time, an even distribution of fiscal tasks duties may reduce the level of fiscality which can diminish the subterranean economy and offer better conditions for the development of firms.

In order to change the way in which the fiscal legislation is applied, in practice, one needs political will and a separation clear cut distinction between the public and private interests, which is very difficult to accomplish. It is necessary that the measures which have been taken so far in this sense to be continued firmly, because, otherwise, their putting into practice must be a failure even if we improve the taxation system and adopt the E.U. standards.

The fiscal policy promoted by the present government is expected to have a favorable impact on economy to contribute to economic stability and reorganization and to economic growth.

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PUBLIC FINANCE AND PROJECTS OF PUBLIC PRIVATE PARTNERSHIP

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Abstract

This paper refers to relations between policy of public finance and projects of public private partnership in the Czech Republic. In 2004 the government set out on a reform of public finances, which is aimed not only at gradually reducing the budgetary deficits but also at improving the quality of public finances. The Czech government has confirmed these objectives in its Programme Declaration. The government's declared expenditure priorities are as follows: research and development, education, transport infrastructure and programmes co-financed from the EU budget. The Czech Government has also adopted a policy introducing public private partnership ("PPP") as a standard tool serving the provision of public services and public infrastructure. The introduction of PPP represents a measure based on the requirement for fiscal moderation and a systematic control over the formation of long-term public sector liabilities. This measure, too, is of a pro-growth nature, stimulating as it is an increase of private investment in the building of public goods and provision of public services.

Keywords: *public finance; project; public private partnership; public service*

1. Introduction

In August 2004 a new Czech government was created and installed in office. The government confirmed in its Programme Declaration that it will follow up on the economic policy of previous governments, focussed in particular on promoting economic growth, reducing the unemployment rate and improving the competitiveness of the Czech economy, and will persist in the reform efforts that had been initiated. An updated medium-term economic strategy is relying on the following two basic pillars: the reduction of public finances deficit and effective promotion of economic growth.

The economic policy is aimed first and foremost at the acceleration of economic growth and at the reduction of unemployment in the nearest period. The government wants to concentrate on improving the legislative and institutional environment for entrepreneurship in the Czech Republic, both for domestic and foreign entities, and on preparation of the labour force to be able to withstand global competition. To ensure long-lasting and sustainable prosperity, this aim has to be incorporated into the final stages of public finance reform, so as to create the conditions for economic convergence with developed countries. Financing of joint programmes of the EU and the CR and promotion of expenditures on research and development and education have been made the budgetary priorities for 2005.

2. Government Objectives and Priorities

The Czech government determined the following economic priorities in its Programme Declaration:

- Stabilization of public budgets and improvement of the effectiveness of public expenditure, with the aim of joining the euro area by 2010;
- Reduction of unemployment by creating better conditions for businesses, active employment policy (particularly in regions affected by structural imbalance) and enforcement of equal opportunities;
- Improvement of the legal environment for entrepreneurship, particularly in the area of bankruptcy legislation, shortening of waiting times for registration in the Commercial Register, introduction of measures aimed at reducing the administrative burden for entrepreneurs and simplifying the communication between entrepreneurs and state institutions; strengthening of law enforcement and continuation of the fight against the shadow economy;

- Improvement of targeting and implementation of government programmes aimed at the promotion of entrepreneurship, so that these would effectively encourage investment in production and services with high value added, creation of new jobs and economic growth based on innovations, investments in modern technologies and on support of small and medium-sized enterprises;
- Support of science, research and education through the development of a knowledge-based society, wider access of the population to lifelong learning and increased government investment in research and development;
- Development of transport infrastructure, including the construction of a high-capacity transport infrastructure and the promotion of public passenger transport;
- Support of families with children through the creation of a favourable social and economic environment;
- Improvement of conditions for a better quality of life in rural areas and respect for the environment;
- Preparation and submission of draft reform of the pension system.

A prerequisite for meeting the said priorities is maintenance of a stable political and macroeconomic environment by applying an optimal economic policy mix. Economic policy is focused on speeding up the process of economic convergence and increasing the adaptability of the economy, in order to reduce the risk of an economic slowdown caused by asymmetrical shocks. Since the beginning of transformation, the characteristics of the Czech economy have moved much closer to those of EU countries, but a certain degree of economic misalignment and structural differences still persist and will persist even after joining the euro area. Stabilisation of fiscal policy, flexibility of the labour market and effective functioning of the financial markets will be crucial for making the Czech economy sufficiently responsive to changes.

Fiscal reforms are prevented the public finances from becoming a barrier to full participation in the euro area (due to excessive deficits and insufficient structural adjustment, notably on the expenditure side). Completion of public finance reform is a basic prerequisite for achieving compliance with the Maastricht criteria.

Fiscal policy should be based on a process of fiscal consolidation and gradual reduction of the current excessive deficit. This process was launched by the public finance reform approved in year 2003. According to this strategy, the general government deficit should not exceed 3.8 % of GDP in 2006 and 3 % in 2008. The adopted system of fiscal targeting is based on two pillars that anchor the budgetary process - on legally binding medium-term nominal expenditure ceilings for central government and on the policy of earmarking any higher-than-budgeted revenues for swifter deficit reduction. Measures carried out during the first stage of public finance reform were primarily aimed at reversing the inbuilt deficit tendencies of public finance and reducing the growth dynamics of general government deficit.

In the next stage of public finance reform the Czech authorities will focus on neutralizing the fiscal impact of current economic policy priorities, i.e. of measures aiming to support the supply side of the economy and create conditions for faster growth of potential output, and on fiscal policy measures aiming for long-term sustainability of the fiscal targets achieved.

3. Reform of Public Finance

In 2004 a number of legislative measures focused on rationalising public expenditure came into force. The government is striving to restructure public expenditure in a way that is strengthening the areas of research and development, education, transport infrastructure, while ensuring that spending on the government's priorities is not endanger the approved expenditure frameworks. Higher expenditure in priority areas should be financed from savings combined with a reassessment of other expenditure, including mandatory expenditure. Further opportunities for the financing of these priorities arise thanks to the savings measures approved in year and implemented in the 2004 state budget.

Furthermore, certain tax changes were approved towards the end of 2003 and have been effective since the beginning of 2004. These tax changes reduce the role of income taxes and raise the importance of indirect taxes. This means a shift from the taxation of labour and profit (which has a negative effect on the markets of production factors) towards the taxation of consumption. This autumn brought the beginning of a debate focussed on changes in income taxes, with special focus on the promotion of investment activity, research and development, as well as support of families with children

The preparation of public finance reform was based on the principle that in the process of deficit reduction expenditure savings should prevail over tax changes. Over the next three years the ratio of general government

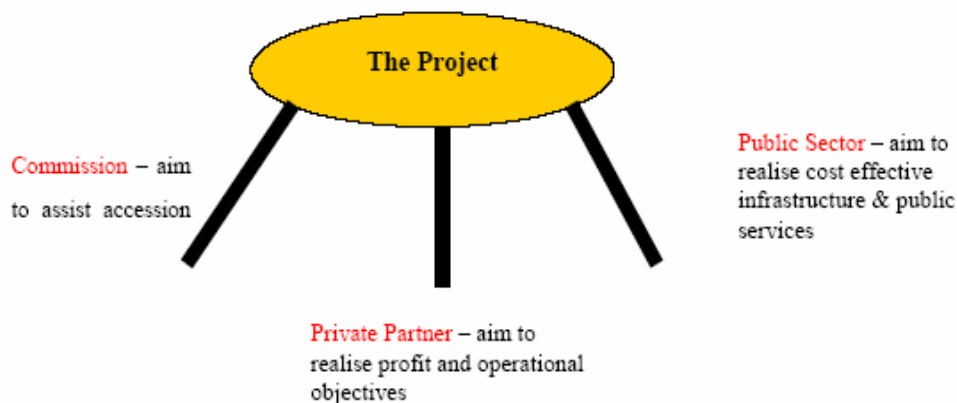
spending to GDP should drop by almost 4 p.p. Fiscal consolidation will affect almost all expenditure items; government consumption, social transfers and subsidies will experience the most significant decline. Starting in 2005, the government expenditures should no longer be burdened by transformation costs. In accordance with government priorities, government investment should increase. It will also be possible to fund additional investments from the Structural Funds and the Cohesion Fund.

4. Public Private Partnership

One of the main commissions of a public sector is to provide public goods and public services in a high quality. As possibilities of public finance are very limited, it demands to look for new resources of financing and investing of these services. One of an alternative or supplemental form of financing of public services and goods could be public private partnership (PPP).

Conception of PPP is based on a partnership between the public and private sector for the purpose of delivering a project or service traditionally provided by the public sector. Public Private Partnership recognises that both the public sector and the private sector have certain advantages relative to the other in the performance of specific tasks. By allowing each sector to do what it does best, public services and infrastructure can be provided in the most economically efficient manner.

Picture 1 PPP Relationship



Source: EUROPEAN COMMISSION. Guidelines for Successful Public - Private Partnerships, European Commission, 2003, page 67.

Therefore the Czech Government has adopted a policy introducing public private partnership ("PPP") as a standard tool serving the provision of public services and public infrastructure.

The Government believes that a systematic and programmed application of PPP can bring about the following:

- real financial benefit and a better utilisation and allocation of public funds;
- development of efficient public infrastructures in shorter terms than otherwise;
- ensuring good quality public services;
- economic growth and boosted direct international investments by giving incentives to private investment in public infrastructure and public services;
- efficient control over the formation of long-term private sector liabilities;
- limitation of negative impact of non-systematic execution of PPP projects;
- increased possibility of drawing on EU funds by a higher co-financing share taken by the private sector in projects of public interest.

The introduction of PPP represents a measure based on the requirement for fiscal moderation and a systematic control over the formation of long-term public sector liabilities. This measure, too, is of a pro-growth nature, stimulating as it is an increase of private investment in the building of public goods and provision of public services. Thus, it is directly linked to the Czech Government's policy of long-term economic growth and social stability in the country. Its nature will facilitate investments into certain socially sensitive areas that otherwise could not be implemented due to fiscal reasons.

The introduction of PPP is conditioned by its programme and systematic application that makes known the PPP fiscal concept and that guarantees compliance with the following fundamental principles set out by the Czech Government:

- Value for Money – It is the main requirement that the resulting economic value of a PPP project should be lower than if implemented in a traditional manner of public sector funding. Since PPP represents a long-term and comprehensive concept, the total resulting economic value should also be viewed in a comprehensive manner (total costs of the public sector and opportunity costs) rather than solely from the sum of the cash payable from public budgets. The total economic value of a PPP project must be determined prior to launching the relevant PPP tender.
- Risk Transfer – That party best capable of managing risk should be that party to bear it; any material risks should be transferred to the private sector.
- Specification of Public Service Standards – The public sector in the capacity of a client must define standards applicable to public services, both in order to guarantee optimum public services and taking into account the economics of such standards.
- Maintenance of Public Assets Value – Since public assets would not be usually transferred to the PPP operator or they should come back to the public sector upon the expiration of the contract, it is essential to define clearly the relevant rules applicable to the maintenance of the value of such public assets managed by the private sector under PPP contracts (as a rule, 5-60 years)
- Ensuring Innovation and Competition – PPP contracts must not result in a monopoly of a single contractor; rather, PPP should manage competition so that it brings about utmost innovations in the given public service.

Those contracts between the public and private sectors can be considered PPP if they would bind the private sector to supply and/or operate public services or infrastructure projects that have typically been the realm of the public sector. They should mainly be projects or services that meet any of the following features:

- Shared responsibility for the supply of infrastructures or services whereby the private sector accepts higher risk, typically combining the design, construction, funding, management and maintenance elements.

- A long-term commitment (at least 3 years) by the private sector to provide good quality public services defined by the public sector.
- Shared expertise and capabilities by the private and public sectors so that the public sector may optimise the exposure and guarantee a higher value of public expenditure application, mainly while making use of qualities inherent to the private sector in the technical, financial, management, and innovation fields.

The implementation of PPP projects in individual sectors and the funding of the relevant infrastructure may also require amendments made to certain special legislative provisions. PPP projects are affected by a wide variety of legal provision. Although it is recommended to amend certain legislation and to adopt some new, it is not suggested that a specific PPP projects act be made.

There is no unique model suggest the development of one. Each project will define what is suitable and what is required. Additionally there is a growing realisation that cooperation with the private sector, in PPP projects, is able to offer a number of advantages, including:

- Acceleration of infrastructure provision - PPPs often allow the public sector to translate upfront capital expenditure into a flow of ongoing service payments. This enables projects to proceed when the availability of public capital may be constrained (either by public spending caps or annual budgeting cycles), thus bringing forward much needed investment.
- Faster implementation - the allocation of design and construction responsibility to the private sector, combined with payments linked to the availability of a service, provides significant incentives for the private sector to deliver capital projects within shorter construction timeframes.
- Reduced whole life costs - PPP projects which require operational and maintenance service provision provide the private sector with strong incentives to minimise costs over the whole life of a project, something that is inherently difficult to achieve within the constraints of traditional public sector budgeting.
- Better risk allocation - a core principle of any PPP is the allocation of risk to the party best able to manage it at least cost. The aim is to

optimise rather than maximise risk transfer, to ensure that best value is achieved.

- Better incentives to perform – the allocation of project risk should incentivise a private sector contractor to improve its management and performance on any given project. Under most PPP projects, full payment to the private sector contractor will only occur if the required service standards are being met on an ongoing basis.
- Improved quality of service - international experience suggests that the quality of service achieved under a PPP is often better than that achieved by traditional procurement. This may reflect the better integration of services with supporting assets, improved economies of scale, the introduction of innovation in service delivery, or the performance incentives and penalties typically included within a PPP contract.
- Generation of additional revenues – the private sector may be able to generate additional revenues from third parties, thereby reducing the cost of any public sector subvention required. Additional revenue may be generated through the use of spare capacity or the disposal of surplus assets.
- Enhanced public management – by transferring responsibility for providing public services government officials will act as regulators and will focus upon service planning and performance monitoring instead of the management of the day to day delivery of public services. In addition, by exposing public services to competition, PPPs enable the cost of public services to be benchmarked against market standards to ensure that the very best value for money is being achieved. International interest in PPPs is attributable generally to three main drivers:
- Investment in infrastructure -economic growth is highly dependent on the development and enhancement of infrastructure, particularly in utilities (such as power, water and telecommunications) and transport systems. Furthermore, in many countries there is an urgent need for new social infrastructure such as hospitals and healthcare equipment, prisons, education facilities and housing. For many governments this is seen as the most pressing area for private sector involvement.

- Greater efficiency in the use of resources - the experience of privatisation has shown that many activities, even those traditionally undertaken by the public sector, can be undertaken more cost effectively with the application of private sector management disciplines and competencies.
- Generating commercial value from public sector assets – significant amounts of public resources are invested in the development of assets such as defence technology and leading edge information systems that are then often used for a narrow range of applications within the public sector. Engaging private sector expertise to exploit these assets in a wider range of applications can lead to the realisation of substantial incremental value for the public sector.

However while certain advantages do exist and can be harnessed, PPP should not be regarded as representing a miracle cure nor indeed a quick fix to infrastructure and service development. PPP should be regarded as an option amongst a range of possible tools to be applied only where the situation and project characteristics permit it and where clear advantages and benefits can be demonstrated. Indeed consideration of PPP should not preclude other options including the traditional public – public models

5. Conclusion

The Czech Republic is currently reporting an excessive deficit, which poses an obstacle on the way towards compliance with convergence criteria. Public finance consolidation and gradual budgetary deficit reduction are the main government priorities. Spending reforms of public finance are aimed not only at gradually reducing the budgetary deficits but also at improving the quality of public finances. As resources of public finance are strong limited, it demands to look for new ways of financing public goods and public services. One of an alternative or supplemental form of financing can be projects of public private partnership (PPP).

Conception of PPP is based on a partnership between the public and private sector for the purpose of delivering a project or service traditionally provided by the public sector. Public Private Partnership recognises that both the public sector and the private sector have certain advantages relative to the other in the performance of specific tasks. By allowing each sector to do what it does best, public services and infrastructure can be provided in the most economically efficient manner.

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PROJECT FINANCE (APPLICATION FOR TRANSPORT INFRASTRUCTURE)

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Abstract

Public Private Partnership (PPP) or more specifically Public Participation in Infrastructure (PPI) represents one of the most common tools of project finance nowadays. So we will define the project finance in the first place and differentiate it from the other kinds of crediting instruments. The article shall give you overview of commence, development and present state of the PPP, its forms as various ways of cooperation between state and private corporation in the role of creditors, sponsors, builders or operators. Application for transportation infrastructure, namely projects of motorways in the Central and Eastern European Countries (CEECs) and some of the largest motorway-projects in the world will follow.

Keywords: *project finance, public private partnership, special purpose vehicle*

1. Project finance

There are a lot of definitions for project finance in literature. For example, J. D. Finnerty defines project finance as: "...the raising for funds to finance an economically separable capital investment project in which the providers of the funds look primarily to the cash flow from the project as the source of funds to service their loans and provide the return of and a return on their equity invested in the project."¹, while F. J. Fabozzi define it as: "A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flow and earnings of the economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan."² and the International Project Finance Association (IPFA) defines project financing as: "... the financing of long-term infrastructure, industrial projects and public services based upon a non-recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project."³ Relatedly, Standard & Poor's Corporation defines a "project company" as: "... a group of agreements and contracts between lenders, project sponsors, and other interested parties that creates a form of business organization that will issue a finite amount of debt on inception; will operate in a focused line of business; and will ask that lenders look only to a specific asset to generate cash flow as the sole source of principal and interest payments and collateral."⁴

Although none of these definitions uses the term "nonrecourse debt" explicitly (i.e., debt repayment comes from the project company only rather than from any other entity), they all recognize that it is an essential feature of project finance.⁵

The following definition, albeit slightly more cumbersome, allows one to distinguish project company finance from other financing vehicles, something the previous two definitions cannot do: Project finance involves the creation of a legally and economically independent project company

¹ **Finnerty, J., D.:** Project Financing – Asset-based Financial Engineering, John Wiley & Son, New York 1996, p. 2

² **Fabozzi, F., J., Nevitt, P., K.:** Project Financing – 7th edition, Euromoney Books, London 2000, p. 1

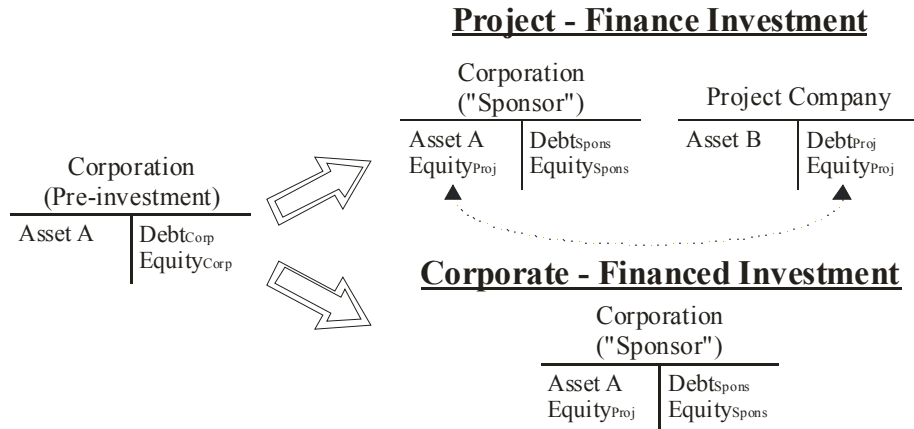
³ www.ipfa.org

⁴ **Standard & Poor's corporation:** Project Finance Summary Debt Rating Criteria, 2003

⁵ Limited recourse debt – debt that carries a repayment guarantee for a defined period of time, for a fraction of the total principal, or until a certain milestone is achieved (e.g., until construction is complete or the project achieves a minimum level of output) – is a subset of nonrecourse debt. The distinguishing feature is that at least some portion of the debt becomes nonrecourse at some point in time.

financed with nonresource debt (and equity from one or more corporate sponsors) for the purpose of financing a single purpose, capital asset usually with a limited life. (See the following chart)

Figure 1 Distinguishing between project and corporate financing



Source: Benjamin C., Esty, Harvard Business School, 2004

1.1 History of project finance

Privet investment in major infrastructure projects is not unusual. Prior to World War I, railways, roads, bridges, power plants, ports, water works and gas-distribution systems were being built all over the world by private entrepreneurs willing to risk all in return for high rewards. Fortune were made and lost.

During the 19th century ambitious projects such as the Suez Canal and the Trans-Siberian Railway were constructed, financed and owned by private companies. However, the private-sector entrepreneur disappeared after World War I and as colonial powers lost control, new governments financed infrastructure projects through public sector borrowing. The state and public-utility organizations became the main clients in commissioning of public works, which were then paid for out of general taxation.

During this post – World War I period in Europe, states invested in the reconstruction of war-damaged infrastructure and new nationalized industries. After World War II most infrastructure projects in industrialized countries were built under supervision of the state and were funded from their respective budgetary resources of sovereign borrowings.

This traditional approach of government in identifying needs, setting policy and procuring infrastructure was by and large followed by developing countries, with the public finance being supported by bond instruments or

direct sovereign loans by such organizations as The World Bank, The Asian Development Bank and The International Monetary Fund.

Development in the early 1980s

The convergence of a number of factors by the early 1980s led to the search for alternative ways to develop and finance infrastructure projects around the world. These factors include following:

- Continued population and economic growth meant that the need for additional infrastructure – roads, power plants, water-treatment plants – continued to grow;
- The debt crisis meant that many countries had less borrowing capacity and fewer budgetary resources to finance badly needed projects; the debt burden required them to adopt an austere approach when planning fiscal spending, compelling them to look to the private sector for investors for projects which in the past would have been constructed and operated in the public sector;
- Major international contracting firms which in the mid-1970s had been kept busy, particularly in the oil-rich Middle East, were, by the early 1980s, facing a significant downturn in business and looking for creative ways to promote additional projects;
- Competition for global markets among major equipment suppliers and operators (particularly in the power and transportation industries) led them to become promoters of projects to enable them to sell their products or services;
- Outright privatization was not acceptable in some countries or appropriate in some sectors for political or strategic reasons and governments were reluctant to relinquish total control of what may be regarded as state assets.

During the 1980s as a number of governments, as well as international lending institutions, became increasingly interested in promoting the development of the private sector, a consensus developed. It supported tapping in the energy and initiative of the private sector, and the discipline imposed by its profit motive, to enhance the efficiency and productivity of what had previously been considered public-sector services.

It is now increasingly recognized that the private sector can play a dynamic role in accelerating growth and development. Many countries are encouraging direct private-sector involvement and making strong efforts to attract new money through new project financing techniques.

Such encouragement is not borne solely out of the need for additional financing, but it has been recognized that private-sector involvement can

bring with it the ability to implement projects in a shorter time, the expectation of more efficient operation, better management and higher technical capability and, in some cases, the introduction of an element of competition into monopolistic structures.

Project Finance is being introduced in both developed and developing countries as an alternative way to finance infrastructure and industrial projects, both small and large. The concept is being used in transportation (toll roads, toll bridges, toll estuarial crossings and railways); energy (private power stations, waste-to-energy plants and gas-distribution pipelines); sewage and water-treatment plants, health care (construction and operation of new hospital buildings and clinical waste disposal plants); education (provision of student accommodation and facilities for universities, colleges and schools); and provision of government offices.

1.1.1 Development of BOOT

Concessions

The search for a new way to promote and finance infrastructure projects led to the introduction of technique, originally used in the 19th and 20th centuries, known as concessions. Concessions were widely used in many parts of the world to develop infrastructure. The Suez Canal is one of many examples of a privately financed concession and this method was also used to build canals, railroads, tramways, water works, electric utilities and similar projects in both industrialized and less-developed countries.

The BOOT formula adds to the old system of concessions, providing new possibilities for reducing or eliminating the direct financial burden which governments would otherwise bear. The objective is to transfer as much borrowing risk as possible to the private-sector promoter and the project itself. Therefore the BOOT promoter must finance the project. (The promoter typically does this by obtaining financing from groups of commercial banks, other financial institutions, export credit agencies and multilateral finance agencies.) Financing is made available on the strength of the project's projected revenue stream and its other assets including the promoter's equity. Normally the lenders would have limited or no resources to the promoter or shareholder of the promoting company.

Project finance

This financing technique, generally known as project finance, was perfected in the 1970s for major private-sector projects, mainly in the area of oil and gas exploration and extraction, but has been extended widely since then. Project techniques are now applied across the world to numerous privately promoted infrastructure projects including power stations, gas pipelines, waste-disposal plants, waste-to energy plants, telecommunication

facilities, bridges, tunnels, toll roads, railway networks, city-centre tram links and now the building of hospitals, education facilities, government accommodation and tourist facilities. Financial markets have become increasingly sophisticated in engineering financing packages to finance almost any type of reasonably predictable revenue stream.

Over the last two decades major international contracting firms, individual entrepreneurs and a number of developing countries have begun to promote infrastructure projects on a BOOT basis. Projects are financed on a limited-resource basis and built operated under a concession from the state or similar public body as a private venture. At the end of the concession the project is transferred back to the state or public body.

What is BOOT?

One method used to involve the private sector in large-scale infrastructure investments is where the private sector is granted a concession from the state to build, finance, own and operate a facility and after the time specified in the concession period is obliged to hand it back to the state. This concept is variously described as BOT, BOOT, BOO, BRL, BLT, BT and BTO, depending on the terms of the agreement.

The acronym BOT stands for “Build, Own and Transfer”, or “Build, Operate and Transfer” (these terms are often used interchangeably). The “owning” is an essential element since the main attraction to host governments is that the promoter’s equity stake underwrites its commitment to a project’s success.

Other variants include BOOT (Build, Own, Operate and Transfer) and BOO (Build, Own, Operate). In BOO projects the promoter finances, designs, constructs and operates a facility over a given period but it does not revert to the government as it would using the BOOT strategy.

Further extensions of the concept are BRT or BLT (Build, Rent/Lease and Transfer) or simply BT (Build and Transfer immediately, but possibly subject to instalment payments of the purchase price).

Another approach, BTO (Build, Transfer and Operate), has become increasingly popular in the Far East and is particularly preferred by power and telecommunications authorities. It is a simpler transaction or concept than BOT and BOOT that can be implemented in a shorter time without the need for the formation of a project company and with the project assets being owned by the public sector.

Stages of a BOOT project

- Build
- Design

- Manage project implementation
- Carry out procurement
- Finance
- Construct

Own

- Hold interest under concession

Operates

- Manage and operate facility
- Carry out maintenance
- Deliver products/service
- Receive payment for product/service

Transfer

- Hand over project in operating condition at end of concession period

1.1.2 The development of PPP

The concept of a PPP – Public Private Partnership has been adopted by various governments in recent years. Instead of the public-sector producing a capital asset and providing a public service, the private sector create the asset through a single stand alone business (financed and operated by the private sector) and then deliver a service to the public sector client, in return for payment linked to the service levels provided.

2. Public Private Partnership

2.1 Requirements for successful PPPs

Political support at the policy level is important for the private sector, because unless PPP is seen to offer continuing business opportunities, firms will be reluctant to develop the necessary that is required to bid for contracts.

Enabling legislation PPP projects need to be supported by enabling legislation that is firmly embedded in the legal structure of the host country. A key aspect of this enabling legislation is the existence of a concession law that can be readily applied to projects.

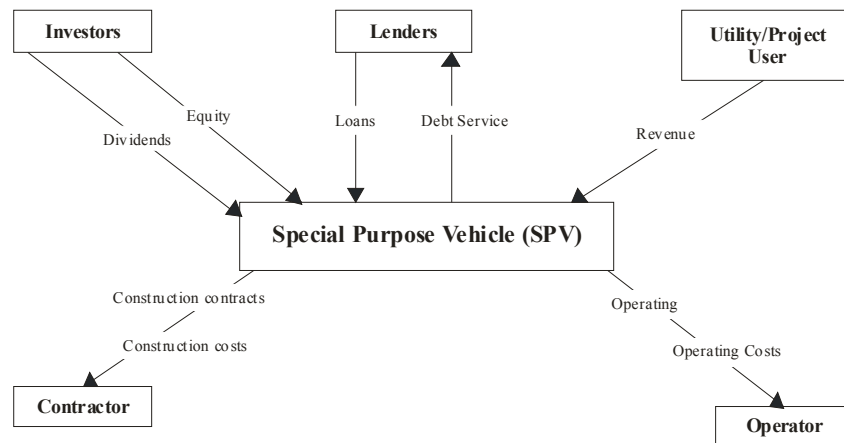
Expertise. Both the public and private sectors must have the necessary expertise to deal with the PPP process.

Project prioritization. The government needs to identify those sectors and projects that should take priority in the PPP process and undertake a review of the viability of each scheme before the project is procured. This avoids unnecessary failures and high bidding costs.

Heavy Deal flow and standardization. A regular and predictable flow of deals based on recognized risk allocation templates, assists the development of a successful PPP programme. Guidance on contract structure also helps to keep costs down.

2.2 The BOOT/PPP structure

Figure 2: Example of a simple BOOT/PPP Structure



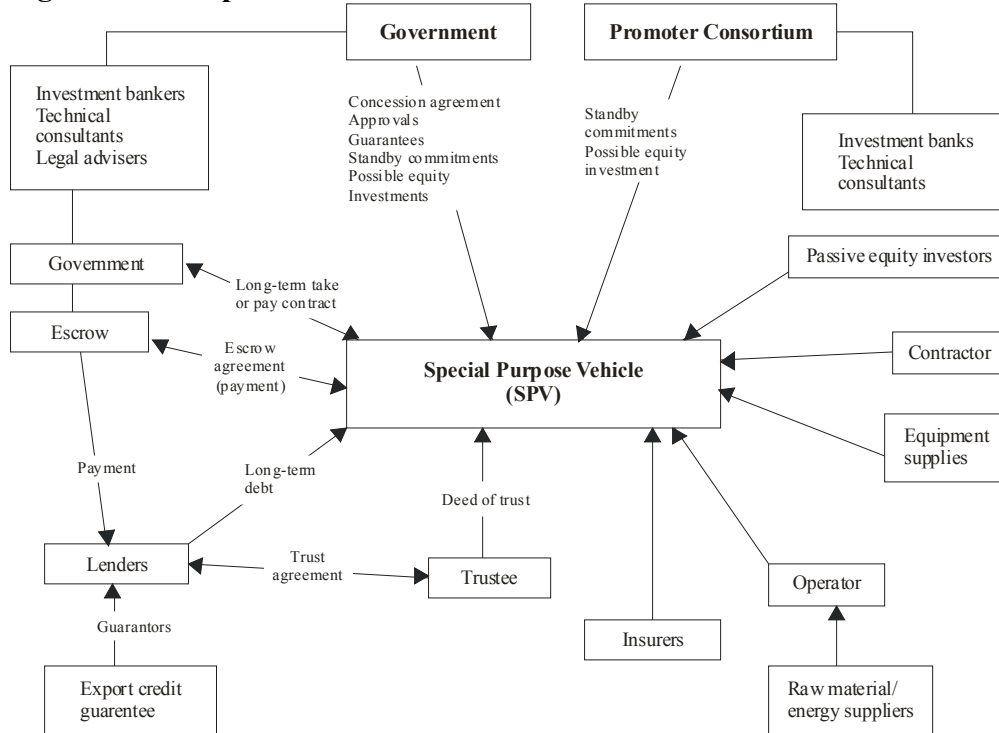
Source: www.ipfa.org

- The concession company promotes the project and has the ultimate liability to the government under concession agreement.
- The concession agreement (sometimes referred to as the implementation or project agreement) is the primary contract between the government and the concession company and forms the contractual basis from which the order contracts are developed. It entitles the concession company to build, finance and operate the facility and imposes conditions as to design, construction, operation of the project and establishes the concession or operation period.
- The equity investors' and lenders' security for their loans and investment is limited to the revenues to be received by the concession company. They will therefore have considerable interest in the revenue forecasts produced by the concession company. Likewise the two areas that place the concession company and equity investors and lenders are the construction contract and operating contract.
- The construction contract. The parties would prefer a contractor to give a fixed price for completion by a fixed date without exclusions.

This is rarely possible in projects of this nature. Finance providers are therefore only prepared to commit themselves to a fixed amount because if the project costs more their funds will be in jeopardy due to the interest burden. Lenders will not accept the risk of delay to completion, although they will normally provide a standby facility to offer some protection against time-and-cost overruns.

- The operating contract. The lenders have to be assured that an experienced operator will be available on completion of construction.

Figure 3: Example of an international BOOT/PPP Structure



Source: www.ipfa.org

- The offtake contract. This is one of the key contracts. As limited-resource projects are, by definition, funded on the security of the future cash flow, there has to be some form of buyer. Projects fall into two categories: those where the identity of the buyer is obvious, for example toll roads and some power stations and those where there is physical product which has to be sold, often on the world market. Where there is a product involved it is essential to identify the offtaker or buyer and to establish the basic terms. Lenders prefer

guaranteed minimum or “floor” prices, but these are frequently unobtainable. There is then the need to establish whether the future price of the product is something upon which the potential lenders to the project are prepared to take a risk. There may be an opportunity for the offtaker to take some of the downside risk by providing a very low floor price, for example one which is below the level; at which the debt would have to be rescheduled with the lenders risking such rescheduling. In exchange the offtaker would expect a high reward in good times.

3. PPP in transportation

Today 30 – 40 percent of PPP are transport-related and the majority of these for motorways and toll roads. The list of PPPs issued by the UK and other industry associations suggests that – on average – including both existing and newly built, there will be about 5 to 10 toll roads/tunnels in each of EU countries over the next 10 years, says Isabelle Kayaloff of IJK & Associates in Germany.

For example, a person driving from the UK in 2004 to Belgrade will have to cover 1.200 km of road and pay € 15 of tolls. The optimal itinerary suggests that that person will travel through at least six countries. Estimated travel time without stopping is about 19 hours. For such a journey, an average car will require a minimum of three tanks of fuel. Total cost of the trip is thus about € 213. The same calculation applies if a traveller wishes to drive to Athens. Total mileage is 1.670 km with a travel time of 30,5 hours and an estimated toll cost of € 160.

In 2008 that picture will change. The same person departing for Belgrade will travel through six countries, of which half will have now some toll system in place. If the standard of 7,5 cents per km is applied – which is generally used in France and Spain – the total toll cost alone of a journey to Belgrade will be in excess of € 54 and for Athens, close to € 200.

What are the solutions?

PPPs need to be relevant to the real needs of the communities they are intended to service. Transportation PPP’s need to be rationalised to address:

- Segregation of road/tunnels that are designed to mitigate specific traffic congestion particularly in urban areas.
- Investment in alternative means of mass transit.
- Re-routing proposed motorways away from towns and residential areas.

- Addressing the traveller's capacity to pay, through possible cross-border harmonisation of tolls (likely to be controversial and not achievable in short term).
- Liberalising rail freight markets and creating efficient management railway networks.

3.1 Case studies⁶

3.1.1 Hungary's M Motorway

Hungary's M5 motorway is a pioneering project in the Central Europe region. It is the first genuine road PPP transaction to close in the region and beat neighbouring countries off the mark to draw in foreign investment to its roads infrastructure, writes Angus Leslie Melville.

The financing was put in place to pay off the existing project debt, provide a payment to equity and fund the construction of a new, 46 km stretch of motorway linking Budapest to the Serbian border.

Indeed, the deal was so impressive that it was nominated as one of the top 10 transactions of 2004 at the Infrastructure Journal Annual Awards 2004, held on 20 January at the Victoria & Albert Museum, London.

The project was popular with the banks from its inception as it forms a vital link in the Trans-European motorway network linking Berlin with Thessaloniki and was seen as a sound investment.

In short, the project was set up to refinance Phase 1 of the M5 motorway and finance Phase 2. The first phase was finished in 1998 and operated as a real toll road up to March 2004 when Hungary incorporated the motorway into the national vignette system.

The existing project financing was refinancing and switched from a toll-based financing structure to a structure based on availability payments by the Hungarian government.

The deal took many industry observers by surprise as it was structured in less than six months and it involved converting a real toll road into an availability road – a first in the project finance world.

Hungary is seen as being pivotal to European efforts to develop an integrated transport system. Success in Hungary is key as it has six essential international roads pass through it – each one representing a major channel of trade economy and communication.

⁶ Case studies are taken from International Journal on Infrastructure

The Hungarian government has been forward-thinking over its role in Europe and had the wisdom to see how it could benefit from being seen as a vital link in the Trans-European Network.

It set forth its objectives back in 2003 for the road sector within the framework of its general transport policy until 2015 – by which time it aims to have reached the EU network density average.

In order to achieve these objectives, the government legislated to enable the use of PPPs in its road building and maintenance regime. Prior to its acceptance of the PPP structure, Hungary favoured wholly-privatized concessions.

As Hungarian transport minister Istvan Csillag says of the M5 project: ‘This is a truly ground breaking transaction, the first of its kind in Hungary – and the professional advisors have contributed significantly to the success of the project.’

‘I am convinced that the success of the M5 will give a boost to the smooth implementation of the M6 motorway currently taking place as well as underlining the importance of the PPP structure in the rapid development of infrastructure sector in Hungary and the whole CEE region.’

Transaction

The M5 motorway was originally financed, built and operated on a private basis, but the government decided to scrap the real toll system at the start of the year and replace it with an availability-dependent PPP deal.

The change to the model means that the government now has to pay AKA an annual unitary charge of €80 m until the end of the concession in 2030 – which covers national vignette holders using the road and compensates for the loss of real toll revenues.

In addition, the government – through its highway management company AKA – has taken a 40 percent stake in the concession company, with Bouygues and Strabag still holding equal shares of the scheme and control of the project.

The financing was also fairly complicated as the lead arrangers – having refinanced the real toll road at the end of 2003 for €205 m – on 11 March 2004 had to buy back the €205 m refinancing from seven syndicate banks when the real toll system was scrapped. They then held it themselves with the debt being serviced via the availability dependent deal to AKA. This debt was taken out as part of the €750 m refinancing.

The second phase closed on 22 September 2004 and involved raising €750 m (US \$ m). Phase 2 financing and implementation of an availability-based payment and performance mechanism for the project.

Table 1: M5 Road Project Restructuring at a Glance

Project name	M5 Road Project Restructuring
Location	Hungary
Description	The M5 motorway comprises an existing 27 km motorway (the already operational Budapest - Szeged section) and a new 40 km new dual lane motorway (from Szeged - Kiskunfélegyháza towards the Serbian border). The first phase of the transaction was closed in March 2004 and saw the motorway brought into the national vignette system of the Hungarian motorways and, following the relevant amendments to the concession agreement, the first Hungarian PPP structure was implemented on the basis of the availability fee model. The second phase, which signed in September 2004, included the refinancing of the facility for the existing section of the motorway and new financing for the extension to the road.
Sponsors	Strabag, Bouygues and Colas
Project Company	Alföld Koncessziós Autópálya (AKA)
Operator	Magyar Intertoll
EPC Contractor	A joint venture between Colas, Bouygues and Strabag
Total project value	€853m (For Phase I and II)
Total debt	€750m
Equity	€83m
Financing	The €750m financing for the project will refinance the original €205m facility for the existing section of the motorway and also finance the extension to the road. EBRD's involvement in the financing is as a parallel lender alongside the commercial banks.
Pricing	The deal is priced at 130 bp during construction of the new section of the road until end - 2005, 120 bp for the first five years thereafter, 130 bp for the next five, 140 bp for the next five and 160 bp for the last 3,5 years.

Tenor	20 years
Mandated lead arrangers	Banco Espirito Santo, WestLB, CIB/Banca Intesa, MFB and EBRD
Arrangers	Banco Espirito Santo (€50m), WestLB (€50m), CIB/Banca Intesa (€79,9m), MFB (€100m), EBRD (€130m), AIB (€18,5m), KfW (€18,5m), Bank of Ireland (€18,5m), Landesbank Hessen-Thuringen (€18,5m), CDC Ixis (€18,5m), Mizuno (€18,5m), Depfa (€18,5m), Natexis (€18,5m), Dexia (€18,5m), OTP (€18,5m), HVB (€18,5m), SMBC (€18,5m), ING (€18,5m), RBS (€18,5m), Islandsbanki (€18,5m), Unicredito Banca Mediocredito (€18,5m) and K&H/KBC (€18,5m)
Co-arrangers	Banca OPI (€12,4m) and IKB (€12,4m)
Legal Advisor to the Banks	White & Case
Legal Advisor to the Government	Clifford Chance
Legal Advisor to the Sponsor	Bouygues in-house counsel
Financial Advisor to the Sponsor	None
Financial Advisor to the Government	ING
Technical Consultant	Kellogg Brown & Root
Model Audit Consultant	PKF
Insurance Consultant	Willis
Environmental Advisor	Scott Wilson
Date Transaction Signed	21-st September 2004
Date of Financial Close	22-nd September 2004

Source: Author's compilation

3.1.2 Canada's Anthony Henday Drive SE road PPP

At the end of January the Government of the state of Alberta reached financial close on the Can\$493 m (US\$ 397 m) Anthony Henday Drive

(AHD) SE road scheme PPP with the Access Roads Edmonton (AREL) consortium, writes Alex Black.

The scheme is part of the province's Can\$2bn (US\$1,5bn), three-year highway construction and improvement programme and was the first DBFO scheme to reach financial close in Alberta.

The other Anthony Henday Drive project – the south west or SW project – is currently under construction. Entirely funded by the Alberta government, it is scheduled to be completed and open to traffic in the autumn of 2006 and will cost around Can\$245m (US\$204m).

Alberta has one of the fastest growing economies of all Canadian provinces and the city of Edmonton is the fifth largest in Canada with a population approaching 1m people.

Table 2: The Anthony Henday Drive SE PPP road scheme at a Glance

Project name	The Anthony Henday Drive SE PPP road scheme
Market	Transport/PPP
Sector	Road
Country	Canada
Date of Financial Close	25-th January 2005
Sponsors	PCL Construction Management, ABN AMBRO and LaFarge Canada
Project Company	Access Roads Edmonton LtD (AREL)
Total project value	Can\$493m (US\$397m)
Construction value	Can\$365m (US\$302m)
Total bond issue	Can\$290m (US\$240m) in two tranches (see Bonds table)
Equity invested by federal government	Can\$75m (US\$62m)
Financial adviser to the project	PwC

Source: Author's compilation

Table 3: Bonds table

Series 'A' bonds	
Bank	ABN AMRO
Bond issue date	January, 2005
Term	32,66 years
Maturity date	September 30, 2037
Repayment	The bonds fully amortise over the term through monthly payments of principal and interest (following an interest only period during the construction period)
Estimated face value	Can\$150m (US\$124m)
Series 'B' bonds	
Bank	ABN AMRO
Bond issue date	Late 2005
Term	31+ years
Maturity date	September 30, 2037
Repayment	The bonds fully amortise over the term through monthly payments of principal and interest (following an interest only period during the construction period)
Estimated face value	Can\$140m (US\$116m)

Source: Author's compilation

4. Conclusion

In February 2005 Ministry of Finance of the Slovak Republic published study on PPP/PPI in Slovakia. This comprises theory of PPP/PPI and gives opinion on it. More important it stipulates that government shall encourages these kinds of investments even though they were not of hundred per cent access in the neighbouring countries – from which – as this study stresses – we should learn our lessons.

There is not much left to comment, probably we should really try to learn how to use this ‘trendy’ instrument for financing of public infrastructure – not only while it has been successfully implemented in the Northern America or also Ireland (not mentioned in this article) which is great example for our economy in many different ways – but also while PPP/PPI in their essence are more efficient and effective than public investment themselves.

Slovak Republic has also very good opportunity – as a member state of the European Union – to combine private resources with EU Cohesion Fund, which would make these investments even more rentable.

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FISCAL POLICY AND ITS PLACE IN TOURISTIC DEVELOPMENT

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Abstract

The present state of Romanian tourism is also due to the fiscal measure and regulation promoted by the governments that have run the country after 1990. Even if the Romanian fiscal system has been subject to major transformations in the process of adapting to the requirements of the competitive market economy there are still certain problems to be solved, problems which affect all companies, including those which work in the touristic sector. Fiscal policy can have a positive influence on sustainable touristic development if its goals are: the encouragement of those companies working in the touristic sector to make investments and to improve the quality and the competitiveness of touristic services, the encouragement and promotion abroad of Romanian touristic destination, the protection of the environment. The fiscal system that has been introduced after 1990 was very burdensome for the companies working in the touristic sector, reducing significantly their income. We hope that tax relief promoted by the present government will attract more tourists and encourage the investments in the touristic sector

Keywords: *fiscal reform, fiscal policy, sustanaible development*

1. Introduction

The complexity of tourism, its social, cultural and economic implications, the interlinking of its distinct components are all reasons for the governments all over the world to pay attention to tourism as they have understood the fact that they can benefit by it.

Tourism is a very complex and complicated industry that comprises many fields. There is no other industry to comprise such a vast group of associated fields as tourism does. It is a combination of industries from all over the world, of the greatest diversity, having a very complicated structure. Taking this as a starting point, it is obvious that the complexity of tourism requires coordination; only governments have the authority and the necessary mechanism to organize such a complex sector.

2. Aspects of State's Implication in the Economic Fields

From the very moment of its coming into being and up to the present, state has had to make a difficult choice: freedom or control? This choice is called by the specialized literature "the dilemma of modern society" and consists in the difficulty of modern society to choose either freedom, giving up on the society's chances to survive or to choose control, in this case giving up on individual freedom.

Therefore, from the economic point of view, the main problem is to choose between the market supremacy and the state's lack of involvement on the one hand, and state's supremacy over the market, on the other. Reality has proved that choosing the individual freedom and the free market has proved to be better than choosing the coordination of the economy by the state. At the same time, it is a well-known fact that individual freedom does not guarantee the support of the citizens, that they need social support and the free market, in its turn needs a stabilizing support from the part of the state. Therefore, from the economic point of view, The main problem is to choose between the market supremacy and state's lack of involvement on the one hand and state's supremacy over the market, on the other. Reality has proved that choosing individual freedom and free market has been better than choosing the coordination of the economy by the state. At the same time, it is a well-known fact that individual freedom does not guarantee the support of the people, that they need social support and, in its turn, free market needs a stabilizing support from the part of the state. Thus, it is a fact that both free market and the state are complementary factors of the economic system, and the boom of the modern economy depends on achieving a balance and sharing the responsibilities between market and state.

Although tourism is an activity supported especially by private initiative, governments play an important part in its development. They have strong reasons to involve in tourism sector. Their involvement is necessary having in view the economic and social importance of tourism and its contribution to the increase of life's quality. At the same time, tourism can have a greater contribution than other fields to achieving some broad goals established by the governments as priorities in the general interest of the citizens: fighting against poverty, improving life's condition, increasing currency chased, intensifying the links between countries and even political goals.

The complex mechanism of interaction between state and market economy requires that the public authority should make use of some means and techniques which are adequate to the difficult role which state has in economy. The allotting, distributive and especially regulator role of the state requires the promotion of the economic policy.

As compared to other economies in the Central and Eastern Europe, the process of transition in Romania has been slow and rather unstable. This state of fact is, in part, due to initial difficult conditions of the previous period of transition when the priorities were the heavy industry, which wasted a lot of energy, the big inefficient agricultural units, the unproductive project and the reducing of imports to allow the prepayment of the foreign debt, to the detriment of the living standards and technological modernization of economy. But, on the other hand, Romania's slow progress regarding transition is caused especially by a not very firm approach and a not very good implementation of structural reform, as well as by a lack of continuity of macroeconomics policies.

3. Problems of Romanian Taxation System after 1990

The present state of Romanian tourism is due to the measurement and fiscal regulation adopted by the governments that have ruled Romania since 1990. In the case of the market economy there is no longer a direct connection between the state than plans and the way of achieving the plan, as it was in the case of the demand based economy. State's attributions are reduced only to promoting financial, fiscal and commercial policies that improve the business environment and are further on applied according to the principle of full autonomy of business in each company.

The reaction of the economy to different policies of the state depends both on the feasibility and adjusting the policies as well as on the degree to

which the economic environment enforces the laws, the efficiency of the democratic mechanism and the inner rules of each enterprise.

After 1989, the Romanian fiscal system has undergone significant changes, adapting to the requirements of the market economy. Today, it satisfies to a great extent the requirements of a competing economy, but there are still a series of problems, both general problems, regarding the entire fiscal system and the way in which it functions, and the problems that are specific for each tax. These problems affect all companies, including those that work in the tourism sector. A main problem identified in the analysis of the evolution of the fiscal system after 1989, is the legislative instability. In time, each of the main taxes has undergone repeated, more or less important changes. Therefore, making long-term business plans is almost impossible, the foreign investors are not encouraged and the internal and external investments are diminished. Another important matter is the way in which fiscal legislation is put into practice and the manner in which the lack of fiscal order is dealt with. In Romania, the taxes and shares owed by the companies do not bring many benefits, this having a negative impact on the economy, as a whole, and on each of its fields. It is very important to keep in mind that only a correct and coherent way of applying the fiscal legislation creates an economic environment that will offer equal conditions for all companies, a fact that will be an advantage for those which are really efficient, thus developing the economy. At the same time, an equal distribution of the fiscal duties might reduce taxation, which will limit the subterranean economy and offer better conditions for firms' development. Another important problem that the Romanian fiscal system has to face is the existence of a strong subterranean economy. This has major negative effects on the economy. Because some firms involved in the subterranean economy do not pay taxes, the fiscal incomes of the state are reduced, which makes necessary a new growth of taxation, which, in its turn, generates an increase of the number of the firms functioning in the field of subterranean economy. This will certainly lead to diminishing the fiscal incomes and to going into a vicious circle. Other problems regarding the fiscal system as a whole are those connected to the value of the taxes. When it comes to the value of the taxes, the Romanian fiscal system is in accordance with what exists at European level and especially in Eastern Europe, but there are still certain steps to be made till the Romanian fiscal legislation will be brought to a balance with that of the European Union.

4. Taxes for Touristic Companies in Romania

The present Romanian taxation system is the result of many years of transition and, although there have been made many efforts, it contains many regulations that hinder the economic development, and especially the touristic sector, where there is a serious competition in the European continent. The fiscal simplification promoted by the present government is hoped to create a better business environment, to contribute to a durable economic growth and to make the Romanian business environment moiré flexible and predictable. The main reason for which government encouraged the fiscal simplification is that increased values of the taxes can have negative effects on the real economy: they hinder the evolution and the restructuring of the internal offer and a part of the economic activity is not taken into account by the national accountancy.

According to the Plan of Governing for 2005 – 2008, in Romania the fiscal policy will be based on the following principles:

- the principle of fiscal neutrality: the fiscal norm must have the same consequences on every company; fiscal neutrality will be limited only by the situations in which, in order to achieve the goals of the plan of governing, there must be accepted, for short periods of time, unequal fiscal consequences;

- the principle of fiscal effectiveness (performance): fiscal norm must have a strong impact on the respective fiscal behavior; it is not accepted any other fiscal norm that does not change a fiscal behavior;

- the principle of the equality of the fiscal treatment: the companies that have similar economic functions, in an certain lapse of time, will be treated in the same way, from the fiscal point of view, irrespective of the existing differences between them;

- the principle of the sustainability of fiscal norm: the taxes will be established in such a way as the taxable base to be stimulated by the tax itself, the respective taxable material becomes more stable and transparent.

The fiscal system introduced after 1990 has been very burdensome for the companies working in the touristic sector, reducing significantly their incomes.

Local taxes represent the first category of taxes which must be paid by the companies working in the touristic sector. This are paid for the local budget of the administrative-territorial unit in the area of which the respective touristic asset is situated:

- first, the tax on buildings must be paid. This is calculated by applying a quota whose value is situated between 0,5% and 1% from the inventory value of the respective buildings, the quota being established by a decision of the local board. It is a well-known fact that a characteristic of tourism is the unequal distribution of tourists and services in time and space. Many accommodation unit, especially those at the seaside, function only a few months a year; other, have tourists all the year round but there are only few. For a long time, they have paid the taxes for the whole year. The fiscal legislation that has become effective in 2004 provides that the tax on building to be reduced with 50% for those buildings owned by the legal persons, buildings that are used exclusively for offering touristic services for a period of maximum five months in a year. This is a very good idea.

- if touristic companies own means of transportation (cars, coaches, minibuses, boats, yachts, ships or means of entertainment – motor bicycles, scooters, motor boats), they must pay the tax for means of transportation. This is calculated according to the respective type of means of transportation, according to law. For these, the companies working in the touristic sector pay the tax for the entire year, although there are not continuous flows of touristic transports. We can speak of continuous flows of tourists especially in peak seasons. A 50% reduction of the tax on the means of transportation will be beneficial, if they are used in touristic activities only five months a year.

- any company working in the touristic sector that must get a certificate, advice or any other kind of license, must pay the tax for issuing the town planning certificate construction licenses and other similar licenses to the specialized department of the local public administration before the respective certificate, advice or necessary license is released. The taxes for releasing construction licenses, sanitary licenses, licenses for carrying on economic activities are insignificant, but the tax for issuing the necessary license for site organization activities having in view the building of construction is 3% of the authorized value of the site organization activities, and the tax for issuing the license for organizing tent camps, for little houses and trailers or champs is 2% of the authorized value of the construction works. The value of these taxes is rather high even if we take into account the fact that the recovery of the investment in the touristic sector is a long term one and not a short time recovery, as in other sectors.

- any firm that works in the touristic sector and benefits from advertising and publicity services according to a contract or any other kind of agreement with another person, has to pay to the local budget a tax. This tax is calculated by applying the quota of 1 – 3% of the value of the advertising and publicity services. At the same time, any touristic company that use a notice board, poster board or any other kind of board for advertising and publicity in a public place has to pay a tax to the local budget of the local

public administration in the area of which the respective notice board, poster board or other kind of boards are placed.

- some touristic companies organize artistic performances or entertaining activities. They must pay to the local budget the tax on performances. The tax quota is 5%. For a play, ballet, opera or any other kind of musical performances, for the broadcasting of a movie in a cinema hall, or for a performances at the circus, the tax quota is 2%. In case of artistic performances or entertaining activities that take place in a discotheque, the tax is calculated according to the area of the respective building inside of which the respective performance takes place, according to the sum fixed by the local council.

- the local council can levy a tax on the accommodation in a hotel, in a place which falls under its authority. This tax, called the hotel tax, is collected by the respective hotels when the person are accommodated. The tax quota is between 0,5 – 5% and is levied on the accommodation tariff, according to the number of stars of the hotel. This tax is benefic, if it is levied in accordance with its goal: to promote the sustainable touristic development of the respective area.

The profit tax has undergone significant changes during transition. Since the 1th of January 2000, the taxation quota of the profit tax has been reduced from 38% to 25%. Even this quota was too high for the touristic companies, because every 3 – 5 years, the touristic structures for accommodation, food or entertainment must be modernized to increase the value of the services offered. A good measure for touristic companies is reducing the value of the profit tax from 25% to 16%, starting with the 1th of January 2005. Such a reduced quota, together with the simplification of the present settlements, will contribute to the development of the business of the touristic companies, especially by increasing direct investments in touristic structures.

We must take into account the fact that many of the touristic companies are small enterprises. A small company is a Romanian legal entity with fulfils the following condition:

- it produced material goods; provides services and/or carries on commercial activities;
- it has 1 up to 9 employees;
- the value of its income does not exceed 100.000 euros;
- the registered capital of the respective legal entity is held by persons, other than the state, local authority an public institutions.

For this, in 2001, the profit tax was replace by the tax levied on all those persons' incomes, calculated with a 1,5% quota for all the incomes irrespective of their source. The value of this quota was increased to 3%,

starting with the 1th of January 2005. This was a rather controversial measure and some economic analysts criticized it. However, both the measure of levying a tax of the income of small enterprises and that of reducing the value of the profit tax have in view the stimulation of economic activity and fighting fiscal evasion. The former goal seems to have been achieved by the small enterprises that work in the touristic sector, although this is not due only to the taxation system. But the measure taken by Romania's Parliament when adopting this tax as low, to allow the small enterprises to choose between the tax levied on small enterprises and the profit tax are not very good. It allows fiscal evasion.

The Value Added Tax (VAT) has undergone significant changes during the entire period of transition. The enforcing of VAT in Romania was promulgated by law in July, 1992. Although the law had to come into force on the 1th of January 1993, it has been enforced since the 1th of July 1993. The VAT was the less stable of all the taxes enforced in Romania. Initially, Romania introduced a system with two quotas: a normal one of 18% and the zero quota; shortly after this, a reduced quota of 9% has been added to these, a quota that was also applied to the tariffs in the Romanian touristic industry. In time, the settlements for VAT have undergone many changes, the most important of these being the reduction of the number of products and services exempted by VAT, but also the number and the value of the taxation quotas. Thus, as far as the level of quotas is concerned, these underwent changes of the 1th of February 1998, the normal quota being of 19% and, as a result of this, the tariffs in Romanian touristic industry were calculated using this quota.

The present fiscal code, which came into force on the 1th of June 2005, has in view a standard quota of 19% and a reduced one of 9%. This reduced quota of 9% is enforced when accommodating in the hotel sector or in other similar sectors, including the hiring of those lands for camping. A low value of VAT can stimulate any touristic company, in a case in which the tariffs of touristic companies are rather high because of the advantage of the price for electric power, water, to which the normal quota of VAT is also applied. The same reduced quota of 9% is applied to the tariffs for entering castles, museums, memorial houses, historical monuments, architectural and archeological monuments, zoos, botanical garden, fairs and exhibitions. But the accommodation, food and treatment services provided by the companies that work in spas or health resort are exempted by paying the VAT, if they have contracts with The National Pension House and Other Rights for Social Insurances.

The 6th Directive of the European Union Council caused the successive changes undergone by the VAT. This process will go on; a series

of fiscal facilities is to be eliminated by the moment of Romania's integration. At the same time, some exceptions stipulated by the 6th Directive which, in the present, are not enforced in Romania, as well as some special treatments for small entrepreneurs, agricultural producers and touristic companies are to be introduced in our legislation.

The present government has in view to keep the present settlements for VAT for a certain period of time; the positive effects of fiscal relief on income and profit will increase the value of VAT up to 16% in accordance with the settlements of the comunitary acquis.

We are going to see if Romania's taxation is burdensome or not (Table no. 1).

Table no. 1. The evolution of Romania's tax revenue in case of inhabitant in dollars and the general and partial taxation degree as well as that for social purposes in the period 1991 – 2003

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
A)	1 244	859	1 158	1323	1564	1563	1565	1844	1585	1645	1773	2220*	2316 *
B)	413	288	362	373	451	420	415	521	476	484	502	612*	646*
C)	33,2	33,5	31,3	28,2	28,8	26,9	26,5	28,2	31,4	29,4	28,3	27,6	27,9
D)	23,2	23,2	22,0	20,3	20,9	19,4	20,0	20,3	22,4	18,6	17,4	16,9	17,1
E)	10,0	10,3	9,3	7,9	7,9	7,5	6,5	7,9	9,0	10,8	10,9	10,7	10,8

* in euros

A) GDP per inhabitant In US dollars

B) The average tax revenues per inhabitant in US dollars

C) General taxation degree: (taxes + contribution) x 100/ GDP

D) Partial taxation degree: (taxes) x 100 / GDP

E) Taxation degree for social purposes: (Contribution to social insurances.x 100) / GDP

Source: *The Reports of the National Bank of Romania, 1991 – 2003.*

It is not my intention to analyze the manner in which the taxation degree (general, partial and for social purposes) evolved in the period 1991 – 2003. It was an oscillating evolution, reflecting the options of the governments that ruled the country during the above-mentioned period. However, the general trend is a decreasing one, being influenced both by the measures of economic and fiscal reform and by the functioning of the economy. My intention was to observe if the taxation is or not burdensome for companies. Having in view the data shown in the above table, we can conclude that the level of taxation is very low in Romania as compared to

that of other countries, especially the European Union countries, where the general taxation degree is between 30% and 55%. This contradicts the opinion of most Romanian citizen.

These low value of taxation are especially due to the fact that the statistics take into account only the tax revenue cashed by the state which, according to some sources, represent only half of the fiscal and social liabilities owed by the tax payers, according to law. Therefore, if they all were collected, the tax degree would be 50 – 60% of the Gross Domestic Product. But in Romania, they are taxpayers that declare and pay all the fiscal and social liabilities correctly, case in which taxation becomes a real burden. At the same time, there are also tax payers that neither declare pay anything or pay only a small amount of the fiscal and social liabilities, and these ones do not feel taxation as burdensome.

Therefore, although the medium level of taxation in Romania is relatively low as compared to that of about 30% of the Gross Domestic Product in other states, taxation is not evenly distributed so that, where as some tax payers pay a taxation of only 10 – 20%, others pay one of 50 – 60%. Most of these are companies working in the touristic sector. At the same time, it is much difficult to take 500 dollars of a 1,800 dollars GDP than taking a sum of money ten times larger of a similar GDP. Although, in both cases, the taxation degree is the same, in the former situation the money remaining after the payment of the respective tax is hardly enough to satisfy personal needs.

5. Fiscal Measures for Encourage companies of Touristic Sector

By introducing the new fiscal policy measures, the present government hopes a tax relief as a means to encourage the business environment, the private initiative and to make legal the underground economy.

Public authorities can use fiscal policy to achieve such goals as:

- influencing the economic processes;
- correlating the economic cycle;
- eliminating the economic dysfunctions.

It is obvious that these goals do not have direct effects on tourism, but they contribute to the process of developing the economy as a whole and to macroeconomic stability; in their turn, these have direct effects on touristic development. A second class of goals has in view the way in which the

measures of fiscal policy influence the activity of companies in general, these, in their turn, influencing directly the companies working in the touristic sector.

Fiscal policy can contribute to economic stability. The fiscal measures compensate the fluctuations of the investment demand eliminating, thus, side effects. Tax abatement, together with the increasing of public expenses is a strategy used, as a rule, during recession, whereas the opposite fiscal measures are used when the aggregate demand tends to become excessive. At the same time, we must take into account the ratio taxation economic circumstances.

On the other hand, the measures taken under certain circumstances can influence the yield of certain taxes, on the other hand these can be used to influence the economy, the fiscal goals being the economic recovery. Beside this, we must have in view the fact that the macroeconomic balance depends on that achieved at the budgetary level. Achieving the budgetary balance requires either diminishing the governmental expenses or increasing the tax values, all these being closely connected to the situation of the economy analyzed in the framework of the fiscal policy of the state.

In order to develop a competing economy, the fiscal policy must correlate the goal of sustainable growth with the requirements of economic stability. Fiscal policy must contribute to encouraging savings and investments by:

- controlling the budget deficit;
- completing the fiscal reform;
- rationalizing the budget options in accordance with the priorities established in the field of expenses;
- ensuring transparency in spending public money.

The most important thing when it comes to the influence of the fiscal policy on companies is its effects on saving and forming the capital. An increase of taxation has as consequence the reducing of savings and of the capital for investments. It is a well-known fact that in tourism, perhaps more than in other fields, upgrading of touristic structures are necessary, in order to enhance the quality of the services provided. So, taxation can hinder the evolution of the companies working in the touristic sector.

Various types of fiscal measures can be used to encourage companies of touristic sector. The most important ones are:

- granting fiscal deductions, for limited periods of time, representing a share of the value of the investments;
- reducing the tax rate for firms for that part of the profit which is ploughed back;

- reducing some of the investment expenses (tax exemption for imported equipments, fiscal reduction for imposing a tax on equipments, etc.);
- granting fiscal reduction for those firm which work hard in the research sector or in professional training or for those which function in disfavored areas;
- granting fiscal reduction, subventions or fiscal incentives for those firms that take measures to protect the environment;
- adopting special fiscal regimes for the groups of companies thus allowing the fiscal integration of the whole results of the group;
- tax exoneration, exemption, reducing or delaying the tax payment;

The budget measures can also influence the touristic development. Among these mention can be made of the financing from the state budget and the local budgets of those touristic activities which encourage the development of any areas and components of touristic offer and promote, in other countries the Romania touristic destination.

6. Conclusion

The fiscal policy can be beneficial for tourism development in Romania if one takes into account the actual state of things in Romanian tourism, the present requirements and future needs; otherwise, if all these are not taken into account, the fiscal policy can hinder the development or even cause the recession of this important field of national economy. Fiscal policy has a positive impact on tourism development only in the case in which public actions are undertaken having in view the priorities in every stage of development, have economic, social effect or other kind of effects correlated with the financial effort, takes into account simultaneously the short-term plans and the middle and long-term plans.

By means of fiscal policy, the development of touristic sector can be protected or encouraged; in such a way, fiscal interventions have in view such goals as: the encouragement of the companies working in the touristic fields to make investments, the improving of the quality and competitiveness of touristic services, the encouragement and promotion abroad of Romanian touristic destinations, the protection of the environment.

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SOME FISCAL ISSUES REGARDING LEASING OPERATIONS IN ROMANIA

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Abstract

The spectacular evolution of the leasing market in Romania has determined the association of leasing companies into professional associations, as well as the emergence of a coherent and professional legal framework. The present study aims at examining the way in which leasing operations, irrespective of their type, influence the financing of the activity performed by both individuals and legal entities. The leasing companies begun to separate based on the services offered, to get to be known by financing objects specific to several market niches. The market's evolution to a superior stage is although conditioned by the sustainability of the economic growth and also by the strengthening of the business environment in Romania. Data in 2004 show that the leasing is a financial product adapted to the Romanian market requests, despite of unfavorable impact of legal background. The increase of leasing companies' portfolios quality, availability of financing sources and the accurate analysis of clients' creditworthiness are considered the main success factors.

Keywords: *financing, through leasing, leasing companies, financial leasing, lease-back, time-sharing, leverage leasing.*

1. Introduction

The increase of macroeconomic ratios and especially their contribution to the companies' income, inflation decrease and the necessity of technological upgrade through investments represent just a few of the factors which will impact the leasing market. Moreover, the premise of implementation of the project for leasing regulations' modification shall contribute to the development of such operations. Even if the new regulations will not bring the necessary clarifications, the experience has proven that even with an insufficient legislation, the leasing is considered a very well known activity on the Romanian financial market. Needless to say that by including the software applications among the goods which can be bought in leasing will increase the market share of leasing companies which will assume the additional risks related to such financings.

The development of leasing operations is closely linked to economic development as a whole, therefore, the technological upgrade, production of goods, the sales and circulation, new services are just a few of the important gains for the leasing activity.

2. Legal requirements regarding leasing activity

A first legal definition of the leasing process in Europe appears in France, and it is called "crédit-bail", according to the law nr.66-455, from the 2nd of July 1966. It included only the real estate leasing, defining the "crédit-bail" process as being a company which can give you real estate stuff for professional use, stuff bought or built by the company itself. The order nr.67-837 from 28th of september 1967 made complete the law from the 2nd of July 1966, differentiating the "crédit-bail" process for personal goods, from the "crédit-bail" operations for imobil stuff and creating the S.I.C.O.M.I. Status (real estate companies for industry and trade).¹

As one can notice from the legal regulation concerning the leasing process of the states members of the Leaseurope, many countries in Europe had no specific legal legislation.² So, the leasing operations are the subject of the general regulations of the civil and / or commerciale legislation.

¹ E.M.Bey, C.Gavalda (1983) – *Le crédit-bail immobilier*, Presses Universitaires de France (PUF), Paris, pag.7

² Source : www.leaseurope.org/pages/Leasing/Legal_Aspects/Leasing_Legal.asp

As it concerns the regulation procedure of the leasing companies from the countries-members of the Leaseurope, one can notice that the ones that belong to France, Portugal, Hungary, Spain and Italy is under the supervision of the Central Bank, whereas the leasing companies from Luxemburg and Sweden are under the supervision of the Supreme Financial Authority. In Belgium and Germany, the subsidiaries leasing companies of some banks, enter, indirectly , under the supervision of the Central Bank.

In countries like Belgium, Greece, Luxemburg and Norway are necessary special approvals for the setting up of leasing companies. With the exception of Greece and Spain, there is no other country known as a member of the Leaseurope where is made a distinction between the leasing operators from the UE and the ones that are not residents in the UE; but in Spain is also needed an authorization from the Ministry of Finance for the leasing companies that are not resident in the UE.

As it was mentioned above, few countries have a specific legislation in the leasing field, although more and more countries are about to legislate the leasing and the progress made in this field is accelerating. Where such laws were put into operation , these were molded according to the Unidroit Convention on International Financial Leasing.³ Although the Convention is oriented towards international transactions, it is a useful pattern for the internal regulations from each country that needs a specific leasing legislation.

In Romania, the first leasing contracts have spread out before the existence of a special law intended to the regulation of this operation. As a result, the way of approaching the leasing was more similar to a let out.

The first regulation concerning the leasing appeared in Romania due to the Government's ruling no.51 dated on the 28th of August 1997 regarding the leasing operations and the leasing companies, that forecast that the leasing is an operation “ in which a part, also known as lessor, is engaged , following the instructions of a second part, also known as a lessee , to purchase from a third part and to confer the usage and the possession of a

³ The Unidroit Convention regarding the International Financial Leasing, signed on the 28th of May 1998 at Ottawa, establishes the juridical backround upon which should take place the leasing operations and should be solved the recent litigations, leaving to the “common law ” the fixing of the competent instances for solving these litigations.

mobile or immobile good, with the purpose of its commercial exploitation or for the final consumption”⁴.

In rule no.90 dated on the 28th of April 1998⁵ for the approval of the Government’s ruling no 51/1997 some changes have intervened, such as: “the lessor is obliged, at the lessee’s request, to purchase or to take over from a third part, also known as a supplier, a mobile or immobile good and to assign the lessee with its possession or usage, in exchange of a payment called due, with the purpose of exploiting or purchasing the good”⁶.

It can be noticed that in the new exact wording the *employment* of the lessor is transformed into *obligation*, and the user’s indication becomes *request*. As well, the lessor can *overtake* the good, not just buy it. Furthermore, concept of *supplier* appears. The term *to confer* is replaced by the *assigning* of the possession or usage (here appears or instead of and) upon the good. At the same time, the purpose of the exploitation is no longer reduced to the *commercial* one or to the *final consumption*, the purpose being, according to the new formulation, the plain and simple exploitation or the acquisition of a good.

In January 2000, the Government’s ruling no.51/1997 was republished, on the grounds of art. VII from rule no.99/1999⁷, and the definition comprised in the new regulation is the following: the leasing is that operation “ by which a part, known as lessor /financier, assigns for a limited period of time the right of usage of a good whose owner is the other part, known as lessee, at the last one’s request, in exchange of a periodical payment, called leasing installment, and at the end of the leasing period, the lessor /financier is obliged to respect the user’s right of the option to purchase the good, to extend the leasing contract or to put an end to the relations stipulated by contract⁸.

In the new definition of the leasing operation also appears the term *financier* , and *the due* has been replaced with the notion of *leasing*

⁴Government’s ruling no.51/1997, art.1,align.1 (the initial form of the ruling)

⁵ Published in O.M. no.170 dated on the 30 of April 1998.

⁶Rule no.90/1997,art. I, point 1.

⁷Published in O.M. no.236 dated on the 27th of May 1999. Rule no.99/1999 also known as “The rule regarding a few measures for the speeding of the economic reform” has six titles, title II being “The modification and completion of the Government’s ruling no.51/1997 regarding the leasing operations and the leasing companies”.

⁸Government’s ruling no.51/1997, republished ,art.1,align.1.

installment. In addition, the possibility of assigning the right of possession disappears, the notion of possession being used incorrectly, because, in juridical terms, possession signifies either an attribute of the property law, when the property law is exerted by the owner, or a state of things, respectively a material ownership of a good due to an annullable title, which permits the owner the acquirement of a property through usurpation⁹.

This triple option which is at the user's hand **differentiates** the leasing contract from other contracts and confers **individuality** to it. For example, the location contract does not bring upon any sales obligation, the inhabitant being obliged to return the good in the same condition it was given to him at the very beginning.

The location-sales contract mentions lessee's obligation to purchase the good taken into location, being assigned to him the property over the good which makes the object of the contract at the same time with the payment of the last installment.

The sales contract with the keeping of property until the payment of the price subordinates the transfer of the property to the complete payment of the price. The sales on credit contract transfers immediately to the buyer the property over the good.

3. The evolution of leasing in Romania

Leasing has proved to be one of the most dynamic areas of Romanian economy, its positive evolution being the more important if we consider the difficult conditions specific to the Romanian economy at this point such as the slow privatization process that has determined foreign investors to keep their distance and, most significant of all, the financial scandals linked with the disappearance of commercial or popular banks and of investment funds, all of the above mentioned having a strong impact on the whole Romanian financial system.

The leasing market has thousands of economic agents who fulfill the main conditions requested by law in order to be marketers: the inclusion of the "leasing activity" in the activity object category and an equity capital of 500 million lei.

⁹ D.Clocotici, Gh. Gheorghiu – *Operations of leasing*, Edition Lumina Lex, Bucharest, pg.32.

3.1 Dimensions and degree of concentration on the Romanian leasing market

There are two representative associations of this industry in Romania: The Romanian Leasing Association of Companies (ASLR) and The Banking Leasing Association (ALB).

The Romanian Leasing Association of Companies (ASLR) ¹⁰ was founded in 1996 as a professional nongovernmental, nonprofit, nonpolitical and independent organization created with the purpose of developing and extending cooperation and collaboration in the leasing operations area. Beginning with the year 2002 ASLR is a member of Leaseurope.

The Banking Leasing Association (ALB) was funded in April 2004 reuniting eight of the leasing companies subsidiary to the Romanian commercial banks, all of them with foreign capital.

Considering the data offered by the ASLR we can conclude that the evolution of the Romanian leasing market has been an upward dynamical one as we see in table 1 .

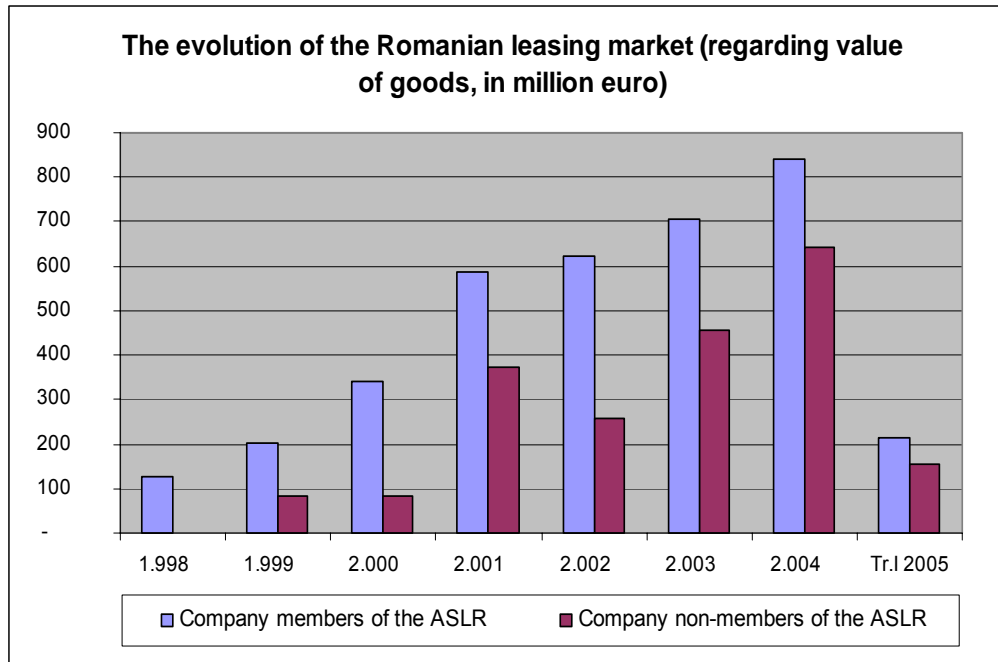
Table 1 The value of goods financed in leasing - EUR mln.-

	1998	1999	2000	2001	2002	2003	2004	Tr.I 2005
<i>Company members of the ASLR</i>	128.5	202.9	340.0	587.6	624.1	706.3	841.1	215
<i>Company non-members of the ASLR*</i>	n.a	82.1	82.2	374.4	257.7	457.0	642.5	155.6
Total	-	285.0	422.2	962.0	899.8	1,163.3	1,483.6	370.6

¹⁰ The initial name of this organization has been “The National Union of Leasing Companies in Romania” (UNSLR), it was changed in June 2003 to “The Romanian Leasing Association of Companies” (ASLR).

*We add that the total value of goods financed in leasing accomplished by ASLR members is only an estimate, as there is no unitary report base for these participants yet.

Figure 1 The evolution of the Romanian leasing market (regarding value of goods, in million euro)



Source: ASLR reports

The evolution of the Romanian leasing market in the last few years is as follows (table 2):

Table 2 The evolution of the leasing market (at ASLR level)

	1998	1999	2000	2001	2002	2003	2004
<i>Number of contracts</i>	6,160	8,746	7,854	14,991	36,093	34,027	49,361
<i>Variation</i>	-	41.98%	-10.20%	90.87%	140.76%	-5.72%	45.06%
<i>Value of goods (million euro)</i>	128.5	202.9	340.0	587.6	624.1	706.3	841.1
<i>Variation</i>	-	57.9%	67.5%	72.8%	6.2%	13.17%	24.63%
<i>Value of contracts (million euro)</i>	-	-	-	-	-	850	1,029
<i>Variation</i>	-	-	-	-	-	-	21.06%

Source: ASLR reports

We can observe that, beginning with 1998 the volume of transactions concluded at ASLR level has registered continuous increase, so that by the end of 2003 the value of goods financed in leasing has been of approximately 0.71 billion euro, respectively a total value of contracts (goods, interest rates and commissions) of about 0.85 billion euro. Although the value of goods financed in leasing has grown in the year 2004 by almost 25% compared to the year 2003, the total value of contracts has only grown by 21%, a fact that proves the reduction of financial and non-financial expenses to be stood by leasing users.

By the end of **the first quarter of 2005** the registered value for goods financed in leasing has been 215 million euro and the total value of contracts 265.5 million euro.

In addition to that, the number of contracts has been situated on an upward slope from 6,160 in 1998 to 36,093 in 2002 and 34,027 in 2003 reaching by the year of 2004 the value of 49,361, 45% more than in 2003. In the first quarter of 2005, at ASLR level, 13,477 contracts have been concluded. This evolution can be explained by taking multiple factors into consideration such as the annual increase in the number of members (17 in 2000, 37 in 2004, 33 in the first quarter of 2005), the market development, the clients awareness regarding the importance of leasing transactions as a way to finance their investments.

Considering the distinction between financial and operational leasing, the main direction of leasing contracts carried on by the company members of the ASLR is towards financial leasing. This can be clearly identified from the data shown in table 3.

Table 3 Financial versus operational leasing (at ASLR level)

	<i>Financial leasing</i>							<i>Operational leasing</i>			
	2002	2003		2004		Trim.I 2005		2002	2003	2004	Trim.I 2005
	<i>Total</i>	<i>Total</i>	<i>Of which cross border</i>	<i>Total</i>	<i>Of which cross border</i>	<i>Total</i>	<i>Of which cross border</i>	<i>Total</i>	<i>Total</i>	<i>Total</i>	<i>Total</i>
<i>Number of contracts</i>	90.1	92.65	2.16	95.93	0.97	96.54	0.89	9.9	7.35	4.07	3.46
<i>Value of goods</i>	88.4	86.03	5.8	92.96	2.05	96.23	2.8	11.6	13.97	7.04	3.77

Source: ASLR reports

The preference towards financial leasing operations can be explained by the much clearer definition of this form of finance compared to operational leasing. The value of cross-border leasing operations (carried on by leasing companies not residing in Romania) was in 2003 5.8% of the total value, about 39.14 million euro, in 2004 their weight dropped to 2.05% of the total value, about 17.22 million euro. Without regard to the type of shareholders, most of the clients of leasing companies are legal entities.

At ASLR level, in 2004, the value of goods financed through leasing represented about 74.90% of the total market, 17.40% being held by the public division the rest of 7.70 concerns legal entities. In the first quarter of 2005 the value of goods financed through leasing in the case of legal entities represented about 63.42% of the total market, 26.78% concern the public division and ONG and the rest, 9.8%, belong to legal entities.

The significant growth of the finance weight for the public division and the ONG by over 9% compared to the statistical data obtained for the year of 2004 is a notable fact. Table number 4 describes the situation of contracts concluded with legal entities in 2004 compared to 2003, reported to the global market for ASLR members, depending on the value of financed goods and the number of contracts.

Table 4 The situation of contracts closed with legal entities

	<i>Financial leasing</i>		<i>Operational leasing</i>		<i>Total</i>	
	<i>2003</i>	<i>2004</i>	<i>2003</i>	<i>2004</i>	<i>2003</i>	<i>2004</i>
<i>Value of goods (million euro)</i>	492.5	704.14	32.8	30.06	525.3	734.2
<i>% Of the total market</i>	72.97%	83.71%	4.86%	3.57%	77.83%	87.28%
<i>Number of contracts</i>	28,012	40,963	2,106	1,948	30,118	42,911
<i>% Of the total market</i>	82.32%	82.98%	6.19%	3.94%	88.51%	86.92%

Source: ASLR reports

In the “clients of legal entities” category, a distinction between the private and the public division can be made. Thus, of the total 49,561 contracts carried on in 2004, the majority were linked with the private division, that means 84.47%, the public division, other clients division and ONG representing about 15.52%.

We must also notice the awareness of the public division concerning this form of finance, the evolution of leasing finances being, in this case, a spectacular one (from 1% in 2003 to 15.52% in 2004).

The companies belonging to ALB concluded in 2004 a number of 18,200 contracts with a total value of 544 million euro, 81% more than in 2003 when approximately 9,000 contracts with a total value of 300 million euro had been concluded.

From the total number of contracts concluded by the members of this association 95% are finances for corporate clients, 3% for the retail component and 2% belong to the public division.

The legal entities segment has dominated the market represented by company members of ALB with a weight of 96.63%, the quote for legal entities being only 3.21%.

Most of the leasing contracts closed were those with external suppliers: 75.4% and 65% of their value in 2004 for ASLR and respectively ALB.

A classification of leasing contracts made by the ALB depending on the tenor span indicates the fact that 60% of these contracts are between 1 and 3 years, more than 31% are between 3 and 5 years and the rest of 9% have a maturity greater than 5 years.

Parallel to the continuous growth of the market, a tendency of concentrating the leasing operations to a smaller number of companies can be observed. Thus, we find, with a volume of financed goods of about 1.5 million euro in 2004, Porsche leasing, Afin Romania, BCR Leasing, RCI Leasing and Tiriac Leasing – 5 of the 37 companies who have subscribed to ASLR in 2004 – totalizes a market quote of about 36%. Also, the 9 companies belonging to the ALB own another 36.26% of the market.

Table 5 The first 15 companies members of the ASLR – 2004

<i>Position</i>	<i>Company</i>	<i>Market share at ASLR level*</i>	<i>Value of financed goods (million euro)**</i>	<i>Market share at market level***</i>
1	Porsche Leasing România	17.87%	145.60	9.70%
2	Afin România	15.85%	121.65	8.11%
3	BCR Leasing	12.99%	119.00	7.93%
4	RCI Leasing România	10.62%	77.77	5.18%
5	Țiriac Leasing ***	9.20%	77.37	5.15%
6	Motoractive	6.97%	58.60	3.90%
7	Eurial Leasing	4.88%	50.00	3.30%
8	TBI Leasing	4.51%	37.92	2.52%
9	Romstal Leasing	4.03%	33.40	2.22%
10	Ager Leasing	2.69%	20.10	1.30%
11	Romexterra Leasing	1.83%	16.12	1.07%
12	D.R.T. Group	1.30%	11.18	0.74%
13	Toyo Motor Center ***	1.23%	10.34	0.69%
14	Auto Italia	1.22%	10.16	0.67%
15	Atlassib Leasing	1.04%	8.75	0.58%
<i>Total (rd.1 – 15)</i>		96.23%	797.96	53.06%
<i>TOTAL, including the other company members of ASLR</i>		100%	841.1	55.06%

* Source ASLR (the market quote is calculated depending on the value of financed contracts)

** The data is supplied by the companies

*** The numbers have been calculated considering the market share supplied by ASLR, reported to the total volume of goods financed by the members of ASLR

**** The numbers were calculated considering the volume of financed goods for the entire market (1,5 billion euro) and the volume financed by each of the companies

Source Mediafax – Financial Directory 2005

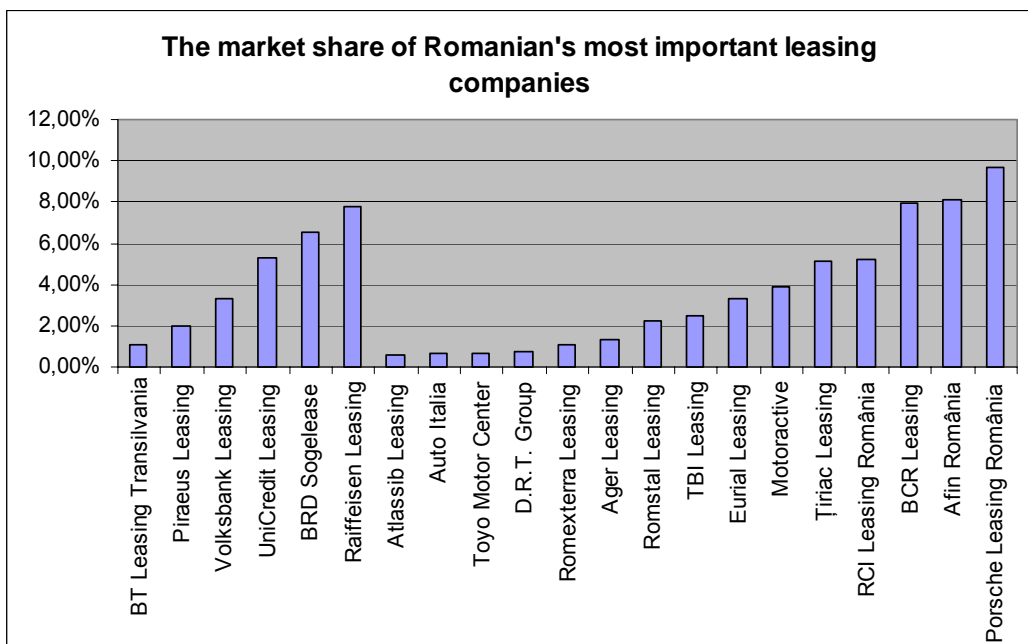
Table 6 Company members of the ALB – 2004

<i>Company</i>	<i>Market share at ALB level*</i>	<i>Value of financed goods (million euro)**</i>	<i>Market share at market level***</i>
<i>Alpha Leasing</i>	-	-	-
<i>BRD Sogelease</i>	18.00%	98.00	6.53%
<i>UniCredit Leasing</i>	14.58%	79.34	5.28%
<i>Piraeus Leasing</i>	5.51%	30.00	2.00%
<i>Finans Leasing</i>	-	-	-
<i>Volksbank Leasing</i>	9.19%	50.00	3.33%
<i>Raiffeisen Leasing</i>	21.50%	117.00	7.80%
<i>HVB Leasing</i>	-	-	-
<i>BT Leasing Transilvania</i>	2.90%	15.79	1.05%
TOTAL, company members of the ALB	100%	544	36.26%

* The numbers were calculated according to the data offered by the companies and the total volume of goods financed by the ALB

** The data was supplied by the companies

*** The numbers were calculated considering the volume of financed goods for the entire market (1,5 billion euro) and the volume financed by each of the companies



Note that bank subsidiaries and captive societies belonging to dealers like Porsche, Iveco or Renault occupy the first positions. Motoractive, TBI Leasing, Romstal leasing and Ager Leasing are the only independent companies who have found a place between the top ten companies of the ASLR.

This polarization is natural because a small sized leasing company as well as a recently funded one cannot overcome the classification, winning a strong position on the market depends greatly on the financial power and the involvement of the shareholders in the activity of the company, simultaneously with an approach of the segments with great development opportunity such as equipment or real estate.

The present configuration of the market is determined not as much by the efficiency of the large companies as by the incapacity of the smaller, especially the independent ones, to raise funds from banks, either due to a weak capitalization or because they weren't able to find a suitable niche on the market. The large weight of companies, subsidiaries to the banks in the market is a consequence of the accessibility to competitive financial resources and a larger clients base.

In the perspective of joining the EU, leasing is expected to evolve in the direction of a stronger structuring of the market between companies affiliated to banks or with a bank status, belonging to manufacturers and independent companies.

The concentration trend of the market is also confirmed by a study of the ALB showing that half of the leasing market belongs to companies subsidiaries to banks, while captive and independent companies have a share of 33% and, respectively, 17%. Together with the nine companies belonging to the ALB, the study has also taken into account the data of BCR Leasing, Romexterra Leasing, Egnatia Leasing, D.R.T. Leasing and Immorent. According to the data of the ALB, contracts that were closed last year by its nine companies represented at the time about 75% of the total volume of contracts financed by all leasing companies affiliated to banks.

Figure 3 The structure of the leasing market depending on the type of company, 2003

- Companies subsidiaries to banks 47%
- Independent companies 17%
- Captive companies 36%

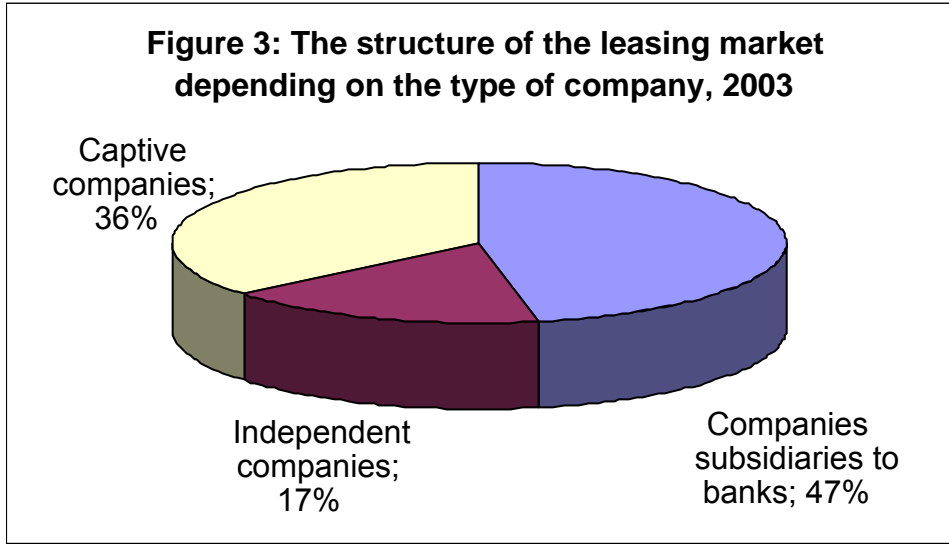
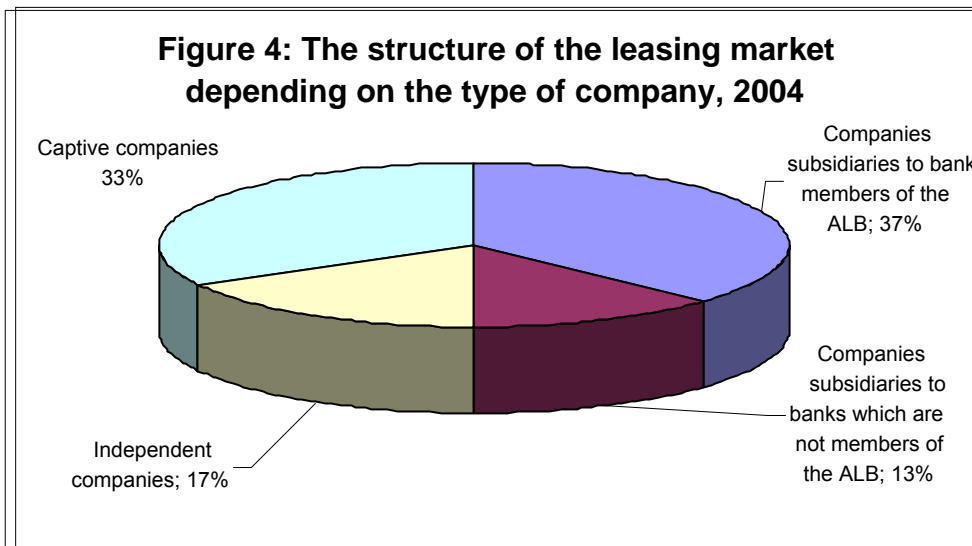


Figure 4 The structure of the leasing market depending on the type of company, 2004

- Companies subsidiaries to bank members of the ALB 37%
- Companies subsidiaries to banks which are not members of the ALB 37%
- Independent companies 17%
- Captive companies 33%



3.2 The portfolio of leasing companies in Romania

The different shareholder – types bank, automobile manufacturer, or investors – influences the portfolio of financed goods.

The access to considerable and competitive financial resources for periods exceeding three years, the capacity to analyze a good business plan, risk reducing management strategies or the sales policy in the particular case of captive companies all ensure availability for financing well defined categories of goods.

Table 7 The portfolio of the ASLR and ALB members depending on the financed goods

	<i>ASLR</i>				<i>ALB</i>	
	<i>2002 *</i>	<i>2003 *</i>	<i>2004</i>	<i>Trim I. 2005</i>	<i>2004</i>	<i>Trim. I 2005</i>
<i>Auto</i>	75.30%	87.84%	92.67%	91.47%	70%	72%
<i>Equipment</i>	23.86%	10.46%	7.07%	7.71%	26%	25%
<i>Real estate</i>	0.84%	1.7%	0.26%	0.82%	4%	3%

* Alpha leasing, BRD Sogelease, HVB Leasing and UniCredit leasing, companies presently reunited in ALB, were in 2002 and 2003 also members of ASLR.

Source Mediafax – Financial Directory 2005

At ASLR level, an organization reuniting 33 members at the end of the first quarter of 2005 compared to 37 members at the end of 2004, 75% are independent leasing companies, 15 % are leasing companies affiliated to manufacturers or goods suppliers and 10% are leasing companies subsidiaries of banks. The structure of leasing contracts at ASLR level depending on the object of the contract is shown in table nr 8.

Table 8 The structure of leasing contracts depending on the object of the contract

	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>Trim. I 2005</i>
<i>Vehicles</i>	75.30	87.84	92.67	91.47
<i>Cars</i>	33.70	56.25	61.06	72.02
<i>Auto utilities</i>	41.60	31.59	31.61	19.45
<i>Commercial vehicles</i>				
<i>Busses</i>				
<i>Industrial equipment</i>	10.06	5.90	4.04	5.18
<i>Agricultural equipment</i>	6.40	2.32	0.67	0.21
<i>Planes / ships</i>	-	0.03	-	-
<i>Rolling material - railways</i>	-	0.02	-	-
<i>Other (office materials medical technique)</i>	7.40	2.19	2.36	2.32
<i>Real estate – office</i>	0.84	1.60	0.21	0.57
<i>Real estate – residential</i>	-	0.10	0.05	0.25

Source: ASLR reports

In case of companies reunited in ASLR the segment of auto vehicles dominates leasing operations representing 92.67% in 2004. Automobiles have won for themselves 61.06% followed by auto utilities, commercial vehicles and busses with 31.61%. On the following positions we find industrial equipment with a 4.04% quote, farming equipment with 0.67%, while real estate represents only 0.26%. In contrast with the preceding years, a considerable drop of equipment finances can be noticed. The downward trend in this segment at ASLR level can be explained through the fact that companies such as Alpha leasing, BRD Sogelease, HVB Leasing and UniCredit Leasing, presently constituents of the ALB, have been members of ASLR in 2002 and 2003.

Table 9 The structure of leasing contracts depending on the object of the contract (at ALB level)

	2004	Trim. I 2005
<i>Auto vehicles, of which:</i>	70.87%, of which:	72.78%, of which:
<i>Automobiles</i>	54%	55%
<i>Heavy auto vehicles</i>	34%	35%
<i>Light auto vehicles</i>	10%	10%
<i>Equipment</i>	25.87%	24.26%
<i>Real estate</i>	3.26%	2.96%

Source: ALB reports

In the case of companies reunited in the ALB, the automobile segment owns a smaller share of about 70%. Of these, 54% are automobiles, 34% heavy commercial vehicles, 10% light commercial vehicles and 2% other types of vehicles. Here we can see a diversification of the portfolio, industrial equipment owning about 26% of the total finances and the real estate segment holding 4%. This type of structure reflects the profile of the companies affiliated to banks addressing at the same time all economical branches. The companies members of the ALB have total assets of 645.6 million euro and over 350 territorial branches. ALB leaders estimate a value of approximately 806 million euro for the bank leasing market at the end of 2005.

First quarter operations in 2005 haven't been able to bring about major changes in this direction.

4. Conclusion

Leasing plays a very important role in the investment conduct, having a significant importance for the economy as a whole and contributing in a positive manner to the general economic situation.

In Romania, the leasing can not be cheaper than the loan, for the simple reason that the majority of the leasing companies are financed by the banks in order to be able to purchase the goods that will make the object of the future contracts. According to LCAR estimations, at present, the banks require, as an average, an interest of 8 - 9% in foreign currency, while leasing companies apply an average of 11 % interest.

The cost of the leasing is influenced by the credit risk of the enterprise. This is the reason why, it is more convenient to make an individual comparison of the cost of the two forms of finance, by taking in consideration the profile of the beneficiary enterprise and, at the same time, the residual value risk taken by the lessor and the credit availability (a rational enterprise can be determined to accept a high price in order to give up its investment project).

As opposed to the financial leasing, in which case the locator presents the value of the leasing installment value, as well as the deducted value of the leasing installments in liquidations and interests, as far as the operational leasing is concerned, the debit installment is rarely known by the beneficiary of the loan, because this information is not made known by the locator through other means but the installment graphic, and not as a interest installment, as the bank creditors do.

Also, the comparison of the costs of the two forms of finance (loan or leasing) has to be drawn up upon the cost after tax. Due to this aspect, the integral deductibility of the leasing installments, an aspect valid in Romania just as far as the operational leasing is concerned, can represent an argument concerning the usage of leasing¹¹, unlike the bank loan, in which case just the expanses with interest are deductible (the enterprise has the right to liquidate the good and to deduct the endowments from the liquidations).

Another advantage of the leasing is that it improves the structure of the balance sheet of the enterprise. Even if this argument is often quoted by the lessors to justify the enterprises' motivation in choosing the leasing, considering the present approach of the leasing's accounting. Even if this leasing variant is not registered in the balance sheet of the lessee enterprise, this form of financing is considered as being an indebtedness form and treated accordingly by the financial institutions and by the financial analysts, regardless of the mean of reflection in the financial situations.

Even if the advantages which incite to the usage of the leasing exist, the enterprise can limit the resort to this form of financing and prefer instead the

¹¹ This aspect is applied only if the leasing installments are normal: the residual value shouldn't be too small, because, in this case, the leasing installments grow, thus growing the deductible expenses as well. If the leasing installments are decreasing, they must have a similar value to the fiscal liquidations which would have been used if the enterprise was the owner of the good; the value of the leasing installments paid in the first year must not overcome 50% of the total installments value, if the duration of the contract is 3 years, 40% for a 4 year contract and 38% for a 5 year contract.(A. Maheu, C. Maige(1998)-*Op.cit.*)

bank loan, if the extreme negative effects of the leasing are high. They refer, in principal, to the loss of the operational flexibility of the utilizing enterprise.

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