# TAXATION IN ROMANIA

*Radu Nechita*

In 2003, when its government published the draft of the first Fiscal Code, Romania seemed to start its own fiscal revolution. Indeed, the document was supposed to include all tax regulation and to prevent its instability. Even more surprising, the social-democrat government proposed a 19% flat tax, supposed to replace the progressive taxation on personal income (with a marginal rate of 40%). Then, reality happened. The government abandoned the flat tax project, to the great benefit of the opposition, which won 2004 elections and implemented in 2005 a 16% flat tax on personal and corporate income tax, miraculously still in force today. And, despite the measures supposed to prevent this, the Fiscal Code was amended more than 100 (one hundred) times during the first decade of its life. The amendments were made only exceptionally by the Parliament (law) and at least six months before their enforcement (as required by art. 4 of the Fiscal Code). Most of the changes were initiated by the government, via "emergency ordinances", enforced immediately or in a couple of days (if not retroactively).

## Structure and level of taxation

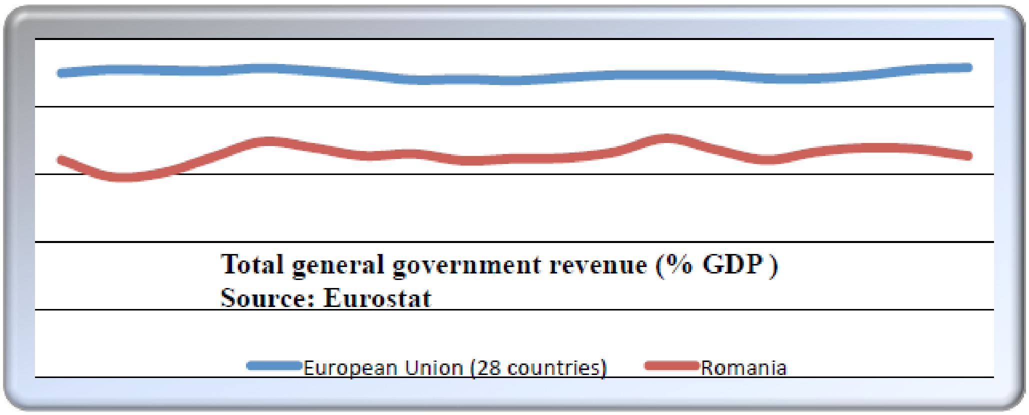
During the last twenty years, taxation level – as a percentage level of GDP – remained relatively low and stable in Romania. It oscillated between 29.6% (in 1996) and an exceptionally 35.3% (in 2007), but only between 32% and 34% since its accession to EU. This situates Romania about 10% lower than EU average, and constantly among EU countries with the lowest level of fiscal pressure. However, a more detailed analysis would challenge the superficial impression that Romania has a favorable fiscal environment.

Usually, politicians and mass media complain about the low level of the fiscal pressure, which they designate with the expression "budgetary revenues". This is not conceptually wrong; it is just taking the side of the Ministry of Finance rather than taxpayers'. Therefore, almost all dysfunctions in public services are attributed to "insufficient budgetary revenues", suggesting at least implicitly that a solution to Romania-EU gap is an increase in taxation level.

However, the evolution of total taxes collected by Romanian government shakes the credibility of this interpretation. Romania's total tax revenue increased from the equivalent of 3.6 billion Euros in 1996 to 21.9 billion Euros in 2013, with a maximum of 27 billion Euros in 2008. Neither quantity, nor quality of public services matched this over six times increase in the amount of collected resources. This suggests that most of Romania's public sector's problems are on the spending side.

There are other relevant facts to take in account before interpreting T/GDP ratio. A significant part of Romania's economy is outside the monetized zone covered by official statistics. For example, almost half of households are in rural area and most of them are involved in subsistence agriculture or connected mostly to unofficial markets. Underground economy's relative weight is among the highest in EU. Out of an official population of 19 million (including about 2 million emigrants), there are only 4-5 million registered jobs, but unemployment rate is among the lowest in EU. Romania has also one of the lowest number of companies compared to its population and one of the lowest rate of founding new companies. All these suggest an uneven distribution of fiscal pressure and, therefore, a low representativeness of T/GDP ratio for the entire Romanian economy.

*Figure 1. Total government revenue (% of GDP) in Romania and EU 28*



## Taxes on consumption

There is a debate if there are any "consumption taxes" at all. Some economists argue that, in the end, all taxes fall on production factors (mostly labor and capital, in a simplified analysis). The argument is as follows: If the consumer pays a product/service according to its marginal utility, any increase in "consumption tax" will diminish production's factors net yield. Going further, it's obvious that taxes are paid, eventually, by real people, not by unanimated objects (land, machinery) or "legal persons" like companies. In this approach, taxes are paid by production factors' owners: either by workers or by various types of "capitalists" (from wealthy investors to simple owners of a pension fund or a life insurance).

However, conventional classifications differentiate between taxes that target directly production factors (taxes on labor, on capital etc) and taxes that hit them in a more indirect way, labeled "consumption taxes" (VAT, excises, sales taxes). Usually, economists agree that the former represent a higher burden on long run economic growth and consider therefore the later as less damageable.

Since 2000, the ratio "Taxes on consumption / GDP" is slightly higher than EU average in all but three years. This trend is expected to continue, but with a higher gap after 2011, when VAT rate was sharply increased, from 19% to 24%. This 26.31% "jump" of the VAT rate was followed by an increase in collected taxes equivalent to 1.3% of the GDP (reaching 12.6% in 2011 and 12.8% in 2012, compared to 11.3% in 2010).

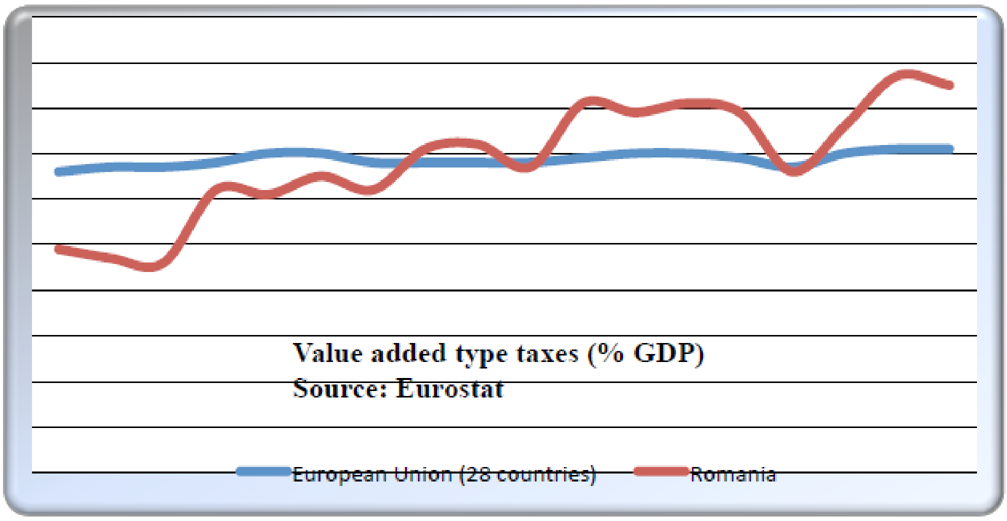
Government reliance on consumption taxes is better illustrated by their share in total taxation, which reached 45.1% in 2012, its maximum level since 2000. During this period, this indicator was always at least 10% higher than EU average. Only Bulgaria and Croatia register a higher value than Romania over the entire period and very few other countries in more than two years (Cyprus and Malta).

These figures suggest that Romania's tax structure is "pro growth", at least according to this criterion and compared with other EU members. Unfortunately, economic growth needs more, much more, than the prevalence of consumption taxes over alternatives funding sources for the government.

One characteristic of Romania's indirect taxes (mostly VAT and excises) is that they are included in the retail price. This means that taxpayers are less aware of the total amount of indirect taxes paid in one year (in contrast with taxes on personal income or real estate), even if the receipts offer all the details.

Because payments are "hidden" in the total price and they are split in numerous transactions spread along the year, these indirect taxes are not "painful" for taxpayers. They underestimate systematically their cumulated amount and, indirectly, the real cost/price of public goods. The result is, ceteris paribus, a higher demand for public services compared to an environment with a more "transparent" and "painful" way of financing them.

*Figure 2. Value added type taxes (% of GDP) in Romania and EU 28*



**Taxes on income**

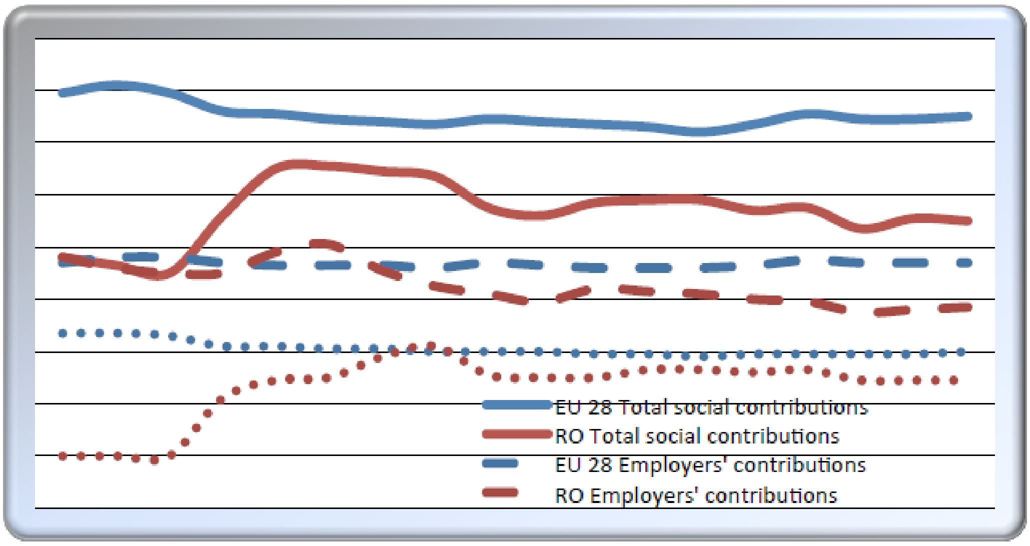
The diminishing trend of income taxes, as a percentage of GDP, started well before 2005, when Romania adopted the 16% flat tax on personal and corporate income. During the last fifteen years, the receipt of income taxes is relatively stable, around 6% of GDP, which represents half of EU 28 average. Since mid-nineties, personal income tax receipts diminished continuously, from about 7% of GDP close to 2% of GDP in 2005. The trend is reversed afterwards, approaching 3.5% of GDP in 2012. Further research is needed to clarify if this happened despite or because of the flat tax. Since 1998, corporate income tax receipts diminished from about 4% of GDP to 2.2% in 2012.

## Social contributions

As many other countries, Romania maintains the fictive difference between employers' and employees' social contributions. From an economic point of view, they both represent a component of the marginal cost of labor factor. The employer will hire the employee if and only if employee's marginal productivity equals or is higher than its marginal cost. This means that the value of employee's work is not only gross salary but gross salary plus the so-called "employer's social contributions".

Since 2008, Romania introduced "the second pillar" of public pension system. Contrary to the "first pillar", which is a pay-as-you-go system, the second pillar is privately administrated on the capitalization principle. Contributions are mandatory, but they are directed on individual accounts, administrated by private pension fund administrators. The contributions are set to increase from 2% in 2000 to 6% in 2016, with a corresponding decrease of "employees' social contributions". The third pillar (capitalization principle, voluntary contributions) has not reach yet a relevant size.

*Figure 4. Actual social contributions – total, employer, employee (% of GDP) – RO and EU 28*



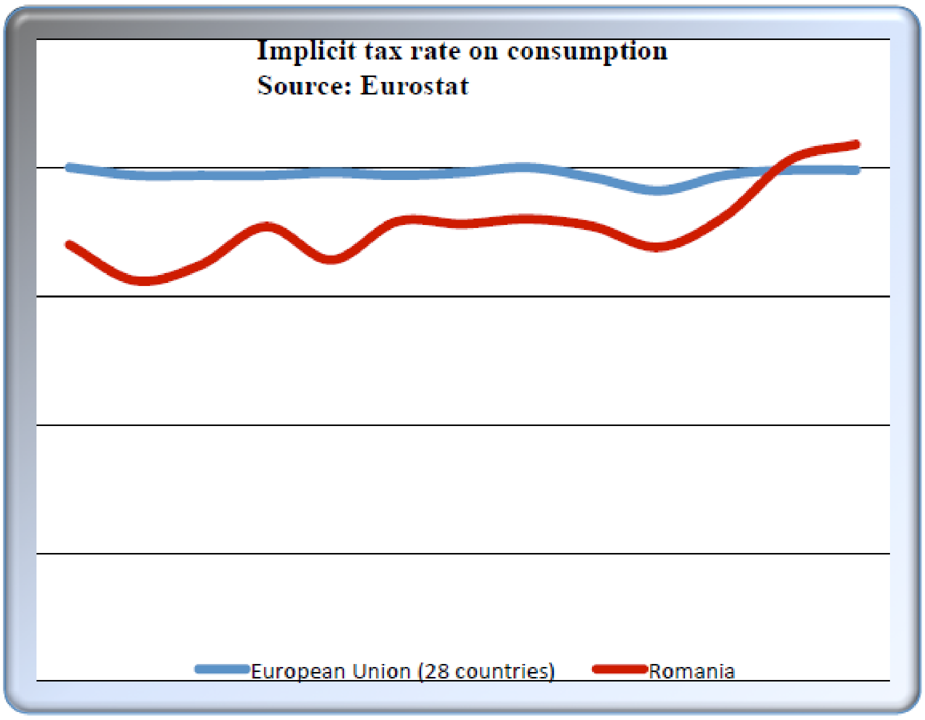
**Implicit tax rates**

In Romania, like in other EU countries, various taxes have the same base (for example, social contributions), deductions and exemptions concern personal and corporate income tax etc. This means that statutory tax rates are less suited for international comparisons than implicit tax rates.

***Implicit tax rate on consumption***

Until recently, ITR on consumption was below EU average with about 2% since 2000. The situation changed in 2011, with a sharp increase in VAT from 19% to 24%, almost the maximum allowed in EU. In 2012, ITR was 1% higher than EU average, reaching 20.9%. The measures taken or proposed to reduce VAT on some specific products (bread, for example) are not expected to change this situation anytime soon, since government plans no significant reduction in normal VAT rate. Excises – still at a lower level than EU average – are set to increase, according to the time schedule agreed by the Accession Treaty. Besides these pre-set increases, government introduced recently (2014) "supplementary excises" on gasoline and Diesel.

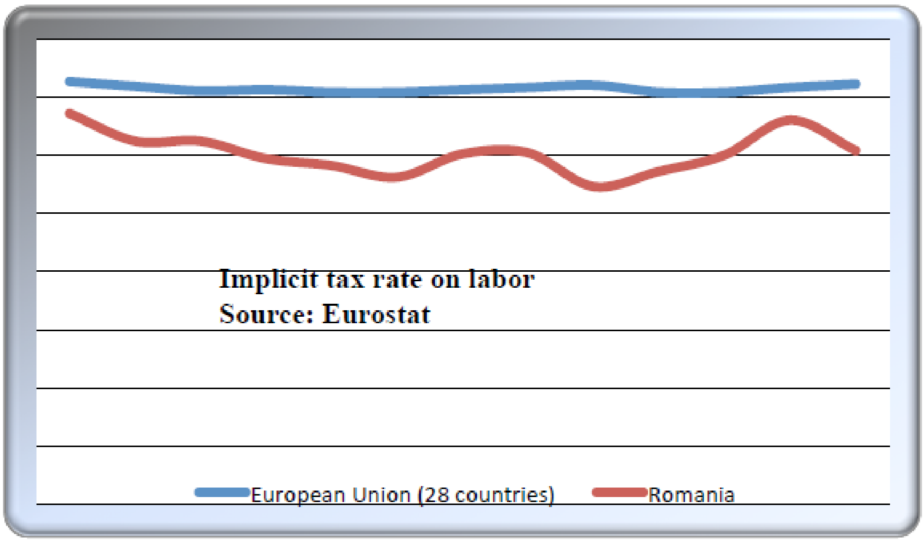
*Figure 5. Implicit tax rate on consumption in Romania and EU 28*



### *Implicit tax rate on labor*

Since 2000, ITR varied between 27.3% (in 2008) and 33.6% (2000), always below EU average (with 2.8-8.7%). The last available figure (30.4% in 2012), is almost 6% below EU average. This situation could be misinterpreted because it combines the effect of a relatively low level of personal income tax (16% of taxable income) and a high level of social contributions. Contributions to the pay-as-you-go public pension system are their most significant component. The distantly second is health insurance contribution. Both have a very low social acceptance because their public service counterpart is correctly perceived as illusory. For example, the dependency ratio for the public pension system is about 1, with no realistic perspectives of improvement, which undermines the credibility of the so-called inter-generational social pact. The gratuity of public health is in large part a myth believed only by those without any interaction with public hospitals.

*Figure 6. Implicit tax on labor in Romania and EU 28*



***Implicit tax rate on capital***

This represents the ratio between collected taxes on capital and the aggregate income from capital and savings of residents, at worldwide level. This ratio varies for most EU member states between 10% and 25% of GDP. The exceptions are Italy and France (over 25%) and the Baltic States, Netherlands and Ireland (5-10%).

Eurostat offers no information concerning Romania's ITR on capital, because there are no available comparable data concerning the capital tax base for 1995-2013 period.

Taxes on capital oscillated between 4.8% and 5.5% of GDP in 2000-2008 period and are below 5% of GDP ever since (4.2% in 2012). This represents slightly over the half of the EU average (8.2% in 2012).

**Administrative fiscal burden**

A very convincing illustration of the fact that Romania is definitely not a "fiscal paradise" is offered by its rankings in World Bank's "Doing Business" reports, especially after 2007, since when the general index takes in account the component "Paying taxes".

According to the ease of doing business, Romania's general rank improved until the crisis – the best ranking was 47, in 2009 report – when the trend was reversed. The result is that in 2014, Romania's rank (73) is similar to the one it had a decade earlier (76 in 2006 report).

In all this period, the "Paying taxes" rank was significantly lower than the general rank, with a maximum gap of 99 places (2009 report). The gap is narrowing continuously since then, reaching a minimum of 61 places in the last available report (2014). This was the combined result of two trends:

- A deterioration in the general ease of doing business;
- An improvement in the fiscal component of this index.
-

This improvement in "Paying taxes" is reflected by the continuous reduction in Romania's "distance to the frontier". This represents the relative level of a country compared to the best practice among 189 countries benchmarked by Doing Business report, considered to be 100%. According to the 2007 report, Romania was at about 40% of the best practice in "Paying taxes" in 2007 report and at 60% in the last edition available (2014). However, narrowing the gap with best "Paying taxes" practices didn't reflect in Romania's rank according to this indicator: In 2014 report, its rank is almost the same (134) as in 2007 edition (131). This suggests that there is a fiscal competition at worldwide level and that Romania is not very successful in this aspect of business environment.

Romania's rank in "Paying taxes" – 134 out of 189 economies – means that there are more than twice as many countries with a better fiscal environment than countries with a worse than the Romanian one.

Even more, this comes after a significant improvement in "paying taxes" rank (20 places) since 2012 report, attributable mostly to the reduction of the yearly number of fiscal payments (from 113 to 39). The reform was anything but complex: since then, all social contributions payments are collected (monthly) in one single account and fiscal authorities split them into various funds (public pension system, health care, unemployment, sick and leave, risks and accidents etc.).

Since 2006 edition, "total tax rate" – as calculated by Doing Business report – diminished continuously from 55.8% to 42.9%. Even compared to other EU countries, this taxation level hardly represents a competitive advantage for Romanian business environment, and it doesn't qualify this country as a tax competition leader. The time spent for tax conformity varied erratically over the period (between 190 and 222 hours/year), which suggests the lack of an effective strategy to reduce this component of the administrative burden. If France needs 132 hours/year, why Romania needs 200? Why not 80-83 days, like Estonia, Ireland and Norway? Or even 55 days, like Luxemburg?

The number of yearly days needed for tax conformity takes in account only partially the high level of instability, ambiguity, unpredictability and arbitrary of Romanian legislation in general taxation in particular. There are about 800-900 annual issues of the official gazette (*Monitorul Oficial*), almost three per day. As mentioned in introduction, since its apparition a decade earlier, Fiscal Code was amended more than 100 times, which means almost a monthly modification. A good illustration of legislative ambiguity can be found in its article 4:

"*Al. 1. The present Code shall be modified and completed only by Act of Parliament, adopted,* ***as a general rule / usually****, six months before its enforcement.*

*Al. 2. Any modification or completion to the present Code shall be enforced in the first day of the year following that in which it is adopted by Act of Parliament.*"

Article 4 is supposed to be a shield against arbitrary changes in taxation, but it is actually meaningless: the so-called *general rule* has never been applied since the Fiscal Code exists. Moreover, most of the changes are made by emergency ordinances; some of them followed and even modified by other emergency ordinances only a couple of days later. Many modifications are not trivial: the VAT increase from 19% to 24%, the introduction or the elimination of new taxes or tax exemptions etc. were made via emergency ordinances.

The last significant example to date is the brand new "tax on special buildings", which can be almost everything, from a pool or a concrete yard to pipelines and electric pillars. A very particular source of uncertainty is represented by the "enforcement decrees" ("*norme de aplicare*"), supposed to explain laws and ordinances, but often, they modify their content and/or are published after the legislation is supposed to be enforced.

**Level of fiscal decentralization**

According to the first article of its Constitution, Romania is a "unitary and indivisible state". Local administration means mostly municipalities and 40 counties plus Bucharest. Since 1998, there are also regions (not even mentioned in the Constitution), with a confusing status (they are NGO's) and insignificant power.

Local budgets revenues are local taxes, transfers from state budget and donations.

According to Fiscal Code (art. 248), local taxes are: real estate taxes (on buildings and land), taxes on vehicles (cars, boats etc.), on delivering certificates and authorizations, on advertizing, on shows and on hotel customers. The enumeration ends with "special taxes" and "other local taxes", which allows sometimes for imaginative solutions adopted by local authorities.

Local taxes' level is established in a rather detailed manner by central authorities (Fiscal Code). For example, real estate taxes are differentiated according to 12 types of buildings, 6 ranks of municipalities and 5 zones for every one of them. The corresponding level of taxation is then modified (or not) according to 3 types of age and increased if building area is superior to 150 square meters (with 5% for every 50 square meters or fraction).

Deliberative local authorities can increase local taxes up to 20% relative to their maximum level, established by the central authorities (Fiscal Code).

There is no fiscal competition or fiscal federalism in Romania. Transfers from state budget to local authorities take two main forms: a percentage of collected personal income taxes ("*cote defalcate din impozitul pe venit*") and subsidies. The first category follows some specific rules, detailed by the Law of local public finances (273/2006), but subject to year-by-year modifications. For 2014, 41.75% of collected personal income tax is redirected to the municipalities where the taxpayers performs their activity, 11.25% to the county budget and 18.5% are to be redistributed at the county level between its municipalities. (Bucharest benefits from the same total of transfers – 71.5% – but their allocation follows specific rules).

This allows for a significant power of central government over local authorities. The process takes the form of political allocation of public funds, which creates favorable conditions to corruption (See Expertforum, 2014 for details).

The limited fiscal autonomy of Romanian local authorities is illustrated by the structure of budgetary revenues. Almost two thirds of their total amount represent central government revenue, while local government revenues barely reach 4%. (EU, 2014, p. 135).

**Conclusions**

Analyzing Romania's fiscal environment according to the most common indicators could lead to the conclusion that this country has one of the mild taxation in EU. The fiscal pressure ratio (total taxes on GDP) is about 10% lower than EU average. Personal and corporate income taxes are at a flat 16% level, and have a relative low share in government revenues (almost half of which relying on indirect taxation). However, social contributions rates are above EU average, but the amount collected (relative to GDP) is lower than EU average. These contributions have a low social acceptance not only because their high rates but also because of the poor quality of their corresponding public services.

A more accurate analysis of Romania's tax system must take in account the administrative burden, which adds to the "monetary" fiscal burden. Compliance costs remain high and fiscal legislation is instable and unpredictable. This is illustrated by the more than one hundred modifications of Romanian Fiscal Code, since its adoption in 2003.

Recent improvements in this field (reduction in number of fiscal payments) were mentioned in World Bank's Doing Business reports, but a stable and predictable fiscal legislation remains up on taxpayers' wish list.

## References

European Union (2014), Taxation trends in the European Union. Data for the EU Member States, Iceland and Norway. 2014 Edition, Luxembourg, http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2014/report.pdf

Eurostat (2014), "Main National Accounts Tax Aggregates".

Eurostat (2014), "Implicit Tax Rates by Economic Function".

Eurostat (2014), "Government revenue, expenditure and main aggregates".

Expert Forum (2013), "Raport Anual Special: Clientelismul politic în alocarea de fonduri către primării și în sifonarea de resurse din companii publice", full text in Romanian: http://expertforum.ro/extra/harta-bugetelor/EFOR-rap-anual-2013.pdf and abstract in English: http://expertforum.ro/en/clientelism-map/

Law 571/2003 on the Fiscal Code, *Monitorul Oficial*, No 927, December 23rd, (With all its modifications).

Law 273/2006 on local public finances, *Monitorul Oficial*, No 618, July 7th, 2006, (with all its modifications).

World Bank, Doing Business reports, editions from 2004 to 2014, www.doingbusiness.org