Fiscal Council's opinion on the draft Emergency Ordinance amending and supplementing Law no. 227/2015 regarding the Fiscal Code

On the 27th of October 2017, the Ministry of Public Finance (MPF) remitted to the Fiscal Council (FC) the letter no. 714901/26.10.2017, requesting the Fiscal Council's opinion on the draft Emergency Ordinance for amending and supplementing Law no. 227/2015 regarding the Fiscal Code.

It is relevant to this case article 21 of the Fiscal Responsibility Law no. 69/2010 republished (FRL), according to which *„proposals for any legislation leading to a reduction of budgetary revenues must provide a financial statement according to article 15 of Law no. 500/2002, as amended and supplemented and meet at least one of the following conditions:*

(a) To have the endorsement of the Ministry of Public Finance and of the Fiscal Council, confirming that the financial impact was taken into account in the budgetary revenue forecast and does not affect the annual budget targets and medium-term targets;

(b) To be accompanied by proposals for measures to compensate the financial impact, by increasing other budgetary revenues."

Short description of the legislative proposal and its budgetary impact

The amendments with relevant budgetary impact introduced by the draft Emergency Ordinance are as follows:

1. Social Contributions:
    a. The number of social contributions is reduced from 6 to 3, two of which are exclusively payable by the employee (social security contribution - SSC and health insurance contribution - HIC, of 25% and 10%, respectively), the employer paying only the newly created employment insurance contribution (EIC) of 2.25%. Compared to the current situation, where the aggregate level of social contributions for normal working conditions is 39.25% (of which 16.5% paid by the employee and 22.75% paid by the employer), the proposed aggregate level of social contributions in the draft normative act is 37.25%.
    b. The basis of calculation for social contributions for individuals who obtain income from self-employment is modified and the exceptions to the obligation to pay them are extended:
        i. In SSC case:
            - There is no obligation to pay SSC by individuals who earn monthly income from self-employment below the minimum wage level and, also, by those who already earn salary income or assimilated to salary for which they are insured in the public system;

- The new SSC rate of 25% is established at an income chosen by the taxpayer, at least equal to the country's gross minimum wage, regardless of the level of income achieved, compared to the current situation where the minimum level is 35% of the gross average salary used to substantiate the social security budget (SSB).

ii. In HIC case:

- There is no obligation to pay HIC by individuals who earn monthly income from self-employment below the minimum wage level and, also, by those who already earn salary income or assimilated to salary for which they are insured in the public system;
- The basis of calculation for the new HIC of 10% is limited to the minimum wage on the economy.

2. Income tax:
    a. The tax rate is reduced from 16% to 10%;
    b. There is a substantial increase in the amount of personal deductions granted in fixed amount (from a current range of 300-800 lei, depending on the number of dependents persons, to a range of 510-1,310 lei); the level of gross salary according to which they are granted is rescaled: the salary level up to which the personal deductions are granted in fixed amount increases from 1,500 lei to 1,950 lei (in line with the increase in the minimum wage from 1,450 lei to 1,900 lei), and the salary level to which they are granted in a regressive way increases from 3,000 lei to 3,600 lei (in line with the 20% increase in the gross wages necessary to avoid the reduction of the net salary given the transfer of contributions from the employee's burden to the employer);
3. Turnover tax for micro-enterprises:
    a. Increasing the threshold for the taxation system for micro-enterprises (which implies a 1% tax on turnover for firms with one or more employees and 3% for firms without employees) from 500,000 euro to 1,000,000 euro annual turnover, while eliminating the possibility to opt between this system and the profit taxation for companies with a social capital of more than 45,000 lei;
    b. Eliminating the exception regarding the turnover tax on firms that earn income from consultancy and management.

The budgetary impact presented by the MPF has as basis for comparison a revenue projection substantiated on a macroeconomic scenario that appears in line with the autumn projection of the National Commission for Economic Forecasting. From the perspective of this macroeconomic scenario, the issues relevant to the impact assessment mainly concern the behavior of gross salaries in response to the proposed legislative changes (in this case, the almost full shift of social contributions to the employee's burden) and the level of transfers to the Pillar II of pensions:

- The MPF's hypothesis is that the gross average wage will increase additionally compared to the baseline scenario by 21.8% (up to a level of 4.162 lei) under the combined effect of raising the minimum wage (from 1,550 in the baseline scenario to 1,900 lei), a 25% increase in public sector salaries as of 1st January 2018, and the transfer towards the employees from the private sector employers, in the form of a rise in gross wages, of the entire cost savings resulting from the reduction of social contributions from the employer's duty. The computations of the Fiscal Council (see Annex 1) indicate that a 19.9% gross wage increase is sufficient to prevent a nominal reduction in the net wage, without this increase leading to a rise in the gross average wage of the employer[1].
- The transfers towards Pillar II are projected to increase both in the baseline scenario as well as in scenario that incorporates the changes in the Fiscal Code from 5.1% to 6%, resulting in an annual weighted average transfer rate of 5.85% assuming actual transfers on the new quota would become operable from March 2018. The change in this parameter (probably in the sense of reducing the share transferred to 3.75% according to public statements) is mentioned in the explanatory note as a possible coverage source of the impact of the legislative package.

Given the above-mentioned assumptions, the impact of the budgetary measures relative to the baseline scenario for 2018 is:

1. Social contributions:
    a. At the level of contributions from wage revenue (excluding income from self-employment), the change in the aggregate level of social contributions from 39.25% (16.5% for employee and 22.75% for employer) to 37.25% (35% for the employee and 2.25% for the employer) is more than offset by the additional increase of 21.8% in the gross salary (if private sector employers increase gross salaries so that net salaries will not decrease relative to the baseline scenario). Under these assumptions, the income from social contributions would be higher by about 9 billion lei compared to the base scenario.
    b. At the level of social contributions related to income from self-employed activities, by eliminating the obligation to pay SSC and HIC for those earning less than the minimum wage and for those who earn salary income or wage assimilated income for which they are insured in the public system, the number of taxpayers is assumed to be reduced drastically, with about 213.6

[1] The calculation ignores the impact of any personal deductions, as well as the case in which the employee is operating in a tax-exempt sector (such as IT).

thousand in case of SSC (up to only 27.6 thousand taxpayers) and about 305 thousand in case of HIC (up to only 154 thousand taxpayers). Together with this reduction in the number of taxpayers, the change in the applicable SSC and HIC quotas (from 10.5% to 25% and 5.5% to 10% respectively), simultaneously with the redefinition of the calculation bases of the contributions (from a minimum of 35% of the average salary used to base the SSC budget to the minimum wage in the case of SSC, respectively on the level of the income achieved at the minimum wage in HIC) leads to a loss of income from social contributions of about 640 million lei (of which 170 million lei at SSC level and 470 million lei at HIC level).

2. Personal income tax:
    a. The reduction of the tax rate from 16% to 10% is estimated to generate revenues lower than those in the base scenario by about 12.7 billion lei, the income losses at the level of other income than wage being about 1.4 billion lei.
    b. The increase in the level of personal deductions is estimated to generate revenue losses of about 867 million lei relative to the baseline scenario.
3. Corporate income tax
    a. Increasing the threshold for taxation of the micro-enterprises from a turnover of 500,000 euros to 1 million is estimated to generate revenue losses (relative to the baseline scenario) of 214 million lei for the 3 quarters in 2018 (annualized 285 million lei).

The Fiscal Council validates in principle MPF's impact assessments as being in line with the macroeconomic assumptions considered. Together, the proposed the amendments to the Fiscal Code would generate a revenue loss in the consolidated budget of 5.2 billion lei (0.6% of GDP) in 2018 compared to the baseline scenario. In the explanatory note of the normative act, the positive impact of the measures for the split VAT payment, the increase of the payments from the firms for persons with disabilities (GEO no. 60/2017) and the promotion of a normative act modifying the system of contribution to privately managed pension funds. In the opinion of the Fiscal Council, it is difficult to make an *ex-ante* evaluation of the possible revenue surplus that would be generated by the split VAT payment. The additional revenue to the budget from the provisions from GEO no. 60/2017, according to the explanatory note, is already intended to cover the growth of social benefits for disabled adults and the families of children with disabilities, with a net effect only in 2018 (158 million lei), given that some of the increases in benefits occur in the middle of 2018. However, the increase in the gross minimum salary from 1,550 lei in the baseline scenario to 1,900 lei under the conditions of the amendments to the Fiscal Code would generate additional incomes compared to those identified in the explanatory note of the GEO no. 60/2017 of about 240 million lei. Ultimately, a possible limitation of transfers to the pillar II at 3.75 pp of the social security contribution (compared to the baseline assumption of an effective level of 5.85 percentage points in 2018) would have an important impact on the loss of revenue calculated for measures amending the Fiscal Code (generating about 4.1 billion lei additional revenue), implying also a long-term cost associated with a substantial reduction in the amounts accumulated in private pension accounts, together with the increase in the future payment obligations of the public pension system (Pillar I), by increasing the participation share of Pillar I from 77.6% (corresponding to a 6% transfer rate reported at the current SSC level of 26.3%) to 85% (corresponding to a transfer rate of 3.75% equivalent for the proposed SSC rate of 25%). However, the above-mentioned measures still do not cover a minus of about 800 million lei in the level of consolidated budget revenues.

Risks

According to the Fiscal Council, the risks associated with the assessment of the impact of the proposed measures are unusually high – using the hypothesis that the private sector employers will raise salaries by at least 20% above the level that would have prevailed in the absence of the package promotion and which would have recorded a significant increase in gross wage compared to the current year. It is easy to imagine a situation where, in the absence of an explicit obligation in this regard, the employer chooses not to increase the salary of the employee in an amount sufficient to avoid the impact on net salary considered for next year before taking into account the promotion of the normative act in question – he may, for example, choose to increase gross wage in 2018 by only 19.9%, thus ensuring the neutrality of the proposed measures on the net salary compared to 2017, but without ensuring the salary increases that would have been involved according to the baseline scenario, or even if unlikely, he may increase the gross wage to an insufficient amount to avoid the reduction in the net salary. The latest evolution appears as unlikely in the context of a tense labor market, but it is by no means impossible, especially since the degree of labor market tension is different at both branch level and territorial level. In essence, an increase in gross wage lesser by one percentage point to that assumed by the MPF in the impact assessments would generate a higher revenue loss of around 0.1% of GDP than the one estimated by MPF.

Furthermore, a simple calculation reveals that the reduction of the personal income tax rate from 16% to 10%, together with the transfer of social contributions to the employee (with a 2.25% residual to the employer in the form of the insurance contribution for work) and the reduction in their aggregate level of 2 pp contributes only in an absolutely marginal manner to the reduction of the tax burden for the employees, at least at the level of the average gross wage (unaffected by the tax deductions), as the gross wage would increase by 19.9% so that the net salary would remain unchanged compared to the baseline scenario (or the initial level); the change, however, affect the composition of labor income taxation, by strongly increasing the share of social contributions to the personal income tax expense. The calculation presented in Annex 1 shows that to pay a certain net salary, the employer's wage cost falls marginally (by 0.12%) compared to the original scenario, and the tax burden, defined as the amount of social contributions and personal income tax due reported to the employer's costs related to salaries, remains virtually unchanged (it is reduced from 42.86%

to 42.79%). Given the above, the loss of revenue in the consolidated budget compared to the baseline scenario arises almost entirely from the combined effect of income tax reduction from 16% to 10% for other revenue than salaries (pension benefits, agricultural activities, interest, capital gains, etc.), with an impact of about -1.4 billion lei, the increase of personal deductions, with an impact of about -866 million lei, changes occurring in the social security contributions paid by independent activities (-642 million lei), changes in the taxation regime for microenterprises (-214 million lei) and, finally, higher transfers to the second pillar generated by the gross wage increase (assuming the transferred share will remain at the actual effective level of 5.85% in 2018, these transfers would increase by about 2 billion lei).

The above-mentioned elements are also relevant from the perspective of another source of risk arising from the proposed amendments to the Fiscal Code. Thus, according to the Fiscal Council, the exemption from the obligation to pay the social and health contributions granted for the persons who receive income from independent activities but also from salaries or from other income for which are ensured in the public system, creates a fiscal arbitrage opportunity with significant potential consequences. Given the fact that the tax burden on the labor force level remains virtually unchanged, a more favorable tax regime for self-employment and micro-enterprises (specifically, in the latter case is relevant the abolition of restrictions on the applicability of this system for the entities that generate income from consultancy and management) encourages the sub-declaration of the salary incomes. The Fiscal Council also considers as unfair that employees have to pay social and health contributions for all their income, while for the income resulted exclusively from independent activities the tax base is limited to the minimum wage regardless of the income level (so taxing became profoundly regressive - at high incomes, taxation is much lower than at low incomes), especially since the public healthcare package is the same regardless of the source of income. The Fiscal Council considers that a fair and equitable approach would have been to reduce the fiscal treatment gap between wage income and self-employment income as a prerequisite for improving the collection by closing tax optimization "loopholes" and not the proposed measures which involves a massive reduction in the tax burden for self-employment, while that corresponding to the wage income remains virtually the same.

In addition, the massive reduction of personal income tax revenues will greatly weaken the financial position of local authority’s budgets, as many of them have a high degree of dependence on the amounts deducted from the personal income tax.

Last but not least, the major change in tax philosophy by shifting social contributions almost exclusively to the employee, a unique case at least at the level of the EU Member States is not accompanied by a justification that will make this approach credible and acceptable to the social partners.

Conclusions

Considered in isolation, the impact of the fiscal change package implies a loss of about 5.2 billion lei, while an assessment of the compensation measures identified in the substantiation note does not indicate its full coverage. However, such an approach is inappropriate - the identified impact is conditioned by the assumptions about the rise in gross salaries that has as a source of origin inclusively the massive increase in the remuneration of public sector employees under the unitary wage law, with major consequences on the size of budgetary expenditures.

Article 21 of the revised FRL conditions the endorsement of the Fiscal Council by the fact that the impact of the proposed measures was taken into account in the forecast and does not affect the achievement of the annual and medium-term budgetary targets. Considering the above, the Fiscal Council cannot certify, in the absence of a complete budgetary construction, the compliance with the budgetary targets assumed through the Fiscal and Budgetary Strategy and, in essence, a general government deficit under 3% of GDP in 2018 (in fact, the actual budget deficit should fall significantly in the coming years in order to meet Romania's commitments at the European level, especially those related to the Fiscal Compact).

Moreover, the Fiscal Council reiterates its objections regarding the approach according to which the persistency of placing the budgetary deficit in the immediate proximity of the 3% reference level would be a benign phenomenon - not only that such an approach is flagrantly contradictory to the fiscal rules established by national law and the European one (the Preventive Arm of the Stability and Growth Pact, the Fiscal Compact), but such a behavior weakens the position of public finances, depriving it of fiscal space in the event of adverse shocks. In this respect, the Fiscal Council considers that the proposal to amend the Fiscal Code is likely to contribute to the widening of the actual and structural budget deficits.

Considering the above and the identified risks, which appear tilted to higher income losses than the assessed ones, the Fiscal Council does not endorse the proposal to amend the Fiscal Code, failing to certify, in the absence of a complete budgetary construction, the fact that the annual and medium-term budgetary targets assumed by the Fiscal and Budgetary Strategy 2017-2019 will not be overcome, these being anyway incompatible with the domestic fiscal rules and European treaties.

The opinions and the recommendations above mentioned by the Fiscal Council were approved by the Chairman of the Fiscal Council, according to Art. 56, para (2) letter d) of the Law no. 69/2010 republished, after being approved by the Council members through vote, on 3rd November 2017.

3rd November 2017

Chairman of the Fiscal Council,

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ANNEX 1

Table 1: Comparative analysis of the change in labor taxation					
	Tax rates, % current legislation		**Tax rates, % proposed amendment**		**Percent change, %**
Gross salary		100.00		119.90	19.90
SSC employer	22.75	22.75	2.25	2.70	-88.14
SSC employee	16.50	16.50	35.00	41.96	154.33
Income tax	16.00	13.36	10.00	7.79	-41.67
Total employer cost		122.75		122.60	-0.13
Net salary		70.14		70.14	0.00
Total contributions		39.25		44.66	13.79
Income tax		13.36		7.79	-41.67
Total taxes		52.61		52.46	-0.29