The Fiscal Council's opinion on the draft Emergency Ordinance regarding the regulation of some fiscal measures (reduction of the personal income tax for dividends revenue, extending the application scope of the reduced VAT rate of 9% for delivery of potable water and irrigation water for agriculture)

On 26th October 2015, the Fiscal Council received from the Ministry of Public Finance by letter no. 678949/22.10.2015, the draft Government Emergency Ordinance (GEO) regarding the regulation of some fiscal measures and the related explanatory note, requesting the Fiscal Council's opinion under article 40, paragraph (2) of the Fiscal Responsibility Law no. 69/2010[1] (FRL).

From the perspective of FRL, for this case are relevant art. 21 and 22, according to which:

„Art. 21: 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.

Art. 22: The initiatives promoted under article 21 are adopted concurrently with the proposed compensating measures, approved by the Government."

Moreover, art. 53, para. (2), let. e) and f) of FRL states among the responsibilities of the Fiscal Council:

„e) analysis and issuing opinions and recommendations on the annual budget laws before approval by the Government and before submission to Parliament, on the supplementary budgets and other legislative initiatives that may have an impact on the budgetary targets, as well as assessing their compliance with the principles and rules specified in this Law;

f) preparation of cost estimates and issuing opinions on the budgetary impact of the normative ordinances, other than the ones mentioned on (d) and the amendments made on the annual budget law during the parliamentary debates".

[1] Corresponding to art. 53, para. (2) of the Law no. 69/2010 republished.

Brief description of the legislative proposal

The draft version of the GEO received by the Fiscal Council on 26th October contains relevant measures in terms of the fiscal impact deriving from the increase at 100,000 EUR of the ceiling for classifying companies as microenterprises, the differentiation in the applicable tax rates on the microenterprises turnover and the frontloading of the reduction to 5% of the tax rate on dividends for individuals and companies, which, according to the Fiscal Code version approved on September 2015, was scheduled for early 2017. Unlike the version displayed on the web page of the Ministry of Public Finance at the decisional transparency section, neither the draft version of the GEO received by the Fiscal Council, nor the accompanying explanatory note refer to the extending of the applicability of the reduced VAT rate of 9% for potable water and water for irrigation in agriculture. Subsequently to the approval of the proposed regulation in the Government meeting on 27th October in the absence of the endorsement of the Fiscal Council, the latter received the final form of the proposed regulation, which includes amendments to the Fiscal Code, including the extension of the reduced VAT rates mentioned above.

According to the explanatory note which accompanied the GEO, the total impact on revenue in 2016 is equal to -2.05 billion lei and the distribution of the first round impact on individual measures is:

- -300 million lei net effect at the level of microenterprises income tax derived from the aforementioned reclassification and the change in the tax rate from 3% of the turnover at the differentiated rates of 3%, 2%, and 1% when microenterprises have none, one or at least two employees;
- -1,357.2 million lei at the level of the tax on dividends paid to Romanian individuals, where 71.5%, respectively, 970.4 million lei , represents the deducted quota which is incumbent on the local budgets;
- -44 million lei at the level of the tax on dividends paid to Romanian legal entities;
- -110.7 million lei at the level of the tax on dividends paid to non-resident individuals and legal entities;
- -233.8 million lei at the level of the VAT revenues, due to the extending application of the 9% reduced rate for potable water and water for irrigation in agriculture.

Sources of coverage for the budgetary impact

The explanatory note provides an automatic adjustment of the local budget expenditures by the equivalent revenue loss at the level of tax on dividends paid to Romanian individuals incumbent on them after applying deducted quota of 71.5%, the net impact of the first round in the budget balance in 2016 being estimated at a level of -1,077.4 million lei. Also, the explanatory note assesses the budgetary impact of the second round effects to 607 million lei, given that the proposed measures are seen as a source of additional economic growth of 0.05 pp and 19,000 more jobs.

The Fiscal Council validates the assessments made in the explanatory note on the size of the first round effects, but has significant reserves about the estimated additional budgetary revenues due to second round effects, whose size covers more than 55% of the budgetary impact of the first round. If the assessment of additional economic growth of 0.05 pp (about 350 million lei), appears to be perfectly reasonable in terms of size of the fiscal stimulus given an automatic reduction in the size of local budget expenditures (1,077.4 million lei, namely 0.14% of GDP), knowing that the default fiscal multiplier is approximately 0.35, not the same can be said about the assessment of the additional budget revenues which, although has as a source this additional economic growth, end up overcoming it by nearly 1.75 times. It is impossible to imagine how the government could collect 175% of the additional tax base and how such a result could be reconciled in any way with a reasonable set of tax revenue elasticity to GDP change. Also, the assessment of the number of newly created jobs appears to be excessive and inconsistent compared to the stated value of economic growth. The latest projection of National Prognosis Commission asserted a percentage point of economic growth to 30,000 additional employees, which makes appear extremely surprising the number of 19,000 newly created jobs associated with an additional economic growth of 0.05 percentage points. A reasonable assessment of the second round effects on the budgetary revenues would probably indicate their size to be 4-6 times lower than the one stated, namely around 100-150 million lei.

The Fiscal Council has also reserves concerning the assumption regarding the automatic adjustment of the local budget expenditure based on the provisions of art. 20, para 1, letter a) of the Local Public Finance Law no 273/2006, provided that such adjustments are not individualized by category of expenditure and we cannot be exclude higher discretionary income allocations to the local budgets from other budgetary revenues, which, *caeteris paribus* would result in a higher deficit of the state budget and, consequently in a higher deficit of the general consolidated budget.

Conclusions

In the Fiscal Council's opinion, from the predictability perspective it would be inauspicious that, only after 2 months after the adoption of new Fiscal Code and before entering into force, this is amended and, more than that, in a substantial manner. In its opinions published during this year, the Fiscal Council has drawn the attention on the implications derived from expressing the fiscal policy's objectives in terms of structural deficit, and on the fact that the measures enclosed in the new Fiscal Code are likely to lead, in the absence of compensatory measures, to a permanent and substantial deviation from the objectives derived from both the European treaties signed by Romania (the Stability and Growth Pact and the Fiscal Compact), and from the relevant national legislation (Fiscal Responsibility Law no 69/2010 republished). In their terms, the relevant target for the fiscal policy is not the reference level of 3% of GDP for the headline deficit provided by the corrective arm of the Stability and Growth Pact – a value close to this deficit being reserved to some adverse cyclical situations (which is not the case in the present and in the medium term), but the level of the headline deficit consistent with the medium term objective defined as a structural deficit of 1% of GDP according to the combined provisions of the preventive arm of the Stability and Growth Pact and the Fiscal Compact[2]. In perspective, the headline deficit of 2016 consistent with the medium term objective would be about 1.1-1.2% of GDP. Even if officially not enshrined, still given the absence of a medium term fiscal strategy that incorporates the impact of the new Fiscal Code, the commitment to abandon these targets is clear from the public statements of the Ministry of Public Finance and is also indicated by the Fiscal Council and the European Commission assessments. To the effects on the revenue side is added the impact of recently approved wage increases and the impact of those likely from the perspective of the parameters of the draft unitary salary law that the Government intends to move forward, that means most likely a dangerous approach to the reference level of the headline deficit of 3% of GDP in 2016 and an exceeding above this level in 2017, along with the entry into force of the new Fiscal Code.

Most of the budgetary impact (75% of budget revenues, 50% at the deficit level under the hypothesis of automatic adjustment of the local budget expenditures) of the current legislative proposal has as source the frontloading for one year of the deadline for the entry into force of the tax reduction for dividends and therefore involves a major impact on the deficit only at the level of 2016, compared to a baseline scenario in which the measure would came into force in 2017. However, the baseline scenario described above already does not appear to be in conformity with the rules established by art. 6 and 7 of FRL. Given the above arguments and previous opinions issued during the current year, the Fiscal Council cannot approve a legislative proposal that implies a faster and deepening deviation from the pre-existing fiscal rules.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of the Fiscal Council, according to article 56, paragraph (2), letter d) of Law no. 69/2010, as amended and supplemented, after being approved by the Council members through vote, on 2nd November 2015.

2nd November 2015 Chairman of the Fiscal Council,

IONUŢ DUMITRU

[2] Moreover, the medium term objective has already been met in 2014, as the MTO corresponded to a headline deficit of 1.4% of GDP, according to ESA 2010.