Fiscal Council's opinion on the draft Government Emergency Ordinance amending art. 19 of Law no. 571/2003 regarding the Fiscal Code (profit tax exemption for reinvested profits)

On April 21st, 2014, the Fiscal Council received from the Ministry of Public Finances (MPF) the letter no. 668810/18.04.2014, requesting the opinion of the legislative proposal on profit tax exemption for reinvested profits. Meanwhile, the aforementioned legislative proposal was adopted at the meeting of the government on April 23rd, 2014, and subsequently published as G.E.O. no. 19/2014 in the Official Journal no. 308 of April 25th, 2014, without the Fiscal Council's endorsement, required under art. 13 of Law no. 69/2010 (FRL) as amended and supplemented. According to the article of the Fiscal Responsibility Law (FRL) mentioned above "*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."

The case in question is covered by paragraph a) of the law article cited above, given the fact that compensation measures to offset the negative impact on revenues have not been taken.

Clearly, a Fiscal Council opinion on the legislative proposal in question could not be drawn up and adopted within the time frame available until discussion in the government meeting. The Fiscal Council notes that, despite its repeated requests (see *Fiscal Council's opinion on the State Budget law, Social Insurance Budget law for 2013 and the updated version of the 2013-2015 Fiscal Strategy, Fiscal Council's Opinion on the Half-Year Report Regarding the Economic and Budgetary Situation and Fiscal Council's Opinion on the Draft Budget Revision for 2013, Fiscal Council's opinion on the State Budget Law, Social Insurance Budget Law for 2014 and the updated version of the 2014-2016 Fiscal Strategy*) for a reasonable time to analyze the documents on which its endorsement/opinion is requested, the Ministry of Public Finance continues to treat the provisions of the FRL and the Fiscal Council's institution with insufficient consideration.

Brief description of the proposed legislation and of the impact on revenues estimates determined by MPF. General considerations

From a fiscal perspective, the recovery of investment in fixed assets such as technological equipment, in the absence of changes in the Tax Code introduced by the current legislative proposal, is realized by deducting the depreciation expenses from the taxable income, calculated either linear (equal tranches during the equipments' useful life) or accelerated - by deducting in the first year up to 50% from the asset's enter value. The legislative proposal regarding reinvested profit tax exemption for certain categories of fixed assets (technological equipments - machinery, technological equipments and work equipments, as specified in subgroup 2.1 of the Catalog regarding the classification and normal useful lives of fixed assets) equals, from a fiscal standpoint, with the complete recovery of eligible investments in the first year of utilization (limited to the accounting profit from that year); in addition, the depreciation will continue to be recognized as a deductible expense over the useful life of the equipment under the restriction of not applying the accelerated depreciation scheme. This legislative measure is temporary, being applicable to eligible investment made between July 1st, 2014 - December 31st, 2016. Over the long term, the measure appears as fiscally neutral (if we ignore the time value of money): the amount of profit that benefits from the tax exemption is allocated to reserves that become taxable upon their utilization in any form. Also, there is an obligation to keep the equipments for half of their life span, but not more than 5 years.

The legislative measure was well received by the business environment, as it is likely to improve the cash flow of the companies in a time when they are experiencing liquidity constraints. The Fiscal Council appreciates that the measure is appropriate from an economic point of view, but has reservations regarding the size of the budgetary impact on revenues assessed by the Ministry of Public Finances, during the period covered by this facility.

The explanatory note attached to the normative act sent by the Ministry of Public Finances to the Fiscal Council estimates marginal revenue losses (an annualized impact of 0.1% of GDP), of 137.5 million lei in 2014 (only one quarter of profit tax receipts would be affected in the case of the cash budgetary execution), 572.7 million lei in 2015, 604.1 million lei in 2016 and 153 million lei in 2017 (the receipts corresponding to the last quarter of 2016, the last year covered by the facility, are collected in the first quarter of 2017). The document does not explain in any way how the impact assessment was reached. The Fiscal Council's calculations (presented below) indicate the fact that the size of the revenue losses is most likely significantly underestimated.

The Ministry of Public Finances states in the same explanatory note that the budgetary revenue losses generated by the legislative measure will not lead to the increase of the budget deficit, as it will be covered according to the provisions of article 21 from the Law no. 500/2002. The cited article states that 10% of the budgetary credits[1] are retained from being spent and the utilization of this reserve is to be made in the second semester. Basically, in order to meet the budget deficit target, the Ministry of Public Finances intents to offset the identified budgetary revenue losses by reducing some expenses (the specific categories are not specified). However, the reference to the law article cited above does not mean that the authorities are exempted from the responsibility to explicitly identify the specific categories of expenditure to be reduced. Moreover, the bulk of the measure impact is expected not to materialize in the current year – for which the provisions of article 21 of Law no. 500/2002 are applicable, but in the next two years. A medium term fiscal

[1] With the exception of personal, health and social insurance expenses, public debt expenditures, expenses arising from international obligations, amounts allocated from the Contingency Reserve Fund and from the Intervention Reserve Fund.

projection which explicitly incorporates the negative impact on revenues and identifies the compensating spending cuts seems necessary and in its absence it is impossible for the Fiscal Council to endorse that the effects of the proposed measure do not affect the annual and medium term budgetary targets.

In addition, the current situation reflects a drawback in the way the medium term fiscal planning is realized: the programmatic documents are vague and not very transparent in terms of the discretionary fiscal policy measures to be adopted, lacking a commitment to a set of measures explicitly incorporated in the aggregate projections of revenues and expenditures. Thus, the Fiscal Strategy contains a simple statement of intent with respect to a set of fiscal policy measures to be adopted, lacking the impact quantification and the proposed implementation terms while the projected trajectories of the revenues and expenditures aggregates are not consistent with their adoption. Referring to the current case, the last iteration of the Fiscal Strategy has merely listed as a specific objective "the tax exemption, for a 5 year period of the dividends reinvested in machinery and technological equipments, research and development, which are increasing the social capital of the firms where they are shareholders, or are used at the participation to the social capital of other companies and which lead to the creation of new jobs".

An alternative assessment of the impact on budgetary receipts starting from the firms' balance sheets

The Fiscal Council interprets the legislative proposal as allowing the companies to deduct from a fiscal point of view the entire acquisition value of technological equipments in the first year of utilization, decreasing the corresponding taxable profit; considering both the way the fiscal facility is designed and the current economic situation – firms are characterized by liquidity constraints, it is expected that almost all companies which realize eligible investments and which are profitable to use this facility, even if it implies a temporary constraint upon their dividend policy.

In its approach, the Fiscal Council starts from the companies' gross investments included in the F40 form "statement of fixed assets", taking into consideration the impact of the proposed legislative change on deductible expenses. The impact analysis is drawn *caeteris paribus*, considering unchanged the behavior of economic agents after this legislative change, respectively assuming that the same level of investment in technological equipment is achieved as before granting the fiscal facility.

Assuming that this behavior will change in the sense of bringing in the present some investments that should be made in the future, the loss of revenue would be higher than estimated[2].

[2] Clearly, there are possible spillover effects if the planned investments for the period after the expiry of the facility are brought within the range covered by this, but not only they are difficult to quantify, but the net effect on the budgetary revenues would be even more unfavorable on the short term compared to the *caeteris paribus* scenario – deductible expenses would increase, taxable profit would decrease accordingly, with a partial and gradual mitigation on the medium and long term given the additional budgetary revenues due to an increase of the sales volume and the number of jobs that would occur more rapidly than it would have happened in the absence of granting temporary facility.

The starting point of the assessment is the level of tangible assets at the end of 2012, for which are available the most recent reports; the revenue loss estimation starts as counterfactual at the level of 2012 (how much lower would have been the corporate income tax receipts if non-taxation of reinvested profit facility would have applied since that year), going to be brought forward at the level of the current year and extrapolated into the future based on a number of assumptions about the evolution of the amount of eligible investment. The database, containing the balance sheets of companies from Romania in 2012, was interrogated for fixed assets increases included in the category “Technical installations and machinery” (equivalent to gross investments) of the profitable companies from the following sectors: industry, agriculture and telecommunications – which by the nature of their activity are those that invest in eligible equipments from the fiscal facility point of view (subgroup 2.1 from the Catalogue regarding the classification and normal useful life of fixed assets) and for the amount of their accounting gross profit. Given that deductible expenses can only increase up to the limit represented by the accounting profit, we distinguish between companies whose accounting profit covers all gross investment in technical installations and equipment and companies whose accounting profit is lower than the increases of relevant tangible assets. The table below summarizes the results of the query, for the first category of companies being reported the gross investments, while for the second category gross profit is reported as it represents the upper limit for deductibility under granting the fiscal facility:

Year 2012	Industry	Agriculture	Telecom	Total new investments that could benefit from the facility
Total tangible assets increases - technical installations and machinery (companies with gross profit > 0 and investments in technical installations and machinery <= gross profit)	13.399	2.342	0.642	16.383
Total gross profit (companies with gross profit > 0 and investments in technical installations and machinery > gross profit	1.38	0.219	0.106	1.705

Given that the analysis includes strictly those economic sectors at the level of which are located the eligible fixed assets in terms of the fiscal facility, it is reasonable to evaluate the amount of deductible expenses after the application of the facility as representing the amount of tangible assets in technical installations and machinery increases (acquisition value), within the limit of the gross profit reported by companies – according to the above table, this amount is 18,1 billion lei, to which is added the linear depreciation, that is mandatory applicable according to the normative act. To evaluate the counterfactual budgetary revenue loss from the application of the facility in 2012, a hypothesis on how the equipments in question are normally amortized is required : the baseline scenario is built on the assumption that, without the facility, half of the investments in technical installations and machinery are accelerated amortized (50% from their value in the first year and linear depreciation for the remaining value), and the rest are linearly amortized, assuming as above an equipment lifespan of 10 years; in addition, all investments are assumed to be made on day 1 of the year. Alternative scenarios from the perspective of this hypothesis are presented in the Annex: the baseline scenario corresponds to scenario II, scenario I assumes that the recourse to accelerated depreciation is generalized (the most favorable situation in terms of budgetary revenue losses following the application of the facility), and scenario III assumes that linear depreciation would have been applied to all companies for investments in eligible tangible assets (the worst situation from the same perspective).

The budgetary revenue loss as a result of granting the tax facility is by definition equal to the difference between the two deductible expenses aggregates multiplied by the tax rate of 16%. In the case of companies for which reported gross profits are in excess of the acquisition value of eligible new tangible assets, the difference is (16.383 + 0.1 x 16.383) – (0.5 x 0.5 x16.383 + 0.5 x 0.1 x 16.383) = 13.11 billion lei; the counterfactual revenue loss for the year 2012 is equal to the difference (13.11 billion lei x 0.16 = 2.09 billion lei), plus the entirely gross profit realized by companies with investments in eligible tangible assets higher than the amount of reported gross profit multiplied by the tax rate (their taxable profit becomes zero, and the revenue loss is 1.705 x 0.16 = 0.27 billion lei), resulting in a total of 2.37 billion lei revenue loss. Considering the alternative scenarios, the variation range of the revenue loss would be between a minimum of 1.85 billion lei (scenario I) and a maximum of 2.89 billion lei (scenario III).

Further we will try to bring the counterfactual estimated loss for the 2012 to the present, considering that in 2013 (for this year the data from the companies' balance sheet are not available yet) compared to 2012, the gross investments in eligible fixed assets varied with the index of gross fixed capital formation in the economy (0.9606 equivalent to a reduction of about 4%), and in 2014 their value would change, compared to the previous year, with the variation of nominal GDP from the latest government forecasts, recently published in the 2014-2017 Convergence Programme (increase of 5.4%); we assume that companies, which in 2012 made investments in eligible tangible assets higher than reported gross profit, will continue to be in this situation for the entire horizon of tax facility applicability and their profit margin will evolve in line with nominal GDP. In these conditions, the annualized loss for the year 2014 according to the baseline scenario would be 2.31 billion lei, which **corresponds to a quarterly average loss of about 607 million lei – equivalent to the shortfall of corporation tax receipts in the cash budget execution of this year in terms of applying the legislative measure from July 1st, 2014.** Continuing to extrapolate the volume of gross investments in eligible technological equipment using the nominal GDP variations from the 2014-2017 Convergence Programme (5.5% in 2015 and 5.5% in 2016), **the estimated budgetary loss under the same scenario would be 2.53 billion lei in 2015, 2.67 billion lei in 2016 and, respectively, 675 million lei in 2017. Considering the alternative scenarios, the budgetary revenue loss would be: (475, 740) million lei in 2014, (1.98, 3.08) billion lei in 2015, (2.08, 3.25) billion lei in 2016 and (528, 823) million lei in 2017. Depending on the scenario considered, the size of the estimated revenue loss is approximately 3.5 to 5.5 times higher than the amounts advanced by the Ministry of Public Finances.**

According to the Fiscal Council, the range described by the scenarios I (minimum revenue loss) and III (maximum revenue loss) accommodates different combinations of assumptions compared to those considered. The evidently exaggerated assumption, that substantiated the scenario I (accelerated depreciation preferred by all the companies for new investments before the introduction of the facility) produce so favorable effects on the size of assessed budgetary revenue loss that is unlikely that a combination of more plausible hypotheses (e.g. accelerated and linear depreciation combination without the facility – perhaps shifted in favor of linear depreciation, partial recourse to the facility and/or restricted behavior in the case of SOEs) to lead to a lower amount of this loss.

Given the large differences between its estimates and those made by MPF, the Fiscal Council invites the Ministry of Public Finances to present publicly the assumptions that substantiated the analysis and the manner of quantifying the impact of the reinvested profit non-taxation on budgetary revenue. Moreover, even in the absence of such differences, more transparency regarding the impact calculations would be welcomed.

Given all the above mentioned, the Fiscal Council cannot validate the fact that the impact of the proposed measure was properly reflected in the budgetary revenue projections. In the Fiscal Council's opinion the large revenue loss and the lack of explicit identification of the expenditure categories targeted by the compensatory reductions have the potential to compromise the achievement of budgetary targets in the medium term. The Fiscal Council does not dispute the appropriateness of granting the reinvested profit facility tax exemption, considering it adequate from the perspective of the economic situation and the business environment support, but its adoption should not be made by violating the law, both in terms of the Fiscal Council's opinion absence and in terms of compliance with the fiscal rules imposed by FRL.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of the Fiscal Council, according to Article 43, paragraph (2), letter d) of Law no 69/2010, based on the vote of the Fiscal Council members in the meeting on May 7th, 2014.

May 8th, 2014

Chairman of the Fiscal Council

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ANNEX

General assumptions
The calculation is performed differentiated for companies with a gross profit higher than investments in technical installations and machinery, respectively for companies with a gross profit lower than investments in technical installations and machinery.
The revenue loss for 2013 was calculated as follows: for companies with a gross profit higher than the investments in technical installations and machinery the starting point is the amount recorded in 2012 adjusted with the GFCF growth (respectively 0.9606), and in the case of companies with a gross profit lower than the investments in technical installations and machinery the starting point is the amount recorded in 2012 adjusted with the nominal GDP growth.
The revenue loss for 2014, 2015, 2016, and 2017 was calculated starting from the amount recorded in 2013 adjusted with the nominal GDP growth from each year.
The collection of revenues from corporate income tax is done with a lag of one quarter. Thus, the revenue loss from 2014 is related to profits from QIII 2014, the revenue loss from 2015 is related to profits from QIV 2014 and QI-QIII 2015 and so on.
All the investments are carried on the first day of the year, so depreciation expenses correspond to the entire year.

Alternative scenarios to determine the loss of budgetary revenue due to non-taxation of reinvested profit	
Scenario I	Starting point: the total new investments that could receive tax exemption from industry, agriculture and telecom sectors in 2012. For companies whose investments in technical installations and machinery are lower than the gross profit was considered the value of gross investments in 2012. For companies whose investments in technical installations and machinery are higher than the gross profit, the latter was considered. Share of companies that use accelerated depreciation: 100%
Scenario II	Starting point: the total new investments that could receive tax exemption from industry, agriculture and telecom sectors in 2012. For companies whose investments in technical installations and machinery are lower than the gross profit was considered the value of gross investments in 2012. For companies whose investments in technical installations and machinery are higher than the gross profit, the latter was considered. Share of companies that use accelerated depreciation: 50%; share of companies that use linear depreciation: 50%.
Scenario III	Starting point: the total new investments that could receive tax exemption from industry, agriculture and telecom sectors in 2012. For companies whose investments in technical installations and machinery are lower than the gross profit was considered the value of gross investments in 2012. For companies whose investments in technical installations and machinery are higher than the gross profit, the latter was considered. Share of companies that use linear depreciation: 100%.

The impact of non-taxation of reinvested profit on budget revenues in the year 2012 (bn. lei)				
	No.	Scenario I	Scenario II	Scenari0 III
New investments that could benefit from this facility - companies with a gross profit higher than investments in technical installations and machinery	1	16.38	16.3 8	16.38
Accelerated depreciation rate	2	0.50	0.50	0.50
The share of companies that use accelerated depreciation	3	1.00	0.50	0.00
The share of companies that use linear depreciation	4	0	0.50	1.00
Linear depreciation (compulsory applicable in the case of the non-taxation reinvested profit –an average useful life of 10 years)	5	1.64	1.64	1.64
Depreciation spending (accelerated and/or linear depreciation)	6=1x2x3 (Sc. I) or 6=1x2x3+4x5 (SC. II, III)	8.19	4.91	1.64
Corporate income tax rate	7	0.16	0.16	0.16
Deductible amounts from corporate income tax in case of application of the proposed legislative measure	8=1+5	18.02	18.02	18.02
Deductible amounts from corporate income tax in case of non-application of the proposed legislative measure	9=6	8.19	4.91	1.64
Budgetary revenue loss compared to the non-application of the measure in the case of companies with a gross profit higher than investment in technical installations and machinery	10=7x(8-9)	1.57	2.10	2.62
New investments that could benefit from this facility - companies with a gross profit lower than investments in technical installations and machinery	11	1.71	1.71	1.71
Budgetary revenue loss compared to the non-application of the measure in the case of companies with a gross profit lower than investments in technical installations and machinery	12=11*7	0.27	0.27	0.27
Total budgetary revenue loss	13= 10+12	1.85	2.37	2.89

	Scenarios for the budgetary revenue loss for the 2014 – 2017 interval				
		2014	**2015**	**2016**	**2017**
	PIB (bn. lei)	**664.4**	**698.8**	**737.2**	**7785**
	Nominal GDP growth	5.3%	5.4%	5.5%	5.5%
Scenario I	**Budgetary revenue loss (bn. lei)**	0.475	1.975	2.084	0.528
	% of GDP	0.07%	0.28%	0.28%	0.07%
Scenario II	**Budgetary revenue loss (bn. lei)**	0.607	2.527	2.666	0.675
	% of GDP	0.09%	0.36%	0.36%	0.09%
Scenario III	**Budgetary revenue loss (bn. lei)**	0.740	3.079	3.248	0.823
	% of GDP	0.11%	0.44%	0.44%	0.11%