

PRESS RELEASE

On the analysis

"BUDGET CONSOLIDATION AND INCREASING TAX REVENUES - A VITAL NEED FOR ROMANIA'S STABILITY AND ECONOMIC SECURITY"

Among our economists, there has long been a concern to carry out more in-depth analyzes of the domestic tax regime, that should try to imagine ways to rethink it, to increase tax revenues, which are at an extremely low level compared to European standards. The stated desire of some economists and colleagues and other experts to get involved in a concrete analysis approach met with the thoughts of the Romanian Fiscal Council, which are not recent. This resulted in the establishment of a Working Group which undertook this research on the domestic fiscal regime based on the great urgencies of economic policy in such bitter times, with international overlapping crises and a war in Ukraine.

The analysis, which took place between February and April 2022, expresses a common denominator regarding the approach of budgetary consolidation and the rethinking of the fiscal regime in the current and future conditions, even if the Group members do not share the same opinions on different issues, or the same economic paradigm. This analysis, moreover, should be seen as work in progress. The members of the Group contributed to this analysis individually, without involving the institutions to which they are affiliated. The context and assumptions underlying the analysis are set out below.

At the beginning of 2022, Romania had to make a fiscal adjustment (a reduction of the budget deficit) of about 4 percent of GDP - from about 7.2% of GDP (ESA deficit) in 2021 to about 3% of GDP in 2024. In addition to this, are the effects of the war in Ukraine, which involves, among other things, increased budgetary expenditures on defense, ensuring energy and food security, protecting vulnerable households from rising energy prices, receiving and hosting Ukrainian refugees, and so on.

With 26% of GDP tax revenues (including social security contributions) collected in recent years, Romania lags far behind countries with a similar level of development, such as Poland (about 36% of GDP) or Hungary (about 36.3% of GDP) and even after a less developed state, Bulgaria (30.6%

of GDP). The causes of this situation are well known: a low collection degree of taxes; a multitude of exemptions that diminish the tax base; certain tax rates are very low compared to those in Central and Eastern Europe.

The macroeconomic / budgetary correction that Romania needs is also visible in terms of twin deficits - the existence of growing external (current account) deficits in recent years. The budgetary correction is also necessary because monetary policy alone cannot maintain the stability of the leu, especially since external deficits have predominantly fiscal causes and of the nature (lack) of structural reforms.

In this context, the budgetary adjustment can only be gradual, but it must take place, be translated into credible measures, have a strong political backing and support for broad economic and social circles - including the business environment. It is absolutely necessary that decision-makers in the political and administrative environment no longer promote tax cuts, as well as the increase in permanent expenditures on the back of temporary revenues.

Tax reform should start by correcting the many privileges and inequities in taxation so that taxation to be fair, uniform and proportionate, regardless of the nature of the business and the way it is organized. The undesirable alternative would be *ad-hoc* increases in taxes and fees, drastic reductions in necessary spending, imposed by the constraints of financing twin deficits. This alternative would be strongly pro-cyclical, with adverse effects on economic recovery and growth.

The authors of this analysis do not dispute the need for sectoral policies and specific state interventions in the economy. Moreover, the international context makes such policies inevitable in areas such as the energy industry, the agro-industrial sector, the defense sector, in addition to the challenges posed by climate change, pandemic, managing the problem of Ukrainian refugees etc. In addition, in the medium and long term, the development of high value-added industries must be taken into account.

State interventions in the economy should follow a number of principles, which have been ignored in recent years:

- public spending must be set on a very strict basis, so as to avoid wasting public money;
- the single tax rate is based on the principle of proportional taxation of labor (in fact, by many derogations from this type of taxation, some taxpayers end up being taxed regressively,

while other taxpayers are taxed proportionally, which erodes the spirit of fairness and solidarity in society);

- companies should not benefit from tax privileges, some even multiple; sector aid policies should aim to increase their investment and productive capacity and not just to maintain a certain level of purchasing power or consumption;

- permanent expenditure cannot be financed with temporary revenues, even if they are from the European Commission.

The rethinking of the tax system must take into account key issues regarding transparency, fairness, the correct distribution of the burden of adjustments to various adverse shocks, solidarity, encouraging labor market participation, encouraging compliance with payment and fulfillment of obligations, discouraging tax evasion and tax arbitrage and so on.

The urgent action front concerns a significant reduction in tax evasion and the elimination of exceptions, thus a major improvement in the collection of taxes and fees in the coming years. Such an action takes into account the current context, marked by the slowdown in economic growth, the energy crisis, the war in Ukraine etc., a context that does not allow the increase of tax rates for taxpayers who do not benefit from exemptions. Depending on the circumstances, additional measures to balance the public budget may be considered, respectively an increase in taxes, such as environmental or property taxes, which are lower than European standards.

The alternative to not significantly increase tax revenues to reduce the budget deficit is to drastically reduce spending (by a few percent of GDP), which is an equation that the members of the Group consider impossible to solve. This does not mean that public spending efficiency is not necessary and possible.

Budgetary consolidation through increased tax revenues is a matter of national economic security and national solidarity, especially if we consider the enormous challenges for the economy, society - energy transition, effects of climate change, demography (especially emigration - exodus of human capital), the need to increase defense spending (equivalent to the erosion of the "peace dividend" obtained after the fall of the Berlin Wall), to increase investment in health and education.

If the recommendations from this study would be implemented, then fiscal revenues (including social security contributions) could increase by about 3.7 to 4.7 percent of GDP over the time taken to correct the budget imbalance. Of this increase, about half would come from the elimination of exemptions and discriminatory treatment (especially corporate income tax, personal income tax and social security contributions), about a third - from improved collection (especially VAT), including through the digitization of NAFA, and about a sixth - from rising tax rates (especially on environmental and property taxes). Such an increase would allow the budgetary correction necessary to get out of the Excessive Deficit Procedure and, especially, the improvement of Romania's financial soundness, the sustainability of the public debt. Looking ahead, Romania's tax revenues should be close to those of the Czech Republic, Poland, Hungary, as a share of GDP, in order to meet the challenges posed by multiple adverse shocks (climate change, energy transition, the new Cold War in Europe).

The analysis highlights, among other things:

- the comparative situation of the local tax regime in relation to what exists in the EU; tax and collection rates, with estimates of possible additional tax revenues;

- state of tax revenue collection; tax bases, exceptions that erode possible revenues and what can be done about it;

- the situation of property and environmental taxes, as well as the causes of the loss of tax revenues in these fields;

- digitalization as a means to help the NAFA reform, to improve the collection of tax revenues, which, however, needs the political will to confront interest groups that want to maintain the current system.

The last section is dedicated to the conclusions and recommendations for rethinking the tax regime. A key message of the analysis is that tax revenues in Romania must be close to the average in Central and Eastern Europe, for the public budget to meet current and future very high needs. This message is also supported by the conclusions and recommendations of some international institutions and the European Commission.

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** The opinions expressed in this document are the responsibility of the authors and do not represent the official position of the institutions to which they are affiliated. The analysis was performed between February 10 and April 30, 2022.*