

SPECIAL REPORT: ROMANIA

A major step towards a clearer and stable fiscal regulation was the creation of the Fiscal Code in 2003. It was supposed to consolidate all fiscal regulations, with the exception of social contributions, which are still subject to different laws and decrees.

The aim of the single comprehensive fiscal regulation was not really fulfilled because, like in other European countries, any law passed by Parliament is completed with “enforcement decrees” (“norme de aplicare”) issued by the government, ministries, agencies, etc. Arguably, this is against the constitutional principle of separation of powers. The process causes delays and uncertainty. Indeed, it is not unusual that the decree changes or contradicts the very logic of the law. Moreover, the government can change at will these “technical rules”, increasing uncertainty. Besides, there is usually a significant delay between the moment when the law comes in force and the moment from which it can actually be applied. This last aspect was improved in 2007. Indeed, since June, the government must publish “enforcement decrees” no later than 30 days after the publication of the law.

The tax cuts started in 2000, when the ruling Center-Right coalition reduced corporate income tax from 38% to 25%. The new Center-Left coalition maintained this level after taking power in 2001. Later, a 19% flat tax on personal income was included in the project for the first Romanian Fiscal Code (August 2003). This idea, that was proposed first in June 2003 by Societatea Academică Română, a free market oriented think tank, was however criticized publicly by Romania’s President and taken out from the final version of the Fiscal Code.

After 2004 elections, the victorious Center-Right coalition started a program of tax cuts, at least for major tax rates. The corporate income tax was reduced from 25% to 16% and the progressive taxation of personal income (five brackets, from 18% to 40%) was replaced by a flat tax of 16%, combined with a regressive personal allowance.

These tax cuts, especially the flat tax, were under constant attack from the opposition. The Social-Democratic Party announced its intention to repeal it in case of victory at the 2008 Parliament elections. The Center-Right – now broken – had a very weak reaction to defend what was actually one of its major electoral themes in 2004.

Will Romania be the first country to quit the “flat-tax club”? The answer to that question depends on the next legislative elections.



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A little bit of background...

Creation of a new tax code in 2003

Corporate income tax cuts from 38% to 25% and then 16% (2005)

16% flat tax on personal income since 2005

Social Democratic Party threatens to repeal the flat tax if elected in 2008

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1. Taxes

✓ Personal Income Tax

The most notable element is that there was no change in this field. The tax is retained at source by the employer. An employee who earns just one salary and no other income has no return to submit.

✓ Corporate Tax

The tax rate remained constant. There were minor changes in the tax base. The reevaluation differences have a more favorable fiscal treatment in 2007. The last reevaluation accepted by fiscal authorities was in 2001. This meant that any reevaluation increased real estate tax (paid to local authorities) but without a corresponding increase in fiscally deductible amortization. Starting with 2007, yearly reevaluations are fiscally allowable. Micro-enterprises (less than 9 employees and less than € 100,000 turnover) can opt to be taxed on turnover rather than on profits. The tax rate has changed each year since it was introduced for the first time by the 2003 Fiscal Code: 1.5% in 2004, 3% in 2005 and 2006, 2.5% in 2007, it is set at 2.5% for 2008 and 3% for 2009. This facility was used as a tax avoidance device: the employees were incorporated as micro enterprises and the labor contracts were replaced by commercial contracts, in order to avoid social security charges. The Fiscal Code has now dispositions designated explicitly to prevent this situation.

✓ Value Added Tax

The tax rates remained unchanged (19% and 9% for books, newspapers, medical prostheses, hotel accommodations), despite some proposals for extending the application of the reduced rate to basic products like food and medicine. The most important changes took place in administrative procedures. The aim was simplification especially in the fields of intra-EU delivery and building sector. Some positive changes introduced at the beginning of the year were later cancelled. For example, in January 2007, VAT on imports was not payable on entry into Romania. However, after April 2007, VAT on goods became payable at the port of entry.

✓ Excises

Excise duties have significantly increased, in order to achieve conformity with EU regulation. It concerns energy, tobacco and alcohol. These are also the fields where the tax evasion is the highest.

✓ Custom taxes

The European Union was Romania's main economic partner well before the last enlargement (1st January, 2007). As a consequence, custom taxes were eliminated for around 60-70% of Romanian imports.

personal and corporate income taxes have not change much in 2007

Micro-enterprises can opt for a tax on turnover. Dispositions have been taken so that this possibility will not be used by employers to avoid paying social taxes for their employees

the main VAT rate remained at 19%

some attempts have been made to simplify the administrative process.

"excise duties have significantly increased to achieve conformity with EU regulation"

on January 1st 2007 custom taxes were suppressed on 60 to 70% of Romanian imports

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✓ Other taxes

The most controversial tax introduced this year was the tax on “the first registration” of cars. The Government presented this as a “green” tax, designed to prevent the importation of very cheap and used cars from EU. Opponents of the tax argued that this was a protectionist tax, directly favoring Dacia-Renault, Daewoo and the importers of brand-new cars. A Romanian citizen contested the tax in court won the first trial. The European Commission asked the government to modify the tax base because it grows progressively with a vehicle’s age and in some cases the tax is too high. The Government reacted by slightly changing the way of calculating the tax and by renaming it as an environmental tax.

2. Social contributions

Romanian legislation maintains the fictional distinction between an employer’s and an employee’s contribution. Table 1 outlines the social contribution rates. The tax base is usually the gross wage (bonuses included). The tax base for employee pension contributions was limited to five times the medium gross wage. Since August 2007, this ceiling was eliminated, which increases the cost of hiring highly skilled workforce under a regular labor contract.

Table 1. Social and labor based contributions in Romania (2007)

FISCAL LIABILITY CONTRIBUTION	EMPLOYEE (%)	EMPLOYER (%)	TOTAL (%)
Pension	9.5	19.5*	29
Health	6.5	6	12.5
Unemployment	1	2	3
Risk & accidents	-	0.4 – 3.6	0.4 – 3.6
Labor inspection	-	0.25 – 0.75	0.25 – 0.75
Fund for salaries guarantee	-	0.25	0.25
Holidays & indemnities	-	0.85	0.85
Total **	17	29.25 – 32.95	46.25 – 49.95

* The figure concerns the contribution for “normal conditions of work”. In the case of “uncommon” and “special” conditions of work, the figures are 24.5% and, respectively, 29.5%.

** The tax base differs slightly from some contributions, but in most cases, it is gross salaries (payroll) or very close to it. The total is not rigorously precise but a useful approximation.

Source: Romanian legislation

a “green tax” on used tax was introduced and hotly debated.

in August 2007, the ceiling on social contributions was abolished, hence increasing the cost of hiring high skilled workers

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✓ Pension contributions

The level of Romanian social contributions is among the highest in the region but this is not the case for Romanian pensions, health care and unemployment benefits. This explains the low social acceptance of these contributions and the efforts made by employers and employees to avoid them. The contrast between high pension contributions and low benefits has at least two explanations: demography and former policies. The ratio between contributors and beneficiaries is inferior to one in the public pension system. Since 1990, successive governments have been tempted to “fight” unemployment by facilitating early retirement. Even current legislation encourages early retirement rather than full-time contribution.

After a very long delay, in 2007, Romania started to reform the public pension system, which will be structured into three pillars. The first pillar will keep the current pay-as-you-go mechanism. The contributions to the second pillar are mandatory but the collected funds are managed by a dozen private pension administrators. Starting in 2008, the employee’s mandatory contributions (9.5%) will be split between the first (7.5%) and the second pillar (2%) for all employees less than 35 years old, and on an optional basis for those aged between 35 and 45. Employees’ contributions to the second pillar will increase by 0.5 points each year, up to 6%. Their contribution to the first pillar will be correspondingly reduced. The third pillar is open to all employees on an optional basis and is also privately administered. The contributions are deductible from taxable income up to € 200/year, which represents less than half of the average gross monthly salary (less than 4% of average annual salary). The employer can make a similar tax exempted contribution, up to € 200/year.

This partial privatization could increase the social acceptance of pension contributions and reduce incentives for tax evasion if they come to be perceived as saving and not merely as a payment without any effect on pension values.

✓ Health care contributions

These payments are supposed to entitle the employees to “free” medical services. However, physicians’ salaries are low compared to other highly qualified professions. As a consequence, “extra payments” are common place in the public medical system. Also, there are shortages in “free” or subsidized medical supplies, there are waiting lists for “free” medical services etc. This situation is an indirect incentive for tax evasion.

✓ Unemployment contributions

Unemployment rate decreased during the last years, due to favorable economic conditions (uninterrupted growth since 2000) and to labor force migration. Contributions to the unemployment insurance fund remained virtually unchanged throughout all this period. As a consequence, the fund has registered consistent surpluses. The government plans to reduce the total contribution (employer and employee) from 3% to 1% in 2008.

pension contributions are unpopular, being high when compared to pension benefits

there is less than one contributor per beneficiary

after a long delay, Romania started to reform the public pension system in 2007

the three pillars system could increase social acceptance of pension contributions

health care contributions give right to “free”, but poor services

low unemployment led to surpluses that will in turn lead to reduced mandatory contributions

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✓ Contributions for risks and accidents

The rate is established according to the enterprise's main activity and not according to the profession and the actual risk of the employee. This infringement of insurance principles is supposed to reduce administrative costs for the employer.

✓ Labor inspection contributions

According to the legislation, the labor history of each employee must be registered in a booklet ("carte de muncă"), which will serve to calculate their pension and other social entitlements. The firms have the option to keep these booklets themselves or to outsource it to the Labor Inspection. The contribution is 0.25% of the payroll in the former case or 0.75% of the payroll in the latter.

✓ Contributions for the salaries' guarantee fund

The salaries' guarantee fund was created in 2006 and became operational in 2007. The fund is supposed to underwrite the due salaries of bankrupt firms.

✓ Contributions for sick leave and indemnities

This fund was created in 2006. The initial contribution was 0.75% of the payroll and was increased to 0.85% in 2007. At the same time, the contribution to health care was reduced by 0.1%, which meant that this represented just a simple transfer from the employer's point of view. Of course, the software had to be upgraded, which represents an indirect tax burden.

3. Quasi-taxes

Romanian regulation includes many cases of payments which are not considered taxes in a narrow sense but, from an economic point of view, are equivalent to taxes: they are mandatory and their level is set by the authorities, either national or local. For example, businesses must have a contract with "licensed" security companies and install an alarm device. Also, any new store must dispose of a certain number of parking places or rent them from the City Council. In the public alimentation sector, there are regular inspections – which is understandable – but regulation set the frequency and the amount of the fee to be paid for this "public service".

On national level, a draft law stipulated that any fiscal statement must be certified by a member of the newly founded Chamber of Fiscal Advisors. These advisors are, in most cases, employees of the Ministry of Finance, which generates a risk of conflicts of interest and corruption. Moreover, a controversial article of the law stipulated that fiscal advisors must inform the fiscal authorities about any fiscal irregularity found in

Romanian regulation makes many payments mandatory which levels are fixed by central or local authorities: quasi-taxes

a draft law stipulated that any fiscal statement must be certified by a "fiscal advisor" usually employees of the Ministry of Finance.

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financial statements. The strong opposition of mass-media, businesses, certified accountants and lawyers forced the government to discard that specific article.

Since 2007, regulation extended the employers' obligations to monitor employees' health and health risks. The legislation stipulates that all costs are supported by the employer, but from an economic point of view, this is another hidden tax on labor.

4. Other non-monetary and indirect fiscal burdens

Statutory tax rates are relatively low in Romania, which explains its high ranking when explicit taxation is the main or unique criteria. This is the case of the "Fiscal freedom" component of the "Index of Economic Freedom" and the "Freedom from Government" area of the "Economic Freedom of the World Report". However, Romania's ranking drops dramatically when non-monetary fiscal burden is taken in account, like in the "Paying taxes" component of "Doing Business Report". Actually, at the World level, Romania has the second highest gap between "Fiscal freedom" and "Paying taxes" rankings.

The non-monetary fiscal burden in the Romanian economy has at least four main causes: the instability, the uncertainty, the incoherence and the absurdity of fiscal regulation. Article 4 of the Fiscal Code illustrates these:

"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."

This is a very interesting sample of Romanian fiscal regulation. Article 4 seems to offer the perfect shield against arbitrary changes in taxation, but it is actually meaningless: since the Fiscal Code was introduced (2003), the so-called general rule has never been applied. The Fiscal Code for 2008 was submitted to Parliament in the second half of December 2007.

✓ Instability

The instability of Romanian fiscal regulation is a burden for all entrepreneurs and taxpayers. The Fiscal Code was amended at least 42 times between 2004 and

employers have the obligation to monitor their employees' health and health risks.

Romania ranks high in freedom indexes based on statutory rates. The ranking drops dramatically when non-monetary fiscal burden is taken in account

non-monetary fiscal burden is caused by the uncertainty, the incoherences and in some cases the absurdity of fiscal regulation

the instability of fiscal regulation is a burden for all entrepreneurs and taxpayers

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2007, by 13 laws, 12 emergency ordinances, 2 ordinances, 4 Government “rectifications”, 7 Government resolutions and 4 “orders” issued by the Ministry of Economy and Finance. As many as 29 of these modifications were initiated by the Government. They were approved only post factum by Parliament, when they were already enforced. However, the frequency of the changes has recently decreased: after 11 and 16 changes in 2004 and 2005, the Fiscal Code was “only” amended 8 and 7 times in 2006 and 2007. These modifications don’t include those referring to the social contributions. The general instability of legislation is illustrated by the fact that the Official Journal (“Monitorul Oficial”) had over 900 issues in 2007.

✓ **Uncertainty**

The very idea of flat tax reform is simplification and uniformity. However, tax exemptions for software specialists were maintained as a way to reduce the emigration of these highly skilled workers. This industrial policy is in contradiction not only with the principles of simplification and uniformity but also with that of equity, because software engineers have some of the highest incomes in Romania. It will be more and more difficult to justify tax privileges, which reduces the desired incentive effect of this law and increase uncertainty in this particular field.

The defense of the tax cuts by the Government is sometimes contradictory. These are presented as a way to stimulate productive efforts and, incidentally, to reduce black economy, because those who produce wealth will keep a larger part of it. At the same time, tax cuts are defended by the authorities on the ground that they increase the weight of fiscal revenues in GDP, which actually means that they increased the government’s control over the wealth created by entrepreneurs and workers. Of course the total fiscal revenues (T) may increase after a reduction in the tax rate (t) – the Laffer effect – as a result of an increase in supply and of the “whitening” of the economy. This would not necessarily contradict the supply-side logic of the tax cuts. The increase in T/GDP ratio is however a different topic. But, as a matter of principle, it is inconsistent to defend the tax cuts referring at the same time to two desirable effects: the increase of the tax burden (T/GDP) and the positive incentive effects on wealth creators. This approach suggests that if, for any reason, the collected taxes decrease, the tax cuts and the flat tax could be abandoned by the authorities. The resulting uncertainty reduces the potential positive incentive effect.

✓ **Incoherence**

When regulation changes frequently, it’s difficult even for the authorities to keep track of changes. One of the most comic situations happened in 2006, when one article of the Fiscal Code established the tax rate on micro-enterprises’ turnover and another one stipulated that micro-enterprises will no longer have the possibility to opt for this form of taxation.

the fiscal code was amended at least 42 times since 2004, often by the government and not the parliament

the “Official Journal” had over 900 issues in 2007!

Despite the flat tax, many exemptions, that is, privileges remain

Governments seem to cut tax in the only hope of raising more revenues. This means that the day the tax/GDP ratio no longer pleases them, governments could increase tax again

even the tax administration can not always keep up with tax reforms, generating incoherence in the whole system

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A more recent example concerns social contributions. According to Law 95/2006, the tax base for health insurance is the salary, even for software specialists. In August 2007, an Order of the CNASS (Health Insurance Fund) stipulated that software engineers' incomes are tax exempted. The contradiction and the uncertainty were only solved (for now...) in December: the tax base for this profession is the equivalent of the minimum wage.

✓ Absurdity

There are also many examples of absurd taxation. For some administrative procedures, the taxpayer needs a fiscal or judiciary stamp with a nominal value of 0.3 lei (less than 0.1 euro) which can only be bought at a usually crowded postal office. The value of the wasted time – even estimated at the minimum wage rate – is at least ten times higher. This doesn't take in account all the operations involved in the process, like the production and the registration of the stamps, the cost of manipulating cash, etc.

The number of payments is unnecessarily high because of the payments' frequency (at least monthly) and the multitude of public entities involved. According to the World Bank's Doing Business Report a "representative business" operates 89 payments per year, the highest figure in the EU and one of the highest in the world. The figure can be even higher, 13 per month or 156 per year: 2 (social security) + 2 (health insurance fund) + 2 (unemployment fund) + 1 (labor inspection) + 1 (risk insurance fund) + 1 (health indemnities) + 1 (salaries' guarantee fund) + 1 (tax on salaries) + 1 (corporate income tax) + 1 (VAT).

The minimum number of statements filed by a limited liability company with one employee is 5 per month (actually, there are 8, but some can be filed in the same time). In 2007, a "newcomer" was the list of bills emitted in 2007 for products or services delivered to any entity registered as a VAT payer in Romania and the list of bills for all products acquired from a Romanian VAT payer. The statement must be submitted in electronic and paper form.

Of course, there is the option (actually, the obligation) to submit some fiscal statements in electronic form, but the printed, signed and stamped paper version is also mandatory. Moreover, the electronic version must be recorded on a floppy disk. The waiting time at the queue is at least one hour per statement (fiscal, salaries, health insurance, etc.). However, since September 2007, in 11 counties (out of 40), the firms without outstanding tax liabilities have the choice to send on-line only the electronic fiscal statements. This facility has been available in Bucharest and for "big taxpayers" since 2006 and it will be extended to all firms in 2008. The number of payments will be reduced to only two per month: one for all social security contributions and one for the taxes collected by the state's budget.

the taxpayer sometime needs a fiscal stamp which costs €0.1 but to get that stamp requires that you stay on line at the post office

a representative business operates 89 (fiscal) payments a year, one of the highest figure in the world

the minimum number of statements filed by a limited company with one employee is 5 per month

some fiscal statements must be returned both in electronic and paper forms.

... and the electronic version must be recorded on a floppy disk!

in 2007 a change for the best took place in this domain

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5. Perspectives for 2008

From a fiscal point of view, the draft state and social security budgets for 2008 have good news and bad news.

✓ Good news

The Government plans to reduce the social contributions (Unemployment, health and pension) with 5.3-6.9 points, from 46.25-49.95% in 2007 to 40.95-43.05% at the end of 2008. This represents a 10% to almost 13% decrease in social contributions tax rates. Table 2 presents the projected changes for 2008.

After 1st January 2008, the regulation allows the firms to issue bills and receipts in electronic format.

The number of payments will be reduced from a dozen to two (one for social contributions and one for fiscal payments).

✓ Bad news

Although the tax rates of social contributions are reduced, their tax base is extended. As a consequence, the net effect will be less impressive. Moreover, the tax rate reductions will not come into force at the same time, which means many changes in accounting software, with all the monetary and non-monetary costs. There is also the possibility that not all the projected reductions will actually become operational as projected, which represents another source of uncertainty.

Despite the fact that salaries increased faster than productivity, the minimum wage was increased to 500 lei for the first half of 2008 and will be 540 lei in the second half. Converted in Euros, it does not represent very much (around 150 Euros), but the negative impact will be significant on low skilled workers and on Romania's competitiveness. This increase will have also a fiscal impact because the minimum wage represents a tax base or reference for some social contributions.

The simplifications in VAT payments decided for the building sector were abandoned in 2007 and they will not be reintroduced in 2008. VAT on imports from EU countries (intra-EU delivery) will be due in customs until 2012, when the authorities will be able to ensure a better control of payments. However, VAT is not due in customs

social contributions will be down 5.3 to 6.9 points

electronic declaration will be more widely accepted

number of payments will be reduced to 2 per month

tax base of social contributions is enlarged

minimum wage will be increased to 540 lei (€150), taking the risk of penalizing low-skilled workers

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by firms who had imports greater than 150 millions lei (43 mil. Euros) in the previous year.

Table 2. Projected evolution of social contributions for 2008

TYPE OF CONTRIBUTION	FISCAL LIABILITY	31.12 2007	01.01 2008	01.07 2008	01.12 2008	EVOLUTION IN 2008
Pension*	Employee	9.5	-	-	-	0
	Employer	19.5	-	-	18	-1.5
Health	Employee	6.5	-	5.5	-	-1
	Employer	6	5.5	-	5.2	-0.8
Unemployment	Employee	1	0.5	-	-	-0.5
	Employer	2	1	-	0.5	-1.5
Risks and accidents	Employer	0.4 / 3.6	0.4 / 2			-1.6
Labor inspection	Employer	0.25 / 0.75				0
Fund for salaries' guarantee	Employer	0.25				0
Sick leave and indemnities	Employer	0.85				0

* The figures are for "normal conditions of work". Similar reductions are planned for "special conditions of work". Employees' contribution includes 2% for mandatory private pension fund (second pillar). Source: Romanian legislation.

6. Conclusion

In Romania, statutory tax rates are underestimating the real fiscal burden. The reduction of non-monetary and indirect fiscal burden is the most efficient way to improve the current situation. Some of the measures taken by the authorities are necessary steps in this direction. However, instability and excessive administrative requirements remain the characteristics of Romania's fiscal regulation.

social contributions will be down 5.3 to 6.9 points in 2008


the reduction of non-monetary and indirect fiscal burden is the most efficient way to improve the current situation

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7. Selected references

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