THE TAX REFORM OF ROMANIA SINCE THE TRANSITION TO MARKET ECONOMY

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This paper is trying to analyze the financial and fiscal reforms in Romania since 1989. The study is based on the necessity to be built a new fiscal system that meets the market economy's requirements. The main concentration is focused on the debate of choosing tax policy. There are presented the two models of variation of income tax policy followed by Eastern European countries: flat income tax – a simple, efficient, but inequitable system (Estonia, Russia, Romania, etc.) and progressive income tax – a complex, inefficient, but equitable system (Hungary, Czech Republic, Slovenia, etc). At the end of this article are presented, also the main advantages and disadvantages of this these tax policies based on national statistics and other countries experiences.

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The 1989 – 2004 periods were times of profound changes and reforms at almost all levels in Eastern European countries. It was necessary to transform a socialist - communist economy into a market economy. This reform had to be built upon a new fiscal system in order to meet the market economy's requirements. As a matter of fact, every Eastern European country has been experience this problem. However, the main objectives of any Eastern European countries have been as follows:

1. to generate enough resources in order to cover public expenses needs.
2. to build up a modern and simple fiscal system that stimulates foreign and nation capital investments and controls tax avoidance and evasion.
3. to harmonize their fiscal system with Western European countries regulations as condition to be integrated in European Union.

At the same time, these countries have been confronted with both strategic and operational problems regarding the national fiscal policy. Some authors showed that ex-communist governments had to choose between implementing a simple, but efficient fiscal policy, or a complex, but more equitable system (Stiglitz 2000, Wright 1997).

The main concentration has focused on the variation in income tax policy regarding the two models followed by Eastern European countries: the flat income tax (Russia, Estonia, Lithuania, etc) and the progressive income tax (Hungary, Romania, Bulgaria etc). However, in matters of tax evasion control, it is obvious that a complex fiscal policy (progressive tax) is, inconvenient for governments because fiscal pressure naturally leads to tax evasion. This was one of the reasons that some countries (Slovakia, Poland, Romania) decided to change their fiscal policy from a progressive tax rate to a flat tax rate.

The transition of Romania to capitalism has had strong implications at the taxation level. Before 1989 the state revenues were collected by taking a large percentage of state owned companies benefit and a tax on wages paid not by employers, but by companies. We can identify at least three stages of fiscal reform during last 15 years. The first occurred between December 1989 - 1992 when have been adopted the most important fiscal rules (i.e. wages tax law, corporate income tax law, and public finance law). The second 1993 – 2002 was the period when appeared valued added tax, capital tax, global income tax, and other important regulations concerning the financial and fiscal intergovernmental relations. At the end in 2003 the Romanian Parliament approved the Fiscal Code of Romania that came up to solve some discrepancies between different fiscal regulations and to simplify the tax administration system. An additional important reform was made at the end of 2004 with the introduction of flat income tax – 16% at both corporate and individual level.

The structure of tax system in Romania

The Romanian taxes are shared by three levels of Government and are presented in Figure 1.

The National Taxes in 2004 were 68 % of Romania's Total Tax Revenues and are based, as we can see in Table 6, mainly on indirect taxes (VAT, Excise Tax, Customs Tax, Corporate Tax, etc.).

The Corporate Income Tax has been a proportional tax and introduced by Law no 12 since Jan 1st, 1991 based on the amount of profits earned, regardless of the type of property and organizational structure of the taxpayer. Law 12/1991 is considered to be one of the most important measures of fiscal reform initiated after the Revolution of December, 1989.

Table 1 - Romanian Statistic Institute - Annually Reports

Table 1:Direct Taxes/Indirect Taxes %													
Year	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Direct taxes (%)	50,5	47,7	54,6	50,7	42,5	31,3	28,2	17,9	30,5	25,7	21,3	23,5	26,4
Indirect taxes (%	49,5	52,3	45,4	49,3	57,5	68,7	71,8	82,1	69,5	74,3	78,7	76,5	73,6
Total fiscal revenues (%)	100	100	100	100	100	100	100	100	100	100	100	100	100

The collection efficiency of Corporate Tax was, at the beginning, very high (in 1995 55% of the revenues collected through direct taxes), but started to decrease, because there were too many loopholes allowing for tax evasion. In order to control this dangerous phenomenon the fiscal legislation suffered several amendments (1994, 1995, 1997, 2001 2003, 2005) establishing new Accountancy Standards and Rules and enforcing drastic sanctions for breaking the fiscal legislation (Table 1).

On the other hand trying to stimulate the economic development and to avoid tax evasion the rate of Corporate Tax has declined since its peak in 1994 (38% in 1994, 25% in 2001, and 16% in 2005).

Currently in Romania the Corporate Tax is imposed either on companies profit (16% - for companies with turnover more than $120.000), or on small companies gross income (3% - turnover less than $120.000).

The Global Income Tax has been applied since January 1st, 2000 and imposed on the following types of income: wages, independent activities, pensions, gambling and awards revenues, capital investment revenues, rental revenues, agricultural activities revenues, and other revenues.

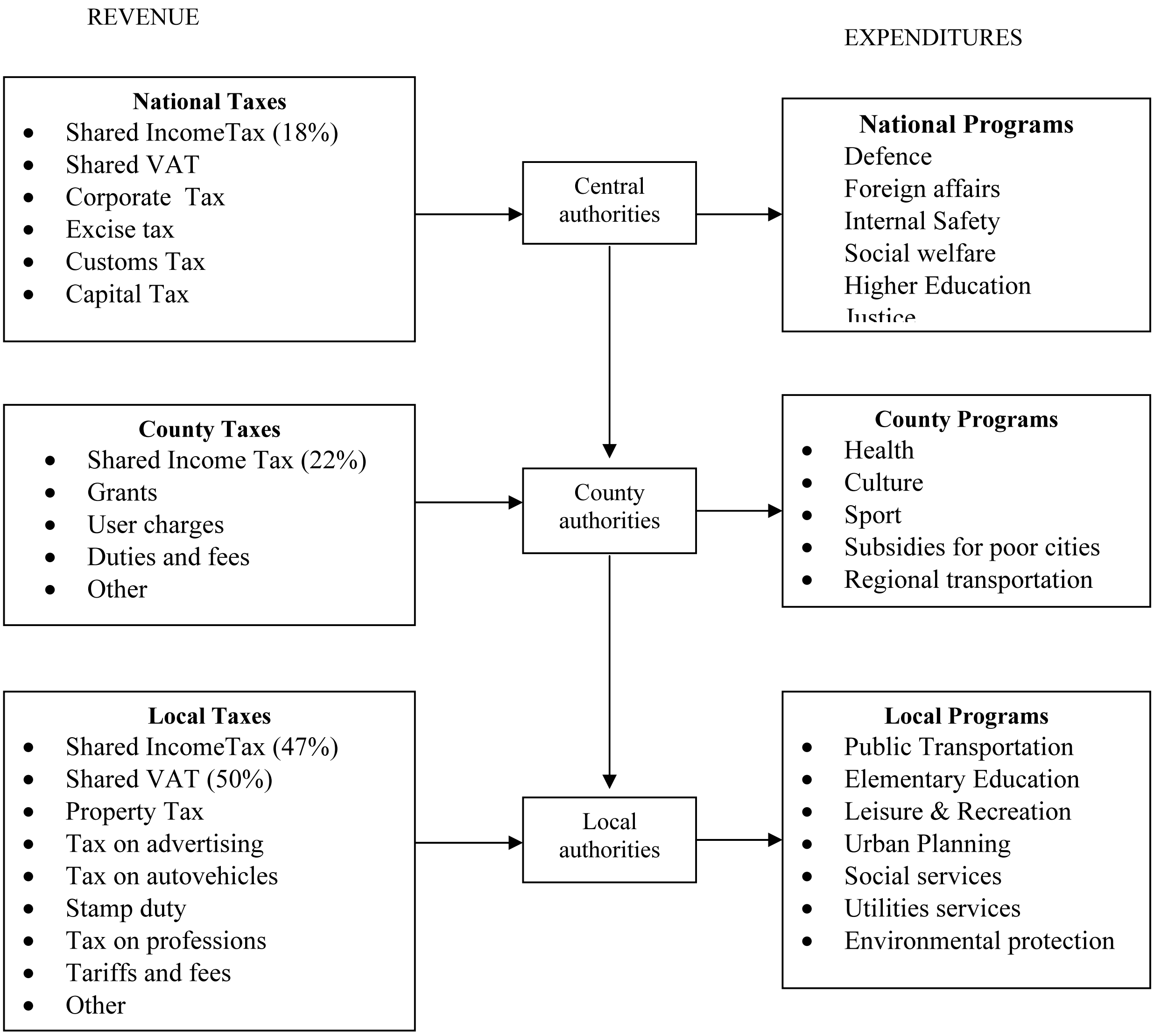

Figure 1 - The structure of Romanian Tax System

During 2000 – 2004, The Global Income Tax was a progressive tax. In 2004 the marginal rates of income are showed in Table 2.

Table 2 – Marginal rates for individual income tax – 1$ = 2.8 ROL

Table 2:Marginal rates for individual income tax	
Annual Income ($)	**Annual tax**
< 1,030	18%
1,031 – 2,486	185 $ +23% > 1,030 $
2,487 – 3,986	520 $ +28% > 2,486 $
3,987 – 5,571	940 $ +34% > 3,986 $
> 5,571	1479 $ +40% > 5,571 $
Monthly income ($)	**Monthly tax**
< 86	18%
87 – 207	15 $ + 23% > 86 $
208 – 332	43 $ + 28% > 207 $
333 – 464	78 $ + 34% > 332 $
> 464	123 $ + 40% > 464 $

Each individual who earned legal income was allowed to deduct at least the minimum monthly wage (64 $) from the tax base - Table 3. A person with severe handicap deducted in 2004, 2 minimum monthly wages (128 $) and if he would have 2 children to keep, the deductions increased to 3 minimum monthly wages. This is the maximum deduction that was permitted by Romanian income regulations in 2004.

Table 3 – 2004 Individual Monthly deduction – 1$ = 2.8 ROL

Table 3 - 2004 - Tax deduction in Romania						
No. crt.	**Tax deductions**	**2000**	**2001**	**2002**	**2003**	**2004**
1.	Basic individual deduction	1	1	1	1	1
	Sever handicap individual deductions	1	1	1	1	1
	Regular handicap deductions	0,5	0,5	0,5	0,5	0,5
2.	Additional deductions: Wife/husband to keep	0,6	0,6	0,5	0,5	0,5
	- for children	0,35	0,35	0,5	0,5	0,5
	- other family persons to keep	0,2	0,2	0,5	0,5	0,5

Starting with 2005, after the introduction of flat income tax, the taxation systems was radically changed, but were maintained regressive individual tax deductions because of social protection reasons, presented in Table 4.

Table 4 – 2005 Individual Monthly deduction – 1$ = 2.8 ROL

Table 4 - Individual Monthly Deduction - number of people to keep					
Gross montly income (GMI - $)	**0**	**1 person**	**2 persons**	**3 persons**	**4 or more persons**
< 357	90	125	160	196	232
358 -1071	90 x [1-(GMI – 357) / 714]	125 x [1-(GMI – 357) / 714]	160 x [1-(GMI – 357) / 741]	196 x [1-(GMI - 357) / 741]	232 x [1-(GMI - 357) / 741]
> 1071	0	0	0	0	0

Property tax

The property tax is the major source of local fiscal revenues. This tax is imposed for the following items:

- buildings and land for buildings owned by individuals
- buildings and land for buildings owned by companies
- agricultural lands not used for their specified purpose

The tax on land is established by central government, annually, accordingly with the Yearly State Budget Law, which sets an interval of values for square meters of land, depending where the land is situated. Municipalities may assign individuals and companies properties to one of four zones of taxation provided by Romanian Fiscal Code, no 571 / 2003. The local councils can, also adjust the rate of tax for each zone, within a narrow bands provided annually by the State Budget Law.

The tax on buildings represents 0.2% from the imposable value in urban areas and 0.1% in rural zones. The imposable value is calculated on built square meter taking into consideration: the structure of building (1^{st}, 2^{nd}, 3^{rd} floor, etc), construction materials used (wood, concrete, reinforced concrete, bricks, etc), the age of building, and city ranking.

The taxes on means of transportation are imposed through Yearly State Budget Law, and differentiated after the cylindrical capacity of the means of transport, and owners, including some reductions or exceptions (handicap person, pensioners, etc.). They are paid quarterly in equal parts every year.

Value added tax was introduced in 1992 through a Government Decree No.3 and it has been one the most important fiscal revenues of the state (Table 7). During last 15 years experienced several modifications concerning exemptions, taxable goods, collection procedures, etc. The most recent important changes have been done in 2002 through Law No.345 when was established the 19% rate on all delivered goods, services or accomplished works. The VAT in Romania is included and added in the selling price. The goods, raw materials, services, etc. purchased from the suppliers are taken over with, so called, “the deductible VAT”. At the end of the month, companies calculate the VAT to be paid by subtracting the deductible VAT from the collected VAT. In case that the collected VAT is less than the deductible VAT, companies are allowed in a specified period of time (depending on the company turnover) to retrieve this difference, and is called receivable VAT.

Excise Taxes were introduced since July 1993, through the Law No.42/1993. While the general taxes on consumption, such as VAT, show common traits of the countries, the special taxes on consumption may vary in role and form from a country to another. In Romania excise tax is imposed on two forms of consumption:

- imported goods – the excise tax rates may vary depending of the type of good and their destination.
- domestically goods such as: crude oil or derived oil goods, alcohol, tobacco and coffee.

We have to note that excise taxes are paid only once by either producers, importers or purchasers. The rate of excise taxes is the same for any domestically or foreign individual or company. In same time we have to mention that excise taxes proceed VAT in the process of taxation consumption goods and they are thereby included in the basis of VAT.

Customs Duties are a way to stimulate exports or to deject imports and to expand economic cooperation between countries.

Import customs duties in Romania have had in recent years a dramatically decreasing fiscal efficiency because of the exemptions provided by Romanian adherence to European Union Treaty. This regulation exempts from customs duties all European Union manufactured goods accompanying with EUR 1 certificate (provides the origin of the good and its manufacturer).

Romania uses only import customs duties and transit customs duties. Subjects of taxation could be companies with import activities or individuals authorised to conduct this kind of operations. The unauthorised persons who imports goods are subject of taxation if the goods value exceeds a certain value.

Customs duties on imported goods are expressed in percentage according to the General Agreement on Tariffs and Trade (GATT) and calculated accordingly with Romanian Customs Tariffs Catalogue, which contains about 3000 categories of product with their market value. This list can be updated and revised by the Ministry of Finance when is felt necessary (inflation reasons).

The transit customs duties are not widely used and they are imposed on the goods which are transiting Romania.

Tax reform in Romania

The tax reform in Romania should be focused, according with European Union Commission, on three major directions: stimulation of private entrepreneurship, foreign investments attraction and encouragement of free initiative and competition.

The past years main criticism was concentrated on two major directions:

- high fiscal pressure at both individual and corporate level
- correspondence with European Union fiscal policy regulations

Regarding the fiscal pressure, a study made by Romanian Chamber of Commerce and Industry – Bucharest (2003) showed that, if we are taking in consideration all central and local taxes and duties, the fiscal ratio in Romania was 45% from GDP, more than in United States and other European countries (between 20-30 % of GDP). Actually, Romania has had until 2004 one of the highest rates of taxation individual income and corporate level (Table 5).

Table 5 –Income Taxation in Europe - Heritage Foundation Statistics 2005

The level of Income and Corporate Tax %				
	Tax on income (%)		**Corporate Tax (%)**	
	2004	**2005**	**2004**	**2005**
Austria	50	50	34	34
Belgium	50	50	33	34
Bulgaria	***29***	***29***	***15***	*19,5*
Croatia	***35***	***45***	***20***	*20*
Czech Republic	32	32	31	28
Ciprus	30	30	15	15
Denmark	59	26,5	30	30
Estonia	26	26	0 reinvested profit	0 reinvested profit
Finland	36	35,5	29	29
France	49,6	49,6	34,3	34,3
Germany	48,5	47	27.9	26,4
Greece	40	40	35	35
Hungary	40	38	18	16
Ireland	42	42	12,5	12,5
Italy	45	45.6	34	34
Latvia	25	25	19	15
Lituania	33	33	15	15
Luxemburg	38,95	38,95	30,38	22,9
Malta	35	35	35	35
Holland	52	52	34.5	34,5
Poland	40	40	27	19
Portugalia	40	40	30	30
Romania	***40***	***16***	***25***	*16*
Slovak Republic	38	19	25	19
Slovenia	50	50	25	25
Spain	48	45	35	40
Sweeden	60	60	28	28
Turkey	***40***	***40***	***33***	*30*
Great Britain	40	40	30	30

On the other hand the exaggerated number of taxes and duties (220), high level of para-fiscality (state social and health insurance duties – Table 7) and unequal treatment of the taxpayers made Romania long time unattractive for foreign investors.

As a matter of fact Goldstein (2001) has identified “six commandments of good governance” in Romania:

1. Low Inflation
2. Low Taxes
3. Public Services Development
4. Individual and Public Safety

5. Tax Equity
6. Individual Liberty and Integrity of Any Citizen.

Unfortunately his and others voices were not heard by Romanian executive until 2004, when our new government radically change the financial and fiscal policy by introducing flat income tax and social and health insurance reform.

At the beginning of 2005 the Romanian mass-media presented these reforms as follows: "Flat tax – economic panacea or Pandora's box"?

If we are looking at the Baltic countries, Russia and, recently, Ukraine and Slovakia, the idea of flat tax was not new concept in Eastern Europe.

The necessity of flat tax in developing countries, as a condition to increase the level of GDP and to sustain economic development (Table 6) was demonstrated by a study made by Alexis de Tocqueville Institute (1998).

Table 6 - Alexis de Tocqueville Institute – 1998 – The effect of taxation on economic growth. Study on 86 countries.

GDP growth (%) 1981- 1997		
	Flat tax rate	**Progressive tax rate**
All countries	2.1	1.1
Developing countries	2.7	1.7

In fact, Romanian Academic Society highlighted in 2003 that the introduction of flat tax will double the forecasted rate of growth of GDP as compared to a progressive rate tax (Table 8), will increase the revenue collection more than 20% and will reduce the revenues collection costs with 100%.

Table 7 – The impact of Tax reform. IMF Report 2004

The impact of Tax Reform/GDP **(%)**				
	2004	**2005**		
	2nd Suppl. Budget	Baseline NoTax Changes	Impact of Tax reform	Draft Budget
Tax Revenue	28.80	29.10	-0.5	28.6
Corporate Tax	2.8	2.9	-0.5	2.4
Income Tax	3.1	3.1	-0.1	3.00
Social Security	9.6	9.7	-0.2	9.4
Other direct taxes	0.9	1.0	0.1	1.0
VAT	7.3	7.3	0.0	7.3
Customs Duties	0.7	0.7	0.0	0.7
Excise Taxes	3.5	3.6	0.3	3.8
Other indirect taxes	1.0	1.0	0.0	1.0

Besides, Government Report Statistics (September 2005) show that after 6 month the revenue collection increased with 16% in comparison with last year same period , despite the fact that the IMF Report predicted a decline of tax revenue by 0.5 % reported at GDP (Table 7).

This new reform has not had only partisans. Many critics have indicated that Romania will be forced to contribute for European Union budget with 2.1% from GDP,

Table 8 - 2004 IMF Report on Romania

Tax revenue / GDP (%)					
	2003	**2004**			**2005**
	Final budget	**Original budget**	**1st Suppl. Budget**	**2nd Suppl. Budge**	**Draft budget**
Total revenue	30.00	29.00	29.80	30.70	30.60
Tax revenue	28.20	27.20	28.00	28.80	28.60
Total expenditure	32.30	31.80	31.90	32.40	32.10
Current expenditures	28.70	28.30	28.70	29.10	28.9
Overall balance	-2.30	-2.90	-2.10	-1.60	-1.5
Primary balance	-0,20	-0.80	-0.5	0.0	0.2

and to control de General Government Deficit (Table 7). Considering that the Romanian Government maintains the same fiscal system, it will be necessary to choose one of these three alternatives:

Table 9 - 2004 IMF Report on Romania

Macroeconomic Variables (%)					
	2003	**2004**		**2005**	
	Final	**Original Program**	**Revised Program**	**Original Program**	**Revised Program**
Real GDP growth	4.9	5.0	5.8	5.0	5.0
Current account deficit	-5.9	-5.2	-5.3	-5.3	-5.2
General government deficit	-2.3	-2.1	-1.6	-1.9	-1.5

1. raising the taxation level
2. introducing new taxes and duties
3. reducing public expenditures

The majority of professionals consider that the most feasible solution would be to raise the taxation level because the other two solutions are very unpopular. Actually, they agreed that the appropriate decision would be to increase the VAT rate from 19% at 22-23%. Unfortunately, this measure will affect especially poor people because of the neutrality of indirect taxes.

In any case this reform was a courageous decision and has had both advantages and disadvantages. The main advantages are considered to be:

- reducing fiscal bureaucracy
- decrease of revenues collection costs
- offers incentive to work, to save and to invest capital
- to control the tax avoidance and evasion.

Among disadvantages we are presenting:

- favors wealthy people
- raise the inflation level by growing the aggregate demand

- the revenues distribution (Musgrave, 1973) is done only by public expenditures what however is affected by the political factor
- fiscal inequity (Maurice Allais)
- remains a progressive tax, because of the regressive deductions system.

Therefore we are considering that the introduction of flat tax in Romania has been a courageous and adventurous decision that will affect Romanian future development. This reform is bereft of positive outcomes if it will not be consorted by other important reform such as: health and social insurance system, privatization of all state companies, eliminating all discriminatory fiscal exemptions and deductions, and strongly enforce the control of tax evasion.

Having a strong social support, the success of flat tax in Romania depends by how executives and legislators will know to implement this reform taking in consideration Romanian particularities, updating legislation, monitorising and evaluating possible threats.

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