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## ***The Effects of Flat Tax in Romania***

Over the last years, the business environment has accumulated structural, institutional and behavioural tensions. The only viable solution was the introduction of a flat tax which was meant to bring a fiscal expansion. It was indeed the time of taking the decision, in spite of critics and opposition from former governance.

The introduction of the flat tax led, first of all, to a simplification and a more efficient computation system of global income taxation, to a significant reduction of bureaucracy and to an increase of transparency in tax collection and administration.

On the other hand, a fiscal expansion was necessary from the following points of view:

- Structural and behavioural inertia in real economy decrease the effect of fiscal expansion of low amplitude, although they are repeated at regular time spans.
- A big share of hidden economy does not react to such low institutional shocks.

Introduction of 16 percent flat tax was launched by decreasing the taxation rate at the level of direct taxation of income and profit, because the economic behaviour is directly generated by this type of taxation, and not at the level of indirect taxation or consumption.

The expected impact was mainly the change in economic behaviour of business environment, by:

- Increasing the tax base by extending the formal economy and making official a part of the hidden economy.
- Increasing the voluntary compliance in paying budgetary obligations.
- Increasing the arrears recovery, depending on the change in financial position of economic agents, following the reduction in profit taxation.

According to the new fiscal policy, duties and taxes should have a stimulative and orientative role for an economic growth and development, a fiscal consolidation and a middle class progress.

Together with the main measure applied in 2005 of introducing the flat tax of 16 percent both on profit and income, a process to align towards the level of flat tax the legal rates of taxation of the other sources of revenues (dividends, interests, capital revenues) started as well.

In the area of income tax, the global system of taxation of income achieved by private persons that assumed the use of a taxation standard with progressive quotas between 18 and 40%, was replaced by a system based on proportional quota of 16%, applied to the largest part of the income categories.

According to the new system, the procedure of globalizing several incomes is given up while the tax becomes final as the system by the taxation of the incomes by each source of income in each category is being replaced.

The categories of income for which the tax is computed by levying the 16% quota on each source of income in the respective category are: incomes from independent activities; incomes from wages and salaries; incomes from yielding the use of goods; incomes from pensions; incomes from agricultural activities; incomes from prizes; incomes from other sources.

The 2005 budget was computed so that it ensures the sustainability of the budget itself and the aggregate demand.

The modelling of the tax bases' reaction to the variation of the legal tax rates was made through a logistic function, function that is, nevertheless, the most adequate for modelling the institutional impulses' transmission. The logistic function was calibrated at the level of parameters in line with the dynamics of indicators from the SAM-MEGA economic model, an annual model for financial programming, based on the equilibrium relations of the national accounts system, used for the macroeconomic forecast and financial programming on medium term.

In the budgetary revenues projection, one took into account the behaviour of economic agents as well,

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although at this moment no behavioural relations have been built on, expressed by:

- The favourable reaction of companies to the fiscal relaxation policy, in the sense of the partial formalization of employment; as a result, one estimated for the entire period a growth of the number of employees by 415 thousand persons, double as compared to what it would have resulted from the normal elasticity between economic growth and employment;
- The improvement in propensity to pay the debts to the budget, expressed for example by the increase of collection rate for social security contribution by almost 2% on an yearly basis; in the same sense one estimated that the taxes on product will maintain their dynamics over the Gross Domestic Product's one;
- The preservation of economic agents' behaviour oriented toward competitiveness and a moderate growth of salaries, in accordance with the economic achievements; as a result, one took into consideration that the gross average wage earning by total economy will not exceed, during the entire period, the increase foreseen in the Governing Programme, of 60%.

From this point of view, the scenario resulted from SAM-MEGA model for the level and structure of budgetary revenues in 2005 does not significantly differ to the rectified budget of 2005.

A comparison between the rectified budget of 2005 (September 2005) and the Governing Programme stresses out the following:

- The revenues estimated for 2005 by the Ministry of Public Finance are 5% higher than the budgetary revenues in the Governing Programme;
- The tax revenues have equal shares in GDP in both cases (27.1%), both for direct taxes and the indirect ones;
- The only difference can be found in the profit tax. The fact that the achievements in the first 9 months determined the Government to increase the provisions concerning the levies from profit tax (29% larger than in the Governing Programme) reflects only the fact that the economy responded to the reduction of this type of tax even better than expected at the moment of elaboration of the Governing Programme.

**The positive effects** of fiscal expansion are significant and emerge mainly from the incentive role of the direct taxation on labour and capital reduction. The assumption according to which the

transfer of resources from the budget to the population and society **has a multiplying effect in economy**, by generating superior revenues for the budget, on the background of more intense economic activity, has proven to be realistic. **The main conclusions emerged from pertinent statistical data analyses which are presented below:**

### 1. Stimulating the economic growth.

- The profit tax reduction assured important financial resources to the economic agents for production and investment.
- Excluding the floods' impact on agriculture, and on the household industry (part of industry with a share of 4 percent in Gross Domestic Product), the Gross Domestic Product of the other branches increased, in the first 9 months, by 6.5 percent as compared to 6 percent in the same period of 2004.
  - GDP growth on 9 months: 3.6 percent
  - GDP growth, without agriculture: 5.8 percent
  - GDP growth, without agriculture and household industry: 6.5 percent

### 2. Technological modernization of economy has accelerated, with positive impact for the future economic growth.

- Gross Fixed Capital Formation has accelerated its growth in the third quarter as well, by 10.5 percent, respectively, determining an increase on 9 month by 9.4 percent.
- **The import of capital goods increased in the first 9 months by 31.2 percent**, as compared to the average increase of imports of 23.7 percent and with the one of consumption goods of 24.7 percent.

### 3. Improvement of the effective rates of taxation

The introduction of flat tax has a significant effect on the taxpayers' behaviour, in the sense of increasing the degree of voluntary compliance, of paying the budgetary obligation, respectively.

**a) To the profit tax** – according to the **balance sheets of economic agents**, on the first 6 months the gap between the legal rate and the effective one, computed on the base of the due tax, was improved:

	Semester I 2004	Semester I 2005
Standard quota	25	16
Effective quota	15.9	11.6

- The differences between quotas have been reduced together with the increase of the profit mass in economy and the diminishing – **in real terms** – of losses.

In the first quarter, the total profit increased **in real terms** by 1 percent, and the total loss has been reduced by 5 percent.

The introduction of flat tax together with the strengthening of the financial discipline led in the first semester to a budget revenue from the profit tax 50 percent higher than the due profit tax.

**b) To VAT** (as compared to the market consumption of population), the effective collecting rate has been improved, reflecting the reduction in fiscal evasion:

14.3% in 2004

15.4% in 2005

The improvement in VAT collecting rates leads to an increase of 36.2 percent of VAT that was reflected in the increase in indirect taxes by 25.3 percent, for 12 months 2005.

#### 4. Budgetary revenues

For the 12 months of 2005, the revenues of the general consolidated budget were higher by 17.8 percent than in the same period of 2004, meaning in real terms an increase by 8.1 percent.

- In absolute terms, the increase in revenues was mill. RON 12,608.7, of which the increase of the state budget was mill. RON 4,404.6.

These results were obtained in the condition in which the appreciation of national currency (unlike in the year 2004 when the national currency had depreciated) has influenced in a negative way the cashing of excises (the excises are computed in Euro and if we have had depreciation, the payment in lei would have been greater).

- Due to the increasing number of both employees and average earning salary, the revenues of the main social security funds (social security fund for health, the state social security budget, the social security budget for unemployment) increased by 11 percent in 12 months 2005.
- The Value Added Tax on whose evolution contributed mostly the reduction of direct taxation at the income level, generating this way an increase of disposable income of population, meaning a higher consumption of goods and services, presented the most signifi-

cant nominal increase of the total budgetary revenue sources, by 36.2 percent respectively, meaning 24.9 percent in real terms.

#### 5. The effects of introduction of the flat tax rate on employment

- The introduction of flat tax assured the reversal of previous historical evolution of annual increase of employees' number from the hidden economy.
- Even if the monthly data regarding the number of employees has shown a seasonality pattern, yet the significant increases registered this year (the highest ones since 2000) showed that the fiscal expansion encouraged employment.
  - In the delivered materials there is a detailed analysis of flat tax effects on employment.
- The final statistical data regarding the first semester (households' inquire) show that the increase in employees' number in the first semester totally represented a transfer from the hidden economy to the official one, by 125 thousand persons, respectively.
- A second conclusion – emerged from the operative data at the end of October – reveals that the employees' number was higher by 140 thousand persons, as compared to December 2004.
- One has to highlight that if we do not take into account the reduction in industry - due to the reorganisation and the need of increasing competitiveness of some activities - **the net increase of employees in other activities is 193 thousand persons, as compared to 2004.**

#### 6. The effects of flat tax on average wage earning

- Flat tax introduction was reflected in the **increase in salary incomes, but these results were pointed out in the evaluations made before the flat tax introduction, meaning a correct substantiation of usefulness of fiscal reduction for Romanian economy.**
- During January–November 2005, the increase of gross average wage earning is only by almost 2 percent over the forecasted level.
- The share of net average wage earning in the gross average wage earning became 76.4 percent, exactly as anticipated.

For the next period, fiscal legislation reform will grant priority to the consolidation of competitiveness advantages obtained by flat tax introduction and to the continuation of the process of alignment to the aquis communautaire. The process of

supplementary diminishment of contributions to social security will continue in short run together with the increase towards the level of flat tax of legal taxation rates for the other income sources. The main objective is represented by the increase of transparency and predictability degree of fiscal policy and creation of non-discriminatory business environment.

The fiscal policy measures, being applicable starting 2006, follow the increase of taxation base and alignment to flat tax rate of 16 percent for the entire revenue category. For example, in this sense, the flat tax of 16 percent will be applied on incomes from dividends, interests, earnings from bonds, from operations of selling and buying foreign currency in time, based on contract, on the incomes from liquidation of a juridical person.