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Weekly Briefing

Romania Economy briefing:

The fiscal revolution and the explosive economic growth in the third semester of 2017

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1. The fiscal revolution

A package of changes related to the Fiscal Code was adopted on 8th November 2017 through the Emergency Ordinance 79/2017 and will come into force from the 1st January 2018. The amplitude and impact of the fiscal changes are so important for the Romanian economic development, that the measures are considered to cause a Fiscal Revolution. Although the aim of the fiscal package is to simplify the fiscal burden and to cut red tape, it triggered numerous unfavourable reactions of the private environment.

The main measures implemented:

- The income tax is reduced from 16% to 10% for incomes from salaries, interests, rents, agricultural activities, forestry, fishery, awards and investments.
- The amounts exempt from taxes are increased.
- The social security contribution (SSC) is transferred from the employer to the employee with the reduction of the SSC from 39.25% to 37.25%.
- The number of the salary contributions is reduced from 9 to 3.
- The introduction of "the insurance contribution for work" of 2.25% payable by employers, which will fund the Guarantee Fund for the payment of wages and benefits (such as unemployment benefits, allowances for sick leaves or work-related accidents and occupational diseases).
- The revision of the way in which small and medium size enterprises (SMEs) are charged: the SMEs with a turnover under one million euro will pay a tax of 1% of the turnover, instead a tax of 16% of their profit.
- The transposition into the national legislation of the EU Directive 2016/1164 provisions for fighting against the externalization of the multinational companies profits: limiting the interest deductions; taxation of the capital that leaves the country; strengthening the anti-abusive rule (the Romanian authorities could refuse companies to take advantage of the tax benefits obtained from abusive arrangements); new rules on foreign controlled

companies, aiming at preventing tax avoidance by diverting revenue to tax haven subsidiaries.

- An economic agent could be sanctioned with the refusal of VAT deduction if there are clear information that he was informed about tax evasion activities of the companies with which he collaborates. The seizure of the companies found in a tax evasion situation with alcohol and tobacco is extended to the means of transport.

The supporters of these measures – the ruling coalition – highlight that these measures will generate more money for Romanians, new opportunities for employers and fiscal simplification, while encouraging a fair attitude towards companies involved in fiscal evasion and multinationals. Still, the business representatives – such as entrepreneurs, analysts, consultants, employers' leaders or investor associations – and the politicians from opposition reject them at least partially, invoking major risks to the macroeconomic stability. The President of Romania, Klaus Iohannis, criticized the announced changes in the fiscal legislation. During the Government meeting that approved these fiscal measures, 200 people were protesting against the transfer of the SSC from the employer to the employee.

The main complaints related to these measures:

- The transfer of SSC from employer to employee would mean a decrease of the net wage for the employee, unless the employer increases the gross wages by 22.75%. Only with this increase the employee will not feel the effects of this fiscal measure. The main fear is that companies in the private environment will not proceed to these increases, due to the fact that they already decided their budgets for the next year. In addition, the employers have other costs, for example related to changing the wage and social contributions' calculation software. This intrusion of the Government in the private business is alarming for employers. To date, just some companies (either multinational, either state companies) announced increases of the wages. In the meantime, thousands of people protested in the whole country against this measure (among them, the employees of the car producer Dacia). Trade union confederations in Romania notified the People's Advocate in this matter.

- The municipal revenues will decrease with about 20% due to the reduction of the income tax from 16% to 10%. The global income tax is one of the main sources for the total revenue of local authorities. Its decrease will affect the local autonomy, due to the fact that the local administration will not have enough funds for investments. This will further have repercussions on the development of the entire country. The measure was also criticized by mayors close to the ruling coalition. The Association of Municipalities in Romania required the Prime-Minister to withdraw such a measure since the highest impact will be supported by the 22 cities that produce over 60% of Romania's GDP.
- Multinationals are affected by the implementation of the EU Directive, and consider that the Government chose to implement the most restrictive version of the Directive, without impact studies and with a very close deadline for the entry into force.

The analysis of the Fiscal Council in Romania indicates a loss of around 5.2 billion lei caused by the entire package of fiscal measures, while the compensatory measures do not entirely cover it. Therefore, Romania will assist to a widening of the budgetary deficit, which is contrary to the European norms.

The ruling coalition is accused of putting under pressure the future development of Romania, by taking measures with a pronounced populist trait that translates into a minimal development of living standards for the citizens. Despite the raising wages, the purchasing power is threatened by price increases, while the economic theory do not encourage measures of fiscal relaxation (such as drops of taxes) in periods of economic expansion, on the contrary. Similar measures meant to attract voters for the parliamentary elections in 2009 were taken also at the dawn of the 2008 economic crisis. Following such a behaviour of public policy-makers, Romania is considered to have suffered one of the most severe austerity regimes in the whole EU.

The measures already taken add to the lack of predictability of the fiscal environment, given that the Fiscal Code already changed 20 times in the last two years, each time generating implementation costs.

2. The explosive economic growth in the third semester of 2017

Romania recorded an economic growth of 8.8% in the third semester of 2017 as compared to the third semester of 2016, meaning that Romania had the highest economic increase in the EU. It also registered the highest growth rate since the economic crisis in 2008, enhanced by a pro-cyclical mix of economic policies. The economic growth reached a peak of 7% in the first nine months of 2017 on a year-on-year basis.

The experts in the field consider that this growth is unsustainable due to an accumulation of macroeconomic imbalances and lack of investments, triggering the risk of overheating the economy. Under these assumptions, the next economic recessions seems inevitable. The peril after such an explosive growth is a sudden braking, without leading to a recovery of the economic gaps.

There are several macroeconomic imbalances that accumulated in the last period, doubting the positive effects of such an impressive economic growth.

Paradoxically to a healthy economic development, the forecasts indicate that Romania will succeed to end the year with a ***budgetary deficit*** of 2.96% of GDP, fortunately under the EU limit of 3% of GDP. Under these assumptions, Romania is the country with the second highest deficit in the EU, after Spain. Or, in times of economic expansion, countries should register lower levels of deficits or even surpluses. It is a hardly reached target even with an explosive economic growth. In addition, the limit is met given a total sacrifice of investments.

The deficit of the current account reached 4.2 billion euro in the first nine months of 2017, 45% higher than the one recorded in the same period in 2016. ***Trade deficit*** increased with 26% in the same period, and reached 8.8 billion euro, the highest level since the economic crisis in 2008. This evolution was determined by an increased in wages during the whole year, which generated a rise by 9.8% in consumption in the first 9 months of the year. The trade deficit is mainly generated by the consumption goods. The imports surpass exports and the situation is augmented by a higher growth speed of imports than of exports. In this context, the main concern is not only that the consumption growth is exceeding the economic growth, but it is well above the increase in the domestic supply. The problem of the current account deficit risk worsening, even if this deficit is partly covered by capital inflows and European funds.

As a consequence of all these evolutions and the fiscal measures adopted by the Government lately, the Romanian currency – the leu – is on a long-term depreciation trend. At the beginning of the week, ***the depreciation of the national currency*** against the euro has reached the lowest historical level.

With an economic growth enhanced only by consumption, while the investments stagnate and a positive contribution of the private environment abolished by the severe decline in the public sector, the economic perspectives are not too bright. In addition, there seems to be no intention of correcting such situation, given that, in the second budgetary rectification of this year, the Government decided to share the public money also for consumption. The Labour Ministry received more funds for social assistance, while other sums of money were intended to cover the local administrations' budgetary needs with salaries.