# The flat tax in Romania. A good economic strategy?

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# THE FLAT TAX IN ROMANIA. A GOOD ECONOMIC STRATEGY ?

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This paper evaluates the main effects of the implementation of tax flat system in Romanian economy. If accompanying measures are not going to be enforced, the introduction of the flat rate of 16% in Romania will lead to unsustainable budgetary deficits and inflationist pressures. The flat tax favors the workers with big salaries and also big and financially solid companies (which, mainly "export" the profit). It will attack the fragile macroeconomic stability. It is uncertain if it will lead to the increase of the degree of employment, having in view the fact that the contributions to the social insurances have a very high level. The alternative scenario is simple. Romania should have chosen to continue what it was confirmed to be a valid element of the economic evolution towards a European standard (progressive fiscal system).

At the end of 2004, the Romanian Government introduced flat tax of 16% on the incomes of individuals and on the profit of the companies. According to the opinion of the authorities who proposed it, this measure represented the structure of a fiscal relaxation. Subsequently, the numerous increases of taxes questioned the relaxation thesis regarding taxation. The present study is not mainly aimed to clarify the concept of fiscal relaxation. However, one remark has to be made. We can state that the introduction of the flat tax is nothing but a perverse reduction of fiscality (taxation system). The contribution rate to the social insurances has a significant share in the aggregated supply and demand and unfortunately it still remained at a high level (47,5%).

The potential expansion of businesses, the increase of direct investments, the reduction of the share of underground economy, a sustainable economic growth, more jobs, the increase of saving and investments, were considered ingredients of a successful program. However, many specialists showed their concern regarding the timeliness of introducing the flat tax. What are the conditions for a successful introduction of the flat tax? Do strong inflationist pressures appear in Romania due to the introduction of the flat tax? Does the macroeconomic stability disappear? Will the benefits of the flat tax observed in Slovakia show themselves in Romania as well?

In the search for answers regarding the introduction of the flat tax, we showed our concerns regarding the numerous approaches to a macroeconomic instrument of policy incongruous with the pattern of European economy and exaggerated for an economy in full process of restructuring.

## The Model

When planning a tax reform, you have to know the magnitude of the multiplying effect of the tax rate reduction due to the fact that this can lead to an aggregated demand in excess thus causing almost unstoppable inflationist effects.

The reduction of fiscality has effects on the aggregated demand as well as on the aggregated supply. However, the effects are differentiated as size (Figure 1). The incidence of the reduction of fiscality is stronger on the aggregated demand ($AD_0$-$AD_1$) and more reduced on the aggregated supply ($AS_0$-$AS_1$). The theorists motivate the increase of the aggregated supply by the improvement of working incentives, although recent studies show that the introduction of the flat tax has as main quality the reduction of the administrative costs (its simplicity).

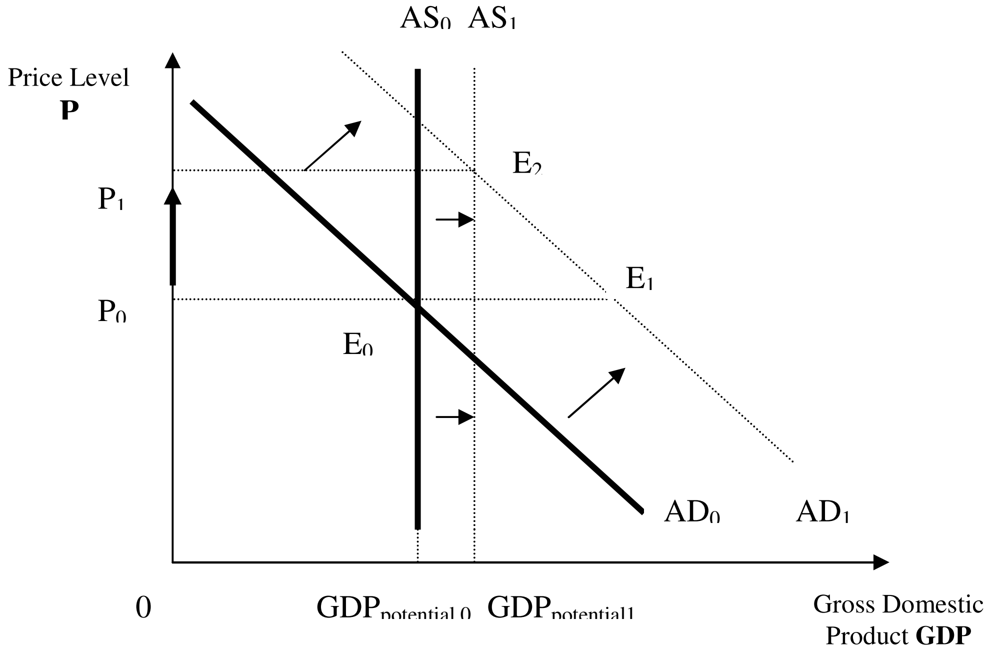


Fig 1 **Fiscal relaxation with flat tax system**

We have to distinguish between the short term effects and the long term effects of the taxation reduction. *On short term* following the taxation reduction, the aggregated demand increases ($AD_0$-$AD_1$) (in Romania, 34% in 2005) and the economy moves from $E_0$ to $E_1$. The gross domestic product is increasing with a big measure causing the decrease of fiscal incomes cashed in the budget with a percentage which is smaller than the decreasing percentage of the marginal taxation rate. *On long term*, the economy will reach point $E_2$ (following the movement of the aggregated supply $AS_0$-$AS_1$ ). As a consequence of the taxation reduction the working incentives grow and in this way the $_{\text{potential}}$GDP moves from $_{\text{potential 0}}$ GDP to $_{\text{potential 1}}$ GDP (in Romania, 11% in 2005). The increase of $_{\text{potential}}$GDP is smaller than the one obtained by stimulating the aggregated demand. It results that the fiscal incomes collected from the state budget increase with a rate which is much smaller than the decreasing rate of the collections to the budget as a consequence of applying the flat tax → the budget deficit increases → strong inflationist pressures appear. The analysis of the diagram also shows that the inflation increases ($P_0 \rightarrow P_1$).

## Complex Reality in Romanian Economy

The fiscal relaxation expected to come from the flat tax will lead to a boom of businesses, will stimulate us to work more, will bring to surface an important part of the "underground" businesses (20% in Romanian GDP), will attract direct foreign investments, will lead to a sustainable economic growth, more jobs, the increase of saving and investments etc. However, the specialists of the International Monetary Fund (and not only them) expressed their opinion saying that timing is wrong.

The expansionist economic policies of the current authorities, under the conditions of an already "superheated" economy will cause a price increase of more than 5%, the inflation target forecasted by the National Bank for 2006 (inflation targeting strategy was introduced in Romania in 2005). The alarming growth rate of the deficit of current account (12% of GDP in 2006), the budgetary "holes" created after the introduction of the flat tax (1% of Romanian GDP in 2006), the increase of public expenses, a still unwise wage policy, the liberalization of the capital current account, the inefficient restructuring, the increase of the expenses for adhering to the European Union and NATO (3% in Romanian GDP, annually, in average), the exponential growth of consumer credits are all factors pressing on the growth of inflation above the forecasted level.

## Who losses and who gains?

The families with big incomes gain, the families with small incomes loose. The calculations of the Ministry of Finance shows that the average incomes of the population have increased with 21% in the first four months of 2005, compared with the same period of 2004. However, the reality is totally different like in many other situations. A study made by Mercury Research showed that an important part of the Romanians (65%) consider that the introduction of the flat tax caused a decrease of their standard of living. The segment of workers with incomes that are bigger than the average (which represent a low percentage from the total in Romania – 12%, are the only ones who benefit from the introduction of the flat tax. And still, somebody keeps helping the flat tax to become a 'winner". That somebody is the taxpayer. He is the one bearing the burden of higher prices. We are talking about prices hiding the increase of taxes, the elimination of the exemptions from V.A.T., the increase of interests. The sellers of real estate properties, the depositors to the banks etc., also contribute to the covering of the budgetary "hole" created by the flat tax.

**What Comes Next?**

An increase of the budgetary deficit (around 3% of GDP, in 2007). A deepening of the trade balance deficit. Probably, an increase of the current account deficit until the level of 12% in the years to come. Inflationist pressures. The decrease of the credibility of the National Bank of Romania, without being its fault. The Central Bank will continue increasing the rate of the interest of reference, strengthening in this way the governmental option for restrictive macroeconomic policies, in accord with the need to touch the short and long term sustainability of the disinflation process. On the other hand, the transition costs (the current budgetary costs, the costs related to the social insurances reform, the additional costs allocated to health, education, army etc.) superposed to the costs related to the adhering to the EU (approximately 1,3% of GDP – the contribution to the common EU budget, 1% of GDP – co financing of structural funds) will lead to high budgetary deficits in the following years.

**What to Be Done?**

The increase of aggregated demand will go far beyond the increase of GDP potential (even if there is a small increase of the productivity of labor). If NBR wishes to obtain a sustained economic growth and the stability of prices, on long term, it will have to promote a proactive monetary policy – to take the measure of increasing the interest rate of reference. NBR does not have to act upon the current situation of the aggregate demand but it has to respond to the inflationist pressures which will appear if the economy grows too fast. For the introduction of the flat tax not to lead to strong budgetary deficits and to high inflationist pressures, we think that the following accompanying measures are needed:

*a) The Improvement of the Financial System:*

- The reduction of the public expenses by reducing the dimension of the governmental sector, a prudent wage policy etc.
- The intensification of execution debt enforcements and of imposing strong constraints to the bad payers;
- The reduction of the share of the contribution to the social insurances - long term equilibrium between the work taxation and capital taxation.

b) *The Implementation of the Policies of Stimulation of the Aggregated Supply*

- A higher legislative stability, institutions capable of exercising the governing;
- The reducing of the internal lags of the fiscal policy (which are already big);
- Predictability in the fiscal reform;
- A stable and predictable competitive environment (the functionalizing of the Council of Competition);
- The granting of state grants only in accordance with the European legislation in this field;
- The stimulation of internal investments and economies;
- Coherent strategies of attracting direct foreign investments;
- The reduction of social contributions in order to increase the degree of employment;
- The increase of manpower by formulating a Labor Code unmarked by ideological prevalence and which admits the flexibility of the labor market and generates the responsibility of the economic actors.

*c) The Reduction of Market Distortions by Limiting/Stimulating the Effects of Negative/Positive Externalities, by:*

- The rigorous setting of proprietary rights;
- The reduction of transaction costs;

- The using of taxes and subsidies in order to eliminate the effects of negative externalities;
- An efficient restructuring and privatization process, accompanied by the enforcement of active industrial policies;
- The free entry and exit on/out of a market of the economic agents (especially the liberalization of the exits from the system).

**The "Reloaded" Model**

The matrix of the policies accompanying the flat rate (proposed above) is able to lead to a bigger increase of the GDP potential (GDP potential 0→GDPpotential1) as compared to the increase of GDP potential from the initial model. The aggregated supply AS will increase with a higher measure and consequently the AS curve will change its place more to the right (compared to the initial model) ($AS_0 \rightarrow AS_1$).

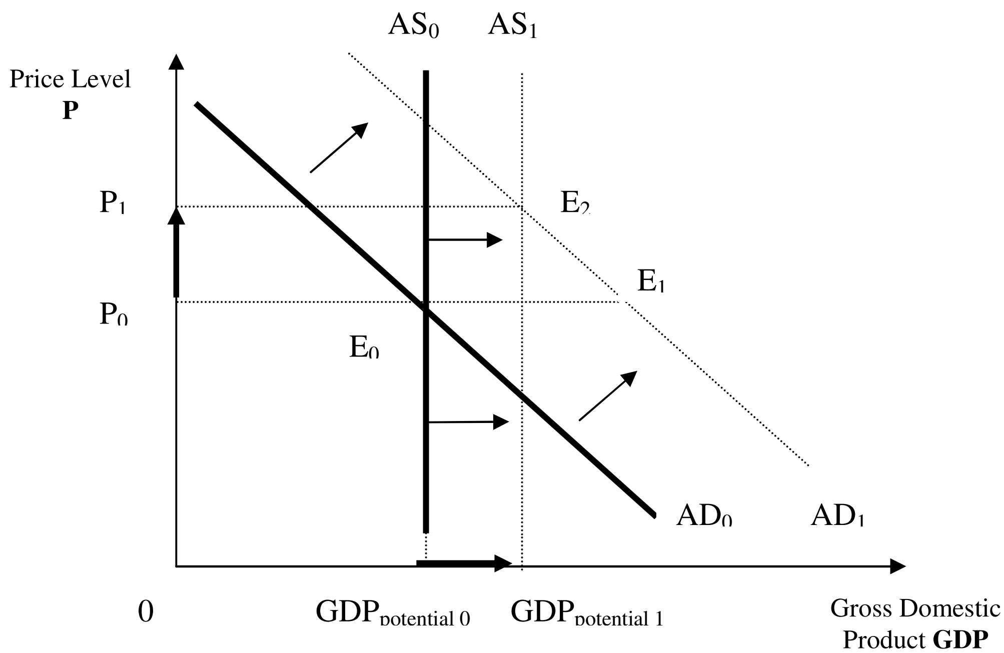


Fig 2 **The "Reloaded" Model**

In this way, the budgetary deficits will be smaller, and the inflationist pressures a little less unbearable ($P_0 \rightarrow P_1$). The

National Bank of Romania will be able to reach the inflation target for the next years, and the deficit of current account will no longer be at “concerning levels”. In this way a virtuous circle is created. We will be able to re motivate the hope that the introduction of the flat tax will be a success.