



HIGH-LEVEL SUMMARY TECHNICAL ASSISTANCE REPORT

ROMANIA

A Tax Mix to Achieve Fiscal Sustainability and
Fairness

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FISCAL AFFAIRS DEPARTMENT

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The *High-Level Summary Technical Assistance Report* series provides high-level summaries of the assistance provided to IMF capacity development recipients, describing the high-level objectives, findings, and recommendations.

ABSTRACT: Romania's medium-term fiscal framework calls for the fiscal deficit to decline gradually from about 8 percent of GDP in 2024 to 7 percent in 2025 and 3 percent (or less) by 2031. With limited scope for expenditure consolidation – given the low expenditure-to-GDP ratio – revenue mobilization is imperative. IMF technical assistance proposes a tax reform package aimed at mobilizing revenues, while improving work incentives, remaining attractive to capital investments, and closing loopholes for abusive tax planning. The key recommendations shift the fiscal burden away from labor taxation (including social insurance contributions) toward taxes on consumption and, to a lesser extent, on capital. The detailed recommendations, if fully implemented, can generate revenues of at least 1.2 percent of GDP in 2025.

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Background

Romania's medium-term fiscal framework calls for the fiscal deficit to decline gradually from about 8 percent of GDP in 2024 to 7 percent in 2025 and 3 percent (or less) by 2031. With limited scope for expenditure consolidation – given the low expenditure-to-GDP ratio – revenue mobilization is imperative. In the short term, Romania has agreed with the European Commission (EC) to undertake (unspecified) tax policy reforms to increase revenues in 2025 by 1.1 percent of GDP. As Romania has the third lowest tax-to-GDP in the European Union (EU), there is ample room for tax policy to complement the ongoing digital transformation of the tax administration to generate additional revenue. IMF technical assistance, requested by the Minister of Finance, proposes a tax reform package aimed at mobilizing revenues, while improving work incentives, remaining attractive to capital investments, and closing loopholes for abusive tax planning. Rather than undertaking the minimum necessary tax adjustments to secure the EU's disbursement of funds, the deficit pressures can be seen as an opportunity for Romania to make important structural improvements to its tax mix, notably shifting the tax burden away from mandatory social security contributions and relying more on consumption and income taxation.

Summary of Findings

The labor income tax wedge in Romania, which includes personal income tax (PIT) and mandatory social security contributions (SSCs) for pensions and health insurance, is among the highest in the EU at lower income levels, although at the average wage Romania's tax wedge is lower than the EU average. The large tax wedge at low incomes creates a barrier to entry into the formal workforce for low-income earners. The lack of progressivity in the tax wedge across the income spectrum implies the PIT system does not fulfill its function as key instrument for redistribution. Tax expenditures associated with SSC exemptions are substantial and discrepancies in SSC liabilities between self-employed individuals and wage workers create opportunities for tax arbitrage. Introducing a system of progressive marginal tax rates can mobilize revenues while improving the vertical equity of the distribution of (net) incomes. This could be accompanied by more generous allowances, or an in-work benefit program, and a reduction or elimination of the SSC for health insurance. Most public pension income is untaxed in Romania, while pension contributions are deductible for PIT. Rectifying this inconsistent treatment of contributions and benefits would improve the sustainability of the pension system.

The importance of the corporate income tax (CIT) in Romania has been declining over time and its revenue performance and productivity are lower than in most of its regional comparators. The CIT tax expenditures resulting from tax incentives are significant. The exemption of reinvested profits accounts for 4.3 percent of CIT revenues, while the cost of the tax credit for sponsorships is particularly high at 7 percent. Incentives for R&D are the most compelling due to their potential positive externalities. Romania's enhanced deduction of 50 percent to encourage R&D could be made more effective by

¹ This is the difference between the gross cost of labor—including all taxes and levies on labor paid by companies—and post-tax wage income of individuals, divided by the gross cost of labor.

converting it to a refundable tax credit, which would provide cash support to companies engaged in R&D, especially those that are new and small.

Romania's anti-abuse framework was recently updated to conform with the EU's Anti-Tax Avoidance Directive. Romania has implemented all common anti-abuse measures, including the controlled foreign company and thin capitalization rules. A new structure in the MOF is dedicated to transfer pricing.

The requirement that enterprises in the microenterprise tax regime have at least one employee has reduced the opportunity of tax arbitrage by self-employed owners. However, enterprises with higher turnover and higher profit margins can certainly face a lower effective tax rate on profit compared to the effective rate in the regular CIT regime. Moreover, self-employed individuals in the microenterprise regime face a lower tax obligation than those engaged in independent activities as freelancers. Reducing the turnover threshold will clean out many entities whose presence in the microenterprise regime is purely to reduce their tax burden relative to other organizational forms.

Tax revenue forgone due to the use of reduced VAT rates, rather than the standard one, is equivalent to a subsidy provided by the government to consumers of the goods or services subject to the reduced rates. Empirical studies show that only a small fraction of this subsidy accrues to low-income households. Similarly, reduced VAT rates may not be a cost-effective instrument to promote the consumption of merit goods. In addition to foregoing revenues, reduced VAT rates create economic costs by introducing price distortions and they raise compliance and administrative costs. Raising the reduced rates to the standard rate would raise substantial revenues.

Excises on cigarette, spirits, and beer are very low in Romania compared to other EU countries. Moreover, wine (except for sparkling wine) is not subject to any excise taxation. Nevertheless, alcohol and tobacco excise taxes generate significant tax revenue, accounting for 1.2 percent of GDP in 2022. 90 percent of these revenues stem from tobacco, reflecting the comparatively lower alcohol tax rates and high smoking prevalence.

Romania has committed to meet the EU-wide emissions reduction targets by 2030 and set a net-zero path for 2050, but current policies fall short of its binding goals. The excise duties on fuels (except for natural gas) should be gradually but significantly increased to align fossil fuel prices in Romania with its climate goals for 2030. To bring current fossil fuel prices to within 75 percent of the optimal prices, retail prices for coal (industrial use), gasoline, diesel, LPG, and kerosene would need to be gradually increased from current levels by 227, 77, 192, 44, and 51 percent, respectively, while natural gas is already optimally priced in 2024—these are significant increases that need to be communicated and phased over time carefully, with offsetting policies to cushion the impact on the poor.

Romania is preparing to merge the land and buildings tax and to move toward market values as the base for the recurrent property tax. Romania aims to adopt a modern computerized automated mass valuation (CAMA) system with a deadline of the fourth quarter 2025. This implies switching the current property tax to a market value-based system. However, to this date, the property tax framework in the Fiscal Code is unchanged. Pilots of CAMA models have been tested on some administrative units, including three in Bucharest. Romania should use value-based assessment where market information allows, both for residential and non-residential properties, and curtail exemptions from the land and building tax, while providing relief in other forms for vulnerable groups and specific taxpayers.

Summary of Recommendations

The IMF's technical support to Romania provided as key a recommendation for reforming the tax system to shift the fiscal burden away from labor taxation (including SSCs) toward taxes on consumption and, to a lesser extent, on capital. The detailed recommendations, if fully implemented, can generate revenues of at least 1.2 percent of GDP in 2025.

A. Labor Taxation

Moving from the single 10 percent PIT tax rate on labor income to a system with two marginal tax rates, 15 and 25 percent, with the latter applicable at the 90th income percentile. To reduce the labor tax wedge on most taxpayers, the health insurance contribution should be significantly reduced or eliminated. Fiscal space permitting, the labor tax wedge at low incomes should be addressed with more generous allowance or by introducing a program of in-work benefits. Pension contributions should either be non-deductible, or pension incomes should be taxed.

B. Taxation of Capital Income and Property

Taxes on dividend distributions to individuals should be increased from the current 8 percent to 10 percent, which is the rate of tax on interest income. This would raise revenues, reduce tax arbitrage opportunities, and improve progressivity. The main recommendations for the property tax are to merge the land and building tax into a single tax and to curtail exemptions while providing tax relief for vulnerable groups in other forms. The taxation of business profits can be improved by eliminating the tax credit for corporate sponsorships and replacing the tax exemption for reinvested profits with a tax credit of up to 50 percent for eligible investment, capped at 10 percent of profit tax liabilities. The R&D tax incentive should be restructured as a refundable tax credit. Finally, the turnover threshold for the microenterprise regime should be substantially reduced from its current level of EUR 500,000, preferably by harmonizing it with the registration threshold for VAT (EUR 88,500).

C. Consumption Taxes

To increase revenues and create fiscal space for reducing the rate of the health care contribution, the reduced VAT rates should be increased to the standard rate, except possibly for staple foods—the increase could be phased over time to smooth its impact on consumer prices. In addition, the standard rate should be increased from 19 percent to at least 20 percent in 2025 and subsequently to 21 percent—close to the EU-27 average of 22 percent. Inflation-adjusted excise taxes on tobacco and alcohol should be increased and the excise rate for still and sparkling wines should be unified at around RON 60/hl (at current prices). Inflation-adjusted excises on fossil fuels should be increased gradually toward their optimal levels. The additional carbon pricing should be accompanied by programs, such as targeted cash transfers, to protect lower-income households from the impact on energy prices.