The Fiscal Council's opinion on the draft Emergency Ordinance amending and supplementing Law no. 571/2003 regarding the Fiscal Code (extending the application scope of the reduced VAT rate of 9% for food products and restaurant services)

On the 15th of April 2015, the Ministry of Public Finance (MPF) remitted to the Fiscal Council, the letter no. 675981 from the 7th of April 2015, requesting the Fiscal Council's endorsement on the draft law amending and supplementing Law no. 571/2003 (extending the application scope of the reduced VAT rate of 9% for food products and restaurant services) under art. 13 of the Fiscal Responsibility Law no. 69/2010 as amended and supplemented (FRL).

According to the aforementioned article of the FRL, *"proposals for any legislation leading to a reduction of budgetary revenues must provide a financial statement according to article 15 of Law no. 500/2002, as amended and supplemented and meet at least one of the following conditions:*

a) to have the endorsement of the Ministry of Public Finance and of the Fiscal Council, confirming that the financial impact was taken into account in the budgetary revenue forecast and does not affect the annual budget targets and medium term targets;

b) to be accompanied by proposals for measures to compensate the financial impact, by increasing other budgetary revenues."

The case in question is covered by paragraph a) of the FRL article cited above, given the fact that there have not been taken any relevant compensation measures to offset the negative impact on revenues. The explanatory note, attached to the proposed legislative measure, lists some possible compensation measures, on which the Fiscal Council will state its opinion in the present document, but they do not fall under the paragraph b) of the FRL article cited above.

Brief description of the legislative proposal and its budgetary impact. General considerations

The legislative proposal envisages several amendments to the Fiscal Code, of which only the proposals on extending the application scope of the reduced VAT rate of 9% to food products, including beverages, without alcoholic beverages, live animals and birds from domestic species, seeds, plants and ingredients normally used in food preparation and also restaurant and catering services, excluding alcoholic beverages, are relevant in terms of the budgetary impact and in terms of the Fiscal Council's endorsement. The provisions of the aforementioned emergency ordinance will be applicable starting from June 1st, 2015.

The draft emergency ordinance has been approved by the Government on April the 7th and subsequently published in the Official Gazette from April the 14th, without having the Fiscal Council's endorsement, required under article 13 of the FRL. The ease with which the fiscal rules were repeatedly circumvented in the past and the violations the article 13 provisions of the FRL which stipulate as compulsory the Fiscal Council's endorsement on legislative measures that lead to reduced revenues, in the absence of other measures that increase budget revenue categories as required by the FRL, highlights the weakness of the constraints exerted by the provisions of the FRL. Given all these, there are serious concerns regarding the commitment to the European fiscal rules that were established into the national law given the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the Fiscal Compact).

It should be noted that a few weeks ago the Government adopted a draft law that contains major changes regarding the tax rates and tax bases of the main tax categories, the implementation of which is scheduled for the period 2016-2019 and on which the Fiscal Council issued a negative endorsement on March 30th [1]. This proposal completes the comprehensive package of fiscal loosening above mentioned, expanding the application scope of the reduced VAT rate of 9% and moving forward the implementation deadline of these changes from January 1st, 2016 to June 1st, 2015.

From the perspective of the first-round budgetary impact, the explanatory note attached to the draft project amending the Fiscal Code assesses a budgetary income loss of 2.44 billion lei in 2015 (corresponding to a period of 6 months of execution in cash standards), 5.17 bn. lei in 2016, 5.51 bn. lei in 2017 and 5.87 bn. lei in 2018. The document presents as sources of compensation for the tax cuts impact on VAT revenues, the second-round effects (resulting from the additional economic growth) and the supplementary revenues expected from the implementation by the National Agency for Fiscal Administration (NAFA) of the structural measures designed to make the system of revenue collection more efficient and to increase the voluntary compliance, both on declaration and payment. The second-round effects (derived from the additional economic growth) are assessed by the Government at about 1 bn. lei in 2015 and at about 1.8 bn. lei in the period 2016-2018. The document also quantifies the additional income receipts from the improvement of NAFA's activity to about 5.5 bn. lei in 2015, 14 bn. lei in 2016 and respectively 18 bn. lei annually in the period 2017-2019.

A parallel evaluation conducted by the Fiscal Council on this measure's first-round budgetary impact, having as a starting point the household expenditure in Romania with the considered

[1] See Fiscal Council's opinion on the draft revision of the Fiscal Code (http://www.fiscalcouncil.ro/FiscalCouncil-sOpiniononthedraftrevisionoftheFiscalCode.pdf).

products for applying the reduced rate, extracted from the National Institute of Statistics's (NIS) publication "The coordinates of living standards in Romania. The household revenues and consumption in 2013" and detailed in Annex 1 indicates a revenue loss of 2.78 bn. lei in 2015, 5.86 bn. lei in 2016, 6.22 bn. lei in 2017 and 6.61 bn. lei in 2018, levels relatively close to those estimated by the MPF. Regarding the second-round effects, reapplying the algorithm described in the Fiscal Council's opinion from March 30th 2015 and detailed in Annex 2 indicate additional revenue of 0.22 bn. lei in 2015, 0.73 bn. in 2016, 1.22 bn. lei in 2017 and 1.58 bn. lei in 2018, corresponding to an additional economic advance of 0.2 pp in 2015, 0.3 pp in 2016 and 2017 and 0.2 pp in 2018, levels significantly lower than from those estimated by the MPF, mostly in the period 2015-2016.

Analyzing the VAT system in the EU countries, it can be observed the widespread practice of using differentiated low rates for food products excluding alcoholic beverages and/or restaurant and catering services as it can be seen in Annex 3. Therefore, implementing such a measure in Romania would be in line with the practices from many EU countries, even if there are plenty of countries that opted for applying a single VAT rate[2]. Also, such a measure could be socially justified, given the regressive nature of the VAT although it made be brought into question the fact that there may be other ways to support disadvantaged/low revenue social categories, the reduced VAT on food having a general nature. The literature has shown that similar effects in terms of social equity can be achieved with lower budgetary costs through targeted direct transfers to poor families or by increasing the deductions granted in the case of personal income tax for low wages.

Reducing tax evasion as a source of offsetting the revenue losses

Basically, the main source indicated by the Government to cover the revenue gap caused by extending the application scope of the reduced VAT rate of 9% is the additional revenue generated by the improvement of the NAFA activities regarding tax collection. Moreover, in the Government's view this improvement has represented the main source of compensation also for the comprehensive package of tax cuts proposed for the period 2016-2019, as the extra revenue assessed by the Government a few weeks ago were of around 14 bn. lei in 2016, and respectively, at about 18 bn. lei per year for the period 2017-2019. Compared to these figures, the explanatory note attached to the current draft emergency ordinance estimates for 2015 additional revenue of about 5.5 billion lei by reducing tax evasion in the context that in Q1 there were collected 3 bn. lei in addition to the program.

The Fiscal Council considers that it is premature to use the additional revenue collected compared to the quarterly program until there are strong indications that these achievements are of a permanent nature and are not only attributable to a temporary reduction in tax

[2] Bulgaria, Denmark, Estonia, Lithuania, Slovakia.

evasion and/or better than expected developments of the relevant macroeconomic bases (an additional economic growth); in the latter case there is the possibility that these revenues are cyclical with no impact on compliance with the budgetary targets set in terms of structural deficit (MTO of -1% of GDP). Moreover, in the first quarter, the net revenues from VAT, where is located the main surplus compared to the revenue quarterly program, respectively 1.8 bn. lei, were favorably influenced by lower reimbursements of VAT compared to the same period from the previous year (given especially the higher repayments made in December 2014), which again calls for caution. In Annex 4 which details VAT receipts from the period January 2014 - March 2015, it can be seen that in the first quarter of this year the advance of the collected VAT was 9.04%, while the net receipts increased by 20.84%, the latter being favorably influenced by the decrease of VAT refunds compared to the same period of the previous year by 21.91%, equivalent to 1 bn. lei. As a golden rule, permanent measures that reduce taxes should be compensated by increases of the same kind of budget revenues and/or permanent expenditure cuts. Relevant to the present situation is also the principle of fiscal responsibility stated by the article 4 of FRL, which requires the government "to manage the fiscal policy in a prudent manner".

The Fiscal Council has argued on many occasions that it is impossible to quantify ex-ante the size of the additional revenues generated by reducing tax evasion, while fully agreeing to the idea of including ex post the additional revenue from collection improvement in the construction of the budget, but only after their amount could be assessed with a high degree of confidence and there is sufficient evidence of the occurrence of a trend in reducing tax evasion at least in the medium term - which would confirm the permanent character of these revenues.

Conclusions

A more rigorous analysis could be conducted in the context of the half-yearly report on the economic and budgetary situation that, beyond the fact that analyzes six months of budget execution, it is also the starting point for drafting the budget revisions, which are accompanied by an updated projection of the budgetary aggregates. Thus, in addition to the analysis of the budget revenues, the development of budgetary expenditure and the extent to which they fall within the initial targets should also be considered, particularly given that the budget execution for the first three months of 2015 recorded a level well below the spending program, particular in the case of investment spending. In the absence of such projections, the Fiscal Council can not validate without reserves that the financial impact of extending the application scope of the reduced VAT rate starting from June 1st, 2015 was taken into account in the forecast of the budgetary revenues and does not affect the annual and the medium term budgetary targets, as required by article 13 of FRL in order to obtain the FC’s endorsment.

Given the above mentioned arguments, the Fiscal Council endorses, but with reservations the draft Emergency Ordinance amending and supplementing Law no. 571/2003 regarding the

Fiscal Code (extending the application scope of the reduced VAT rate of 9% on food products and restaurant services). If the additional revenue observed at the 3 months execution[3] prove to be not only due to a more favorable than expected evolution of the macroeconomic relevant bases or to conjectural factors, thus reflecting indeed a permanent progress in terms of collection efficiency, the Fiscal Council considers that the fiscal space necessary to compensate the scope broadening of the reduced VAT rate of 9% for food products and restaurant services could be identified. The Fiscal Council warns that an accommodation of the VAT reduction under discussion in this opinion, by a further reduction in public investments, given that from 2012 they registered a noticeable downward trend (recording in 2014 a minimum of the past nine years as a percentage of GDP in ESA2010 standards[4]) could have major consequences on the medium and long term economic growth potential, given the major need for public investment in infrastructure.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of the Fiscal Council, according to Article 43, paragraph (2), letter d) of Law no. 69/2010, based on the vote of the Fiscal Council members in the meeting on May 12th, 2015.

May 12th, 2015.

Chairman of the Fiscal Council

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[3] Representing the most recent monthly budget execution available on the MPF's website.

[4] The year 2014 recorded a budget deficit of only 1.5% of GDP according to ESA 2010 standards, given an initial target of 2.2% of GDP, which lead to achieving in advance the medium term objective (MTO), a structural deficit of 1% in GDP, although this target was planned to be achieved in 2015. Romania has not used the fiscal space available in 2014, mainly to the underperformance of investment expenses.

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ANNEX 1

General assumptions:
1. The starting point for estimating the revenue loss involved by the legislative proposal was the household expenditure with the considered products for applying a reduced VAT rate, extracted from the NIS publication "Coordinates of living standards in Romania. Household revenues and consumption in 2013 ".
2. The input data refer to the money spent on consumed and unconsumed food and drinks, animal and poultry feed products, livestock purchases, purchases of seeded products (excluding the value of agricultural products from own resources) from which the households' expenditure for bread, flour and bakery products (they are already in the scope of the reduced VAT rate) and those for the purchase of alcoholic beverages were deducted.
3. More specifically, the input data were represented by that in Tables 20 and 41 in the aforementioned publication, considering the average number of people in a household, respectively 2.857.
4. To determine the budgetary impact for the period 2015-2018, the estimated revenue loss for the 2013 was extrapolated with the growth of the household final consumption related to the purchase of goods recorded or projected by NCP for the period 2014-2018 (8.36%, 5.68%, 5.47%, 6.12% and 6.27%).

	No.	2013
Expenses for food and beverages consumed (lei / person / month)	1	182.75
Expenses for unconsumed food and beverages (lei / person / month)	2	16.68
Expenses for feeding live animals and birds domestic species, for animal purchases, for seeding products (lei / person / month)	3	4.52
Expenses for bread products (lei / person / month)	4	29.97
Expenditure for alcoholic beverages (lei / person / month)	5	6.33
Expenses for the products proposed for applying a VAT rate of 9% (lei / person / month)	6=1+2+3-4-5	167.65
Expenses for the products proposed for applying a VAT rate of 9% net of VAT (lei / person / month)	7=6/1,24	135.20
Population (mil. inhabitants)	8	19.94
Total annual expenditures for products proposed for applying a VAT rate of 9% net of VAT (mil)	9=7*8*12	32355.33
Annual revenue loss due to the application of VAT rate of 9% (mil. lei)	10=9*0,15	4853.3

Source: NIS, Fiscal Council's calculation

The impact of applying a reduced VAT rate of 9% for food products and non-alcoholic beverages, live animals and birds from domestic species, seeds					
	2014	2015	2016	2017	2018
Annual revenue loss due to the application of VAT rate of 9% (mil. lei)	5259.3	5557.9	5861.7	6220.5	6610.8
Loss of revenue to the budget in terms given the measurement application starting from June 1, 2015	-	2778.9	5861.7	6220.5	6610.8

Source: Fiscal Council's calculation

	The growth of household final consumption related to the purchase of goods
2014/2013	8.36%
2015/2014	5.68%
2016/2015	5.47%
2017/2016	6.12%
2018/2017	6.27%

Source: NCP

ANNEX 2

The effect on GDP relative to the baseline scenario of a fiscal stimulus amounting to 1 m.u.					
	2015	**2016**	**2017**	**2018**	**2019**
2015	0,4	0,4	0,3	0,1	0,0
2016	0,0	0,4	0,4	0,3	0,1
Cumulative	0,4	0,8	0,7	0,4	0,1

The impact on GDP of the proposed measure (million lei)					
	2015	**2016**	**2017**	**2018**	**2019**
2015	1083,8	1192,2	794,8	397,4	0,0
2016	0,0	1143,0	1257,3	838,2	419,1
Cumulative	1083,8	2335,2	2052,1	1235,6	419,1

Source: Fiscal Council's calculation

The other required inputs are the elasticities of the budgetary aggregates to GDP (estimated for Romania in Price et al., 2014) and the amount of the first-round effects of the introduced measures in the year they occur (an additional fiscal impulse relative to the baseline scenario).

Elasticities of the budgetary aggregates to GDP for Romania	
PIT to GDP Elasticity	1,3
CIT to GDP Elasticity	2,0
SSC to GDP Elasticity	0,6
Indirect taxes to GDP Elasticity	1,0
Unemployment expenses to GDP Elasticity	-3,9

Sursa: Price et. al. (2014)

The amount of the fiscal impulse initiated in year i (mil. lei)	
2015	2779
2016	2931

Source: MPF

ANNEX 3

VAT rates across EU member states – situation on the 1st of January 2015

Member state	VAT standard rate	VAT rates applied to foodstuffs and restaurant services and catering			
		Foodstuffs		Restaurants	
		VAT rate	Remarks	VAT rate	Remarks
Austria	20.0	10.0	Food, beverages, excluding alcoholic beverages, live animals, seeds, plants and ingredients for food processing	10.0	incl. catering, excl. coffee, tea, alcoholic and soft drinks
Belgium	21.0	6.0	Food, beverages, excluding alcoholic beverages, live animals, seeds, plants and ingredients for food processing	12.0	incl. catering, excl. coffee, tea, alcoholic and soft drinks
Bulgaria	20.0	20.0		20.0	
Croatia	25.0	5.0	All types of bread and milk, including breast milk substitute; excluding milk and milk chocolate	13.0	incl. catering, excl. provision of alcoholic and soft drinks
		13.0	Animal and vegetable fats, sugar, and cereals food for babies and small children		
Cyprus	19.0	5,0	Food, beverages, excluding alcoholic beverages	9.0	incl. catering, excl. provision of alcoholic and soft drinks
Czech Republic	21.0	10.0	Basic foods for small children	21.0	
		15.0	Food, beverages, excluding alcoholic beverages		
Denmark	25.0	25.0		25.0	
Estonia	20.0	20.0		20.0	
Finland	24.0	14.0	Food, beverages, excluding alcoholic beverages	14.0	Restaurant and catering services excluding provision of alcoholic beverages
France	20.0	5.5	Food, beverages, excluding alcoholic beverages	10.0	incl. catering, excl. provision of alcoholic beverages

Member state	VAT standard rate	VAT rates applied to foodstuffs and restaurant services and catering			
		Foodstuffs		Restaurants	
		VAT rate	Remarks	VAT rate	Remarks
Germany	19.0	7.0	Food, beverages, excluding alcoholic beverages	19.0	
Greece	23.0	13.0	Food, beverages, excluding alcoholic beverages	13.0	incl. catering, excl. provision of alcoholic beverages
Hungary	27.0	18.0	Milk, dairy products and products containing cereals, flour, starch or milk	27.0	
Ireland	23.0	4.8	Supply of live animals	9.0	incl. catering, excl. provision of alcoholic beverages
		9.0	Food, beverages, excluding alcoholic beverages		
Italy	22.0	4.0	Basic foods	10.0	incl. catering, excl. provision of alcoholic beverages
		10.0	Food, beverages, excluding alcoholic beverages		
Latvia	21.0	12.0	Basic foods for small children	21.0	
Lithuania	21.0	21.0		21.0	
Luxemburg	17.0	3.0	Food, beverages, excluding alcoholic beverages	3.0	incl. catering, excl. provision of alcoholic beverages
Malta	18.0	0.0	Food, beverages, with the exception of pre-cooked foods or highly processed (ice cream, chocolate, beverages and pet food) and alcoholic beverages	18.0	
Netherlands	21.0	6.0	Food, beverages, excluding alcoholic beverages	6.0	incl. catering, excl. provision of alcoholic beverages
Poland	23.0	5.0	Food, beverages, excluding alcoholic beverages	8.0	incl. catering, excl. provision of alcoholic beverages
Portugal	23.0	6.0	Basic foods	23.0	
		13.0	Food (except basic foods), beverages, excluding alcoholic beverages		
Romania	24.0	9.0	Bread, flour and wheat	24.0	
Slovakia	20.0	20.0		20.0	

Member state	VAT standard rate	VAT rates applied to foodstuffs and restaurant services and catering			
		Foodstuffs		Restaurants	
		VAT rate	Remarks	VAT rate	Remarks
Slovenia	22.0	9.5	Food, beverages, excluding alcoholic beverages	9.5	excl. provision of alcoholic beverages
Spain	21.0	4.0	Basic foods (bread, flour, eggs, milk)	10.0	incl. catering, excl. provision of alcoholic beverages
		10.0	Food, except basic foods, water drinks		
Sweden	25.0	12.0	Food, beverages, excluding alcoholic beverages	12.0	incl. catering, excl. provision of alcoholic beverages
United Kingdom	20.0	0.0	Food, except desserts, chocolate, ice cream, alcoholic and soft drinks	20.0	

Source: http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf; http://www.ibfd.org/IBFD-Products/International-VAT-Monitor-Latest-Articles; Council Directive 2006/112/EC (the VAT Directive) and Annex III - Council Directive 2006/112/EC

ANNEX 4

Collected VAT, refunded VAT, and VAT revenues according to the General Consolidated Budget (GCB), between January 2014 – March 2015

	Collected VAT		Refunded VAT		VAT revenues	
	Million lei	% compared to the same period from the previous year	Million lei	% compared to the same period from the previous year	Million lei	% compared to the same period from the previous year
Jan-14	6,729.06	10.37	1,701.69	-6.89	5,027.60	17.76
Feb-14	4,827.26	-5.00	1,464.91	16.49	3,362.12	-12.07
Mar-14	5,076.61	0.28	1,424.69	35.31	3,651.92	-8.92
Apr-14	5,795.63	2.20	1,422.63	-20.39	4,373.00	12.60
Mai-14	5,542.49	-1.33	1,389.79	5.85	4,152.70	-3.52
Jun-14	5,431.65	4.76	1,323.89	5.11	4,107.76	4.64
Jul-14	6,166.07	3.98	1,480.19	3.61	4,685.88	4.09
Aug-14	5,817.57	3.04	1,878.43	33.34	3,939.14	-7.03
Sep-14	6,024.39	4.80	1,347.40	32.61	4,676.99	-1.17
Oct-14	6,502.42	4.51	1,621.54	22.65	4,880.88	-0.39
Nov-14	6,230.40	2.86	1,482.93	11.25	4,747.47	0.49
Dec-14	6,407.92	7.91	3,134.90	**120.36**	3,273.02	-27.52
Jan-15	7,049.66	4.76	1,090.03	**-35.94**	5,959.62	18.54
Feb-15	5,335.07	10.52	1,270.61	**-13.26**	4,064.47	20.89
Mar-15	5,751.41	13.29	1,224.78	**-14.03**	4,526.63	23.95

Source: Ministry of Public Finance, Fiscal Council's calculations

Note: VAT revenues represent VAT receipts according to GCB, and are composed of collected VAT minus refunded VAT, to which are added the penalties for late payment of VAT. The latter, however, are relatively low, the monthly average in 2014 being 51.21 mil. lei (53.91 mil. lei in 2015).