

## Personal Income Tax in Romania: Where to?

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**Abstract.** *The personal income tax is a topical theme because this tax has a very significant impact on the state budget in any country. There are two types of tax rates in the world that are expressed in percentage terms in relation to the value of taxable material (in the case of income tax, profit, etc.), others in the monetary unit on the value of the taxable material (in the case of excise duties). For their part, the percentage taxation rates may be progressive and proportionate. We have shown in the article that developed countries of the world practice in the case of individuals the progressive tax, and former communist countries, among them Romania, the proportionate one by the single tax rate. Our goal is to show that proportional tax, in addition to failing to comply with the principle of fiscal equity, cannot bring significant amounts to the state budget. We have come to the conclusion that in Romania, in 2018, the single tax rate for individuals of 10% will not be able to bring sufficient budget revenues to GDP; for example in 2017, the personal income tax on in Germany accounted for 8.9% of GDP, while in Romania only 3.5% of GDP. The solution that we see in the near future is the shift from single tax to progressive and global taxation for individuals.*

**Keywords:** income tax, progressive tax, single tax rate, global tax, the principle of fiscal equity.

**JEL classification:** F15, F36, G00, G10, G20, G21, H00, H21, H26, H71.

### 1. Introduction

Taxes and duties are a form of compulsory levy available to the State, without direct and non-refundable consideration of a part of the taxpayer's income and fortune to cover public expenditure.

Always the finance and tax specialists have posed the question: to what extent and in what situations would taxes be fair? Of course, it would be ideal for taxpayers that taxes are as small as possible, and that it would be optimal for the State to ensure that taxes are high enough to ensure that expenditure is financed. At the same time, it is very important to know what tax each taxpayer must pay from his income and wealth, so that there will be no discontent and injustice among taxpayers.

Unfortunately, to date, this ideal of taxation cannot be achieved because no kind of tax applied to individuals is perfect and leads to shortcomings between both the taxpayer and the State as well as between the taxpayers.

Lately, one of the most disputed issues was the one related to the two tax systems, namely proportional and progressive rates.

### 2. The stage of knowledge

The first forms of progressive taxation come from the Middle Ages. According to Romanian economist V. Vasiliu: *"Taxes have been perceived during this entire era. Moreover, we meet the application of the proportional and progressive taxation principles, according to some rules. But one cannot speak of a system of taxation, but of isolated taxes such as: graduated poll tax, established in 1830, or progressive*

capitation, as well as progressive taxes on property and income, set at 1435 (Dowel, 1935)) in England; or capital gains tax on income from movable or immovable property set up at 1427 (Ganestrini, 1935)) or, finally, of **progressive tax** paid by German cities. It may be thought that since the principle of progressivity was applied, the distributive aspect of the tax burden was finding an application close to the ideal taxation. However, injustice caused in almost all states or bourgs where these taxes were raised was one of the highest (Vasiliu, 1935))”.

With all these isolated attempts at progressive taxation, most and more developed countries have initially adopted the proportional system. Isidore Heldenbusch described in 1898 as proportional the tax *“that taxpayers pay in proportion to their wealth, e.g. assuming the tax fixed at 10%, the one who has an income of lei 1000 will pay 100, the one with income of lei 10.000 will pay lei 1000, the one with income of lei 100.000 will pay 10.000 lei etc”* (Heldenbusch, 1898).

The same author describes with beautiful words also **the great drawback of proportional taxation**, namely the violation of a fundamental principle of taxation, namely the principle of justice and equity in matters of taxation: *“This one, although it is the system of taxation adopted by most of the states, it does not satisfy the conditions required by the spirit of justice. At first glance, it seems as if the proportionality system is fair and natural, and at the same time very simple from the mathematical point of view. But this is not our purpose. Let’s see if from the practical point of view we can say about it the same thing. We already answer now: No! Is it equitable that X, who has an income of lei 1000, will pay lei 100 and Y, with an income of lei 10.000, to pay 1000? While the former uses his income to satisfy his strictly necessary needs, the latter, on the contrary, has far more than necessary. X paying lei 100 is deprived of part of the strict necessity and is for him a relatively enormous sacrifice, while Y pays the extra lei 1000, making a much smaller sacrifice”* (Heldenbusch, 1898).

At the beginning, the progressive tax was vehemently contested and criticized by the supporters of proportional tax who assigned progressive taxation to the socialist school, highlighting the dangers of income levelling, going to the danger of confiscating fortunes.

French economist and politician Joseph Garnier has supported **the limited progressive system**, showing that this is most equitable among all taxation systems because it grows proportionately with the taxpayer’s income in a slow way, with a moderate limit. Isidore Heldenbusch describes this type of tax through the following illustrative example: *“It is established that the one who has an income of lei 1000, for example, will not pay any tax; the one with an income of lei 1200 will pay a small tax, the one with an income of lei 1400 will pay for the amount of lei 1200 of his income, which pays the precedent, plus what is called in arithmetic the reason for the addition of lei 200. The one with an income of lei 1600 will pay the tax for lei 1400, plus twice the reason and so on. In this way, as we see, the tax will not exceed 5 or 10% of the income”* (Heldenbusch, 1898).

At the end of the 19<sup>th</sup> century, the most developed European countries - Germany, France, England - used progressive tax, of course, for direct taxes and mainly for personal income tax. In fact, many economists and great writers supported the progressive tax: Montesquieu, Jean Jacques Rousseau, the Marquis of Mirabeau. But the most beautiful tribute of progressive taxation was that brought by Jean Baptiste Say: *“A simple and proportionate contribution isn’t it heavier for the poor than for the rich? The individual who only produces the bread necessary to feed his family, must contribute exactly the same proportion as the one who, thanks to his distinguished talents, his immense possessions, his considerable capital, not only enjoys and procures himself all the pleasures of luxury, but also increases everyone in his wealth? Do you not find in this claim something that strikes at the equity?”* (Baptiste Say, 1821).

Adam Smith, though originally contested the too high tax rates, in his opinion, can lead to reduce government revenue, praised the progressive taxation, showing that it is fair and that it fits well in the case of wealthy people: *“It is not quite unjust that the rich contribute to the State’s expenses not only in proportion to their income but even beyond that proportion”* (Adam Smith).

Ideology of **“progressive tax”** or **“differentiated tax”**, as it was known in the literature, was also supported by Karl Marx and mentioned in the **“Declaration of the Rights of Man and of the Citizens”** in 1789. From that statement it comes to the theory that a common contribution reported in a balanced way to each taxpayer, according to the income of each, is essential. In 1848, the theory of progressive tax is also found in the Communist Party ideology as a necessary measure for the transition to communism. Beginning with the second half of the 19<sup>th</sup> century, progressive taxation has begun to apply in the USA.

### 3. Progressive and proportional tax in Romania and the European Union

The tax rate is the tax per unit of measure of the taxable material. There are several types of tax rates in the world, some of which are expressed in percentage terms in relation to the value of taxable material (income tax, wages, etc.), others in monetary unit per unit of taxable amount (in the case of excise duties).

Percentage tax rates can be divided into two broad groups: progressive and proportional.

It is certain that the progressive tax, combined with the global one, is practiced in all developed countries of the world, where the population has a high degree of civic and fiscal education.

These countries usually associate the progressive tax in instalments with the global taxation of income, which means that all cumulative incomes of a natural person in a fiscal year from wages, dividends, rents, independent activities, pensions, gambling, stock exchange gains, prizes, agricultural activities, etc.

**Progressive taxation**, as we have shown, implements a fundamental principle of taxes and duties, namely **the principle of justice or tax equity**. This principle implies that those (natural persons taxpayers) who have a higher income must contribute more to the budget, but not by the same tax rate applied to a higher tax base (this happens anyway), but by tax rates that increase in proportion to earned income.

Romania has applied the progressive tax system coupled with the globalization of income for four years, between 2001 and 2004, with five steps of taxation:

- 18% for a monthly taxable income of up to RON 251.3;
- RON 45.3 plus 23% of which exceeds RON 251.3, for a monthly taxable income between RON 251.3 and RON 608.3;
- RON 127.3 plus 28% of which exceeds RON 608.3, for a monthly taxable income between RON 608.3 and RON 975;
- RON 230 plus 34% of which exceeds RON 975, for a monthly taxable income ranging from RON 975 to RON 1,362.5;
- RON 361.8 plus 40% of which exceeds RON 975, for a monthly taxable income of over RON 1,365.5.

It should be noted that the gross average salary in December 2004 was in amount of lei 973.3. During the four years, although the tax system was progressive and global, the revenue globalization was only partial. It means that only income from wages, from self-employment and from rent (with the exception of housing rents) has been cumulated for the purpose of progressive taxation.

**So it can be said that Romania does not respect the principle of tax equity.**

Since 2005, it has been practicing, together with 7 other EU Member States, a system of proportional taxing of individuals with a single tax rate; the rate is 10% starting with 2018. As shown in table no. 1.1, all countries that apply the EU's single rate taxation scheme are emerging economies: Bulgaria (10%), Czech Republic (15%), Slovakia (19%), Hungary (9%) and the three Baltic States, Estonia (20%), Latvia (15%) and Lithuania (15%).

Denmark, Sweden and the Netherlands have the highest progressive tax rates in the EU, countries with highly developed economies, with hundreds of years of democracy and well-being, healthy tax education and respect for the law. In Denmark, the maximum tax rate is up to 62.3%, in Sweden up to 56.7% and in the Netherlands up to 52%. Central European countries, where millions of Romanians work, have progressive taxes, cutting tax on those with very low incomes, and at the same time applying taxes of up to 50% for those with very high earnings. E.g. **Spain** applies a minimum rate of 19% to those who earn revenue of up to € 12.450 in one year, and upwards increases to 45% for those earning over € 60.000/year. In **Italy**, those with annual incomes below € 15.000 pay a 23% tax which progressively increases with income and is up to 43% for those with annual incomes over € 75.000. In **Germany**, a person who earns less than 7664 euros per year is exempt from tax, but for taxpayers who exceed this income tax may increase to 47.5%.

In those countries that apply the progressive tax system, although taxes seem very high, there is still one **very well-designed system of personal deductions**. Thus, the tax administration allows taxpayers according to certain criteria to deduct from the income obtained, before taxes, various expenses related to health care, transport, rent, children's education, insurance, home repair, etc. In this way, the tax in these countries causes the providers of such services to tax these services and pay taxes on income obtained, unlike in Romania, where most of these revenues are not taxed (rents, private lessons, etc.).

**Table no. 1. Income tax in the countries of the European Union in 2018**

State	Income tax	State	Income tax
Austria	0% - 55%	Latvia	15%
Belgium	25% - 50%	Lithuania	15%
Bulgaria	10%	Luxembourg	0% - 39%
Czech Republic	15%	Malta	0% - 35%
Cyprus	0% - 35%	Netherlands	33,1% - 52%
Croatia	12% - 40%	Poland	18% - 32%
Denmark	8% - 62,3 %	Portugal	11,5% - 46,5%
Estonia	20%	Romania	10%
Finland	0% - 31%	United Kingdom	0% - 45%
France	0% - 41%	Slovenia	16% - 41%
Germany	0% - 47,5%	Slovakia	19%
Greece	0% - 45%	Sweden	0% - 56,7%
Ireland	20% - 41%	Spain	19% - 45%
Italy	23% - 43%	Hungary	9%

Source: Eurostat, table created by the author

#### 4. Romania, where to?

**In our opinion,** In Romania, the single tax rate has proven its effectiveness in a period that is about to end. Its introduction shortly before the outbreak of the global economic and financial crisis was a happy coincidence. This is because the year 2009 found the Romanians with more money in pockets, and the slightly more healthy economy was able to cope better with the challenges of the crisis.

On the other hand, **we consider that our country's budget can not have too high income with too low taxes.** This issue must be discussed openly, without hiding behind populist or political statements.

The practice and the difference between Romania and developed countries has shown that one can not at the same time have highways, modern roads, hospitals and schools as in the West, and low taxes and fees with an inefficient structure (emphasis on indirect taxes).

Romania is by far the last in the EU with 28.9% in 2017 (the EU average is 44.4%) in terms of **share of revenue in GDP**, an indicator that ultimately indicates the health and strength of an economy.

**Table no. 2. Evolution of budget revenues in the main countries of the former communist bloc (budget revenue as share of GDP,%)**

Year	EU average	Hungary	Czech Republic	Poland	Bulgaria	Romania
2017	44,4	48,8	40,3	39,8	34,9	28,9
2018	44,4	48,5	40,7	40,3	35,5	30
2019	44,3	47,2	40,8	40,1	35,3	30,3
2020	44,2	46	40,9	40	35,3	30,3
2021	44,1	43,5	40,9	40	35,3	30,5
2022	44	43,7	40,9	40	35,3	30,5

*Source: International Monetary Fund, quoted by Ziarul Financiar of 16 October 2017 in the article: "Romania looks like a country in crisis from the point of view of the revenues to the State budget, although it is in economic boom".*

As one can see, in 2017 Romania had budget collections compared to GDP by 20 percentage points less than Poland, just below Bulgaria and more than 15 percentage points below the EU average, according to the IMF.

**In our opinion, if we want a rich and prosperous Romania, we must all accept some higher taxes.** On the contrary, with constant tax cuts combined with poor collection, with a steady increase in public expenditure, we will not be able to get too far. And tax theory and practice says the ideal time to raise taxes and duties is not at all during a financial crisis, but in boom years.

Romania has exceeded the recession period, and in 2017 it even had the highest economic growth in the European Union. Moreover, according to a study conducted by the Romanian Academy in 2018, materialized in the report entitled "Romania's development strategy over the next 20 years", Romania records the largest disparities between the salary incomes of citizens from all European countries. In this regard, academics propose, in addition to other wage policy measures, to renunciation of the single tax rate and to introduce a tax that will increase in proportion to the income achieved.

Since 2018, when we adopted the 10% tax rate, our country ranks first in the EU, along with Bulgaria and Hungary, with the lowest tax on personal income, but at the same time, as we have shown above, we are the last in terms of the share of revenue in GDP.

If we compare with Germany, which has tax revenues equivalent to almost 40% of GDP, we notice a difference of almost 10 percent, as shown in Table 1.3. These percentages do not come from VAT (of which Romania collects 0.8% more than Germany in terms of GDP), nor from the corporate tax (of which Romania collects only 0.2% less than Germany, in terms of GDP); the 10 percent comes mostly from the personal income tax, where the Germans collect 8.9 percent of GDP from the State budget as against 3.5 percent of GDP as we collect.

**Table no. 3. The structure of tax collections in Romania versus Germany in 2016**

	GERMANY (% of GDP)	ROMANIA (% of GDP)	Difference (% of GDP)
VAT	7,0%	7,8%	+0,8%
Income tax (wages, etc)	8,9%	3,5%	-5,4%
Profit tax	2,4%	2,2%	-0,2%
Company social contributions	6,6%	5,5%	-1,1%
Employee social contributions	8,5%	3,0%	-5,5%
Others	4,6%	6,0%	+1,4%
<b>TOTAL</b>	<b>38,0%</b>	<b>28,0%</b>	<b>10,0%</b>

Source: European Commission, DG Taxation. The annual study "Taxation Trends in the European Union", 2016, published in Ziarul Financiar on 4 July 2017

Of course, the difference comes from the fact that wages in Romania are well below those in Germany, from undeclared work and tax evasion, but, **in my opinion**, first of all the difference between the level of wage tax between the two countries.

As we have seen, Romania has a single income tax rate of 10% in 2018, while German income is taxed from 0% to 47.5% for high incomes.

Under these conditions, what is to be done? At some point, in 2012, the return to progressive taxation with a maximum of 16% and rates of less than 8% and 12% was attempted, an equally unfortunate variant for the State budget. The idea was criticized by the head of the IMF mission in Romania at that time, Erik de Vrijer: *"The idea of progressive taxation with a maximum rate of 16% is not very wise or advised. The transition to the progressive rate should not affect the budget revenues, which could be achieved if tax rates higher than 16% are proposed. In the proposed form, the progressive rate would significantly reduce revenues. If you have a lower income share, then the salary fund should also be reduced. I do not think it's a very tempting proposal."* (Vrijer, 2012).

The IMF representative showed that if the passage from a fixed tax rate to a progressive one is really wanted, then some rates should be less than 16%, others higher, to achieve at least the same income.

Then, at the beginning of 2017, the government's brought to discussion and proposed the **household tax**, in amount of 10%.

As is results from the version published by the Ministry of Finance, this type of tax was intended to total within the **household** the income from salaries and assimilated to salaries, income from self-employment activities, income from

assignment of goods, investment income, pension income, agricultural income, gambling, real estate transfer and income from other sources.

Following the introduction of the household tax, the tax deduction procedure was cancelled, the calculations being made by tax consultants. Fortunately, the system has not been implemented. **In our opinion**, the household tax had a number of shortcomings:

- it does not solve the problem of state budget revenues, on the contrary, it increases the budget deficit;
- it was not a fair tax system;
- there was a risk that money that was not withheld at source would be spent by taxpayers (risk that should also be assumed in the case of progressive tax);
- there was nothing clear about the tens of thousands of tax consultants who had to calculate the taxes.

## 5. Conclusions

*The solution that we see applicable* in a few years in Romania is the introduction of progressive tax associated with revenue globalization with three progressive tax rates (10%, 20% and 30%) applied to well-proportioned and conceived revenues. This type of tax would be fair and at the same time would redress as much as possible the deficit of the State budget.

Of course, it will not be easy at all; it will require a comprehensive reform of the tax system. In our country people are accustomed to withholding tax, it will certainly be difficult for them to make heavy statements once a year. In such conditions, the monthly salary received by the employee will be the gross one of which only the social contributions will be retained, and the employee will file a tax return and pay his own salary tax. It will of course be very important the mutual trust between the taxpayer and the tax authority, but *we believe that the introduction of the progressive and global tax sooner or later is inherent and any delay will deprive the State budget of important amounts and will further affect the middle class in our country.*

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