Professor Florin GEORGESCU, PhD
The Bucharest University of Economic Studies
Associate Professor Bogdan-Octavian COZMÂNCĂ, PhD
The Bucharest University of Economic Studies
Ana-Maria CAZACU, PhD (Corresponding author)
E-mail: ana02mary@yahoo.com
Alexandra-Mariana COJOCARU, PhD Student
The Bucharest University of Economic Studies

FISCAL AND INCOME INCENTIVES TRIGGER IMBALANCES IN A PARTLY FUNCTIONAL MARKET ECONOMY

Abstract. *This paper focuses on identifying the micro- and macroeconomic effects of income and tax incentives granted to companies and individuals in Romania from 2013 to 2019. The analysis underscores that fiscal policy easing did not lead to significant headway with firms' economic performance, capitalisation and payment discipline. Moreover, in the absence of a notable increase in domestic supply, substantial fiscal policy easing aimed at households translated into negative developments in the trade and exchange rate equilibrium owing to an unsustainable rise in imports. Romania's current economic state calls for swiftly amending the legislation on commercial companies, bearing in mind that they are substantially undercapitalised relative to legal requirements and show a chronic payment indiscipline (without providing a positive feedback to tax incentives). At the same time, within the amended legal framework, the business behaviour needs to be improved, consistent with the 'rules versus discretion' philosophy prevailing in Northern and Central Europe.*

Keywords*: tax incentive, income growth, domestic demand, domestic supply, firms' capitalisation, payment discipline, automatic fiscal stabilisers, personal income tax progressivity.*

JEL classification: H20, H32, L20, D22, E10

1. Fiscal policy decisions implemented in the period 2013-2019

This time span saw the implementation by the authorities – with a view to lifting households' standard of living, based on increasing domestic production by fostering investment, consumption and job creation – of a number of fiscal measures, most of

them tax incentives[1]. For the general government budget these incentives to tax payers are, by law[2], fiscal expenditure.

1.1. Measures targeting entrepreneurs

The tax incentives targeting entrepreneurs were inspired by neoliberal theories, acting mainly via spurring aggregate supply (supply-side economics), as a result of the government waiving part of the tax revenues to the benefit of the private sector. According to the principles of the above-mentioned ideological thought, this sector is expected to achieve a more efficient allocation of resources than the government, i.e. depending on market requirements and the economic agents' interests by taking into account the three fundamental pillars of the capitalist society that are its determinants (Saunders, 1995), namely private property, the free market in which prices are set, and profit-making, as a goal of human action. Against this background, at the level of non-financial corporations in the period 2013-2019, ten measures were adopted that can be classed as tax incentives. Their cumulated unfavourable impact on the budget is of lei 75.9 billion (EUR 16.7 billion). These tax incentives refer, chronologically, to:

a) Lifting the ceiling on tax deductions for R&D expenditures from 20% to 50% as of January 2013 (- lei 0.05 billion worth of tax receipts, equivalent to EUR 0.01 billion).

b) Exempting from taxation the reinvestment of earnings in technological equipment (machinery, equipment and installations purchased starting 1 July 2014); the list of assets eligible for tax exemption on reinvested earnings was enlarged in 2016 by including new technological equipment such as computers; peripheral equipment; cash registers; control and billing apparatus, as well as software used in economic activity (minus lei 5.3 billion, or EUR 1.2 billion, accounting for 7% of the volume of tax incentives granted to entrepreneurs in the reviewed period).

c) Cutting by 5 percentage points the social security contribution owed by the employer starting October 2014 (minus lei 59.6 billion, or EUR 13.1 billion, i.e. 79% of the entrepreneurs' total tax relief).

d) Reducing taxation of dividends as of January 2016, as follows: (i) cut in dividend tax from 16% to 5%; (ii) lowering by the same amount of the tax rate applicable to dividend income received from Romania by non-residents, and (iii) exemption from taxation of the dividends received from a Romanian legal person. Therefore, tax receipts saw a cumulative compression of lei 7.4 billion (EUR 1.6 billion), making up 10% of the total impact of incentives granted to entrepreneurs.

e) Easing the taxation of micro-enterprises, as this category of firms benefitted successively from a number of tax incentives, as follows: 1) starting January 2016, the decision was taken to differentiate, according to the number of employees, the

[1] Fiscal measures cover all the actions taken by government authorities, regardless of their reducing or increasing the tax burden on entrepreneurs and/or consumers. Tax incentives are decisions leading to a decline in the tax burden on entrepreneurs and/or consumers and, hence, a cut in revenues.

[2] At a European level, Directive 2011/85/EU on requirements relating to the budgetary framework of the Member States (Article 14) and Law No. 69/2010 on fiscal responsibility at local level.

tax rate applicable to the turnover of micro-enterprises[3] (firms with 9 or less employees), equal to 3% at that time; 2) as from January 2017, the income threshold up to which a company falls into the category of micro-enterprises quintupled, from EUR 100,000 to EUR 500,000[4]; 3) in January 2018, the threshold on micro-enterprises' earnings was raised again, doubling from EUR 500,000 to EUR 1,000,000.

The negative impact on the budget coming from the tax incentives targeting this category of firms amounted to lei 3.6 billion (EUR 0.8 billion), accounting for 5% of the tax relief for entrepreneurs in 2013-2019. It should be noted that the cumulated positive effects on entrepreneurs from the tax incentives referred to in points a) to e) above, in amount of lei 75.9 billion (EUR 16.7 billion), were partly reduced (lei 5.6 billion, or EUR 1.2 billion) by 6 restrictive decisions[5]. As a result, from 2013 to 2019, the 16 fiscal measures targeting entrepreneurs, of which 10 were favourable (lei 75.9 billion, or EUR 16.7 billion) and 6 were restrictive (lei -5.6 billion, or EUR -1.2 billion), had a quite favourable impact on the entrepreneurs' financial capacity (lei 70.3 billion, or EUR 15.5 billion), with the government's tax revenues falling by the same amount.

[3] 1% for the firms with 2 or more employees; 2% for the firms with one employee; and 3% for the commercial companies in that group with no employees, together with levying a 1% tax on the turnover of newly-established micro-enterprises for the first two years in operation, regardless of payroll size. At the same time, it was decided to increase the income threshold up to which a company falls into the category of micro-enterprises, from EUR 65,000 to EUR 100,000.

[4] Moreover, Romanian legal entities liable to corporation tax (16%) which on 31 December 2016 reported earnings below EUR 500,000 benefited from the option of a more attractive turnover tax treatment as from 1 February 2017, as follows: tax rates were set at 1% for the micro-enterprises with one or more employees and 3% for the micro-enterprises with no employees.

[5] (i) introduction of the tax on special constructions (about lei 3.5 billion, equivalent to EUR 0.8 billion, or 63.5% of the total value of restrictive decisions targeting entrepreneurs), (ii) increase in some mining royalties as of January 2014 (lei 0.3 billion, equivalent to EUR 0.08 billion, or 5.4% of the impact of restrictive decisions). Apart from these measures, Government Emergency Ordinance No. 114/2018, as amended by Government Emergency Ordinance No. 19/2019, set forth the taxation of four major areas of activity, as follows: (iii) the banking sector, by levying a half-yearly charge of between 0.2% and 0.4% on net financial assets. The decision has a positive impact on the budget (lei 0.8 billion per year). Tax receipts for 2019 were lei 0.4 billion (EUR 0.08 billion, or 6.4% of the total value of restrictive decisions targeting entrepreneurs) in amounts for one half-year; (iv) the energy sector, by increasing the annual cash contribution from 0.1-0.2% to 2% of the turnover owed by ANRE licence-holders for conducting business in the electricity and natural gas sectors (excepting electricity and heat in cogeneration), with a favourable impact on the budget of lei 0.5 billion, or EUR 0.1 billion, equivalent to 8.1% of the value of restrictive decisions targeting entrepreneurs, (v) the communications sector, by raising the price of monitoring charged to providers of publicly available electronic communications networks and to providers of electronic communications services from 0.4% to 3% of the year-earlier turnover, except for postal and courier services (with a positive impact on the budget of lei 0.4 billion, or nearly EUR 0.1 billion, equivalent to 7.2% of the total value of restrictive decisions), (vi) the gambling sector, by introducing new annual licensing fees ranging between EUR 1,000 and EUR 5,000 per year, and 2% of the total monthly fees paid by gamblers, while for video lottery a 3% rate on the gambling income of the licensed operator was introduced (totalling lei 0.5 billion, or EUR 0,1 million, i.e. 9.4% of the impact from the implementation of restrictive decisions targeting entrepreneurs).

1.2. Measures targeting consumers

Turning to the tax incentives granted to consumers, it should be pointed out that they were inspired by the neo-Keynesian theories, acting mainly by stimulating aggregate demand (demand-side economics), except for the measures on loosening taxation in the area of VAT and excise duties which, according to economic principles, act both on the supply side and the demand side. Thus, at the level of consumers, who are, on the one hand, the households and, on the other hand, the entrepreneurs, a number of 30 decisions were adopted, which fall under the definition of tax incentives. The total favourable impact on consumers for the period 2013-2019 amounted to lei 128.1 billion (EUR 28.2 billion), with the government's tax revenues declining by the same amount. Law-makers sought these incentives to help boost economic growth by increasing domestic consumption and improving competition, with favourable effects on job creation, curtailing tax evasion and supporting vulnerable population groups. The key tax incentives benefiting consumers[6] refer to:

a) Cuts in standard and reduced VAT rates.

As a result of easing indirect taxation, the average VAT rate declined by one third in the reported period, from 22% in 2012 to 14.5% in 2018. This average VAT rate places Romania in 2018 on the lowest tier among the 10 new EU Member States[7]. Moreover, with regard to the standard VAT rate, currently at 19%, according to the authors' calculations, Romania fell in the descending-order ranking of EU countries from #5 in 2012 (higher rates reported only Hungary: 27%, followed by Denmark, Croatia and Sweden: 25%) to #26 in 2018 (on a par with Cyprus and Germany, lower rates having only Malta and Luxembourg, on 18% and 17%). The additional income made available to consumers by cutting tax receipts, as a result of implementing the above-mentioned tax incentives concerning the VAT, amounted to lei 76.6 billion (EUR 16.9 billion), accounting for 60% of total tax incentives granted to consumers over the reviewed period.

b) Amendments to the legislation on income of the self-employed starting January 2016[8]. This resulted in a tax revenue contraction by lei 0.15 billion (EUR 0.03 billion).

c) Easing, as of January 2016, of the legal framework on taxation of income from (i) wages and related income (tax-free gift vouchers to a certain limit and a higher level of personal deductions) and (ii) rental income (increase in flat rate expenditure to be deducted from rent income). With regard to these tax incentives, the unfavourable impact on the budget amounts to lei 3.2 billion (EUR 0.7 billion).

---

[6] No information was found for separately assessing the impact of lowering indirect taxation (VAT and excise duties) on households and entrepreneurs. Therefore, the full positive impact of easing indirect taxes on all recipients of these decisions and consumer categories was presented.

[7] According to calculations by the Fiscal Council in its Annual Report for 2018.

[8] They comprised: (i) removal of the cap on deductible outlays for the entrepreneurs, for facultative pensions and health insurance benefitting employees, and (ii) lowering of the tax base for taxpayers earning income from intellectual property rights.

d) Cut in the excise duty on motor fuels[9], alcohol and alcoholic beverages, removal from the excise duty scope of domestically-produced crude oil and some luxury products (jewellery, fur garments, hunting weapons, etc.) as from January 2016. The cumulated negative influence of these decisions ran at lei 5.2 billion (EUR 1.2 billion).

e) Exemption of pensions below lei 2,000 from the income tax and non-taxation of pensions with the health insurance contribution as from February 2017. Consequently, the amount of lei 8.7 billion (EUR 1.9 billion), accounting for 7% of the total tax incentives granted to consumers over the reviewed period was left with pensioners, thus compressing fiscal revenues.

f) Substantial cut in the income tax rate from 16% to 10% as from January 2018 caused citizens' disposable income to rise by lei 29.6 billion (EUR 6.5 billion), suppressing fiscal revenues accordingly, to 23.1% of the total impact of tax incentives targeting consumers between 2013 and 2019.

g) Exemption from income tax and health insurance contributions, together with the removal of the contribution to the 2nd Pension Pillar for construction firms[10]. The negative impact on the budget owing to this measure amounted to lei 2.2 billion (EUR 0.5 billion) in 2019 alone.

Apart from the 30 tax incentives benefitting the consumers, in amount of lei 128.1 billion (EUR 28.2 billion), the authorities adopted 15 restrictive decisions, which mitigated partly the favourable effects of the stimulative measures, mainly by raising the levels of excise duties (lei 35.6 billion, equivalent to EUR 7.8 billion, or 71.3% of the total negative influence on consumers[11]). The above-mentioned measures mitigated partially the favourable effects of the tax incentives targeting consumers (lei 128.1 billion, or EUR 28.2 billion) by lei 50 billion (EUR 11 billion), yet the net effect of the tax breaks remained substantially positive at lei 78 billion (EUR 17 billion). Hence, from 2013 to 2019, the authorities adopted a total of 61 fiscal measures targeting entrepreneurs and consumers (Table 1), with the amount made available economy-wide, by compressing tax receipts, amounting to lei 148.5 billion

[9] The cut in the excise duty, by scrapping the EUR 0.07 special excise duty on motor fuels, was implemented for three quarters of 2017.

[10] The tax incentives to this sector apply to income from wages and similar income up to lei 30,000 per month in the period 2019-2028.

[11] Most of the excise duty hike affected motor fuels and tobacco. Other restrictive decisions: (i) broadening the tax base for the income from agricultural activities starting October 2013 (plus lei 3.2 billion, or EUR 0.7 billion worth of tax receipts), (ii) upping the tax on buildings as from January 2013 (plus lei 2 billion, or EUR 0.5 billion), (iii) lifting the tax on buildings, land and motorcars as from January 2016 (plus lei 1.5 billion in tax receipts), (iv) removing the exemption from payment of social security contributions for the income of the self-employed and introducing the obligation to pay the health insurance contribution for the persons earning income from investment, intellectual property and other sources (plus lei 3 billion, or EUR 0.7 billion), and (v) removing the cap of five gross average wages for the payment of state social security contributions (plus lei 4.6 billion in fiscal revenues, equivalent to EUR 1 billion).

(EUR 32.7 billion, 15.9% of GDP[12]). Out of the total, lei 70.3 billion (EUR 15.5 billion, accounting for 47% of the measures, or 7.9% of GDP) are attributed to the decisions with a positive impact on entrepreneurs and a further lei 78.2 billion (EUR 17.2 billion, i.e. 53% of all measures or 8% of GDP) were aimed at boosting consumers' purchasing power.

Table 1. Number and cumulated impact of fiscal measures implemented in the period 2013-2019

	Impact **lei bn.**	Impact **EUR bn.**	Impact **% of GDP**	**Number**
1. Fiscal measures (1=2+3), of which	**148.5**	**32.7**	**15.9**	**61**
for **entrepreneurs**	70.3	15.5	7.9	16
for **consumers**	78.2	17.2	8.0	45
2. Tax incentives, of which:	**204.0**	**44.9**	**22.5**	**40**
for **entrepreneurs**	75.9	16.7	8.6	10
for **consumers**	128.1	28.2	13.9	30
3. Restrictive decisions, of which:	**-55.5**	**-12.2**	**-6.6**	**21**
for **entrepreneurs**	**-5.6**	**-1.2**	**-0.7**	6
for **consumers**	**-49.9**	**-11.0**	**-5.9**	15

Source: MPF, authors' calculations

2. Decisions on wage and pension policies

Worth noting is that the decisions adopted in the period 2013-2019 had a positive impact on households' income. The measures are inspired by the neo-Keynesian school of thought, by directly boosting aggregate demand (demand-side economics). As for the minimum wage, it rose at a swift pace from 2012 onwards, with favourable influences such as, beside higher income for the employees, the contraction of the shadow economy, increases in employment and fiscal revenues. Other papers (Heemskerk, Voinea and Cojocaru, 2018) also prove that a pre-announced increase in the minimum wage, given the initially low level and a demand shortfall, produces prevailingly positive effects. The economic lever of the minimum wage is used by the government to preserve an adequate ratio between remuneration of labour and capital, which is an important tool for rightly setting the ratio between economic efficiency and social equity without affecting the competitiveness of domestic production. Starting from a low level of the net monthly minimum wage, which in 2012 amounted to a mere lei 538, or EUR 121, it grew sharply in the past 7 years to lei 1,263 (EUR 264) in 2019. Special mention deserves the fact that the 135% increase (lei 725, or EUR 143) in the minimum wage against 2012 is well above the cumulated 13.2% increase in prices over the same period.

With a view to underpinning tertiary education and boosting investment, it was decided, as from 2019, that the whole-economy minimum wage be 12% higher than

[12] The percentage of GDP refers to the sum of annual weights showing the ratio of the impact of the measure and the GDP for the year when that influence was calculated.

the net wage for the employees with higher level of expertise (lei 1,413, or EUR 296), i.e. by 87% for the construction workers (lei 2,362, or EUR 494). These measures, together with significant public-sector pay rises, particularly in healthcare, education and social assistance, alongside the wage hikes in the private sector (notably in IT and financial services sub-sectors), entailed a substantial increase in the whole-economy average net wage from lei 1,507 (EUR 338) in 2012 to lei 3,179 lei (EUR 665) in November 2019 (up 109.4%). Moreover, the whole-economy average net wage rose at a faster rate starting 2017, from 8% in the period 2013-2016 to 14% in the period 2017-2019.

Turning to the minimum pension, worth mentioning is its doubling between 2013 and 2019, from lei 350 (EUR 79) to lei 704 (EUR 149), based on the 14% increase implemented in 2015 and the successive hikes of about 20%, on average, per year in the period that followed. Hence, the average pension also experienced a rise, from lei 773 (EUR 173) in 2012 to lei 1,235 (EUR 261) in September 2019, i.e. by 60%. It should be pointed out that the average annual pension stood 5% higher between 2013 and 2016, while over the next three years the average annual increase was substantially higher at 10%. Given the cumulated 13.2% hike in the general price level from 2013 to 2019, far below the increase in wage earnings, household income posted significant cumulative real increases of 107% in the minimum wage, 80% in the average net wage, 78% in the minimum pension and 41% in the average pension. Fiscal and income policy decisions had significant positive effects on household income. From 2012 to 2019, the share of compensation of employees in the national net income (NNI) increased by 8.5 percentage points (from 40.6% to 49.1%), while in the gross domestic product (GDP) it expanded by 7.4 percentage points (from 32.9% to 40.3%). Those dynamics were recorded amid the narrowing share of the remuneration of capital in both NNI (down 8.5 percentage points, from 59.4% to 50.9%) and GDP[13] (down 5.2 percentage points, from 55.8% to 50.6%).

3. Effects of tax incentives targeting entrepreneurs

This section deals with the manner in which the major stimulative decisions targeting the corporate sector (supply-side measures) adopted in the period 2013-2019 were reflected in the financial standing of the domestic real sector.

3.1. Analysis of the tax incentives' impact relative to their destination

a) Lifting the ceiling on tax deductions for R&D expenditures

The assessment of developments at company level shows that the incentive for this type of activity, though beneficial for boosting the economic potential of companies and real economy performance, was unsuccessful, as the involvement of local firms in R&D activities remains feeble compared to other EU Member States. Thus, firms' R&D expenditure as a percentage of GDP is almost 5 times lower in Romania than the European average, i.e. 0.3% compared to 1.41% in 2018. It notes

[13] The difference up to 100% between the GDP and the sum of labour and capital remuneration is net taxes on product.

that, in Romania, only 0.06% of firms (about 400 out of the total of 667,700) allotted funds for R&D expenditure in 2018 (down from 0.08% in 2013). Furthermore, by company size, it was found that these activities are concentrated with corporations, accounting for 70% of total R&D expenditure incurred by the real economy in 2018 and, by the shareholders' country of origin, in the sector of majority foreign-owned companies, which make up approximately 80% of total. Hence, the business model of domestically-owned firms, characterised generally by low technology and knowledge levels and weak productivity, results in limited efficiency of measures to encourage innovation and research across these companies and thus economy-wide, considering that small local businesses are prevalent in Romania.

b) Exempting from taxation the earnings reinvestment in technological equipment

The analysis of developments in gross fixed capital formation (GFCF) by destination shows that, despite the incentives provided by the law-maker, the share of equipment expenditure in total investment has narrowed steadily since 2013, from 45% of the total to an all-time low of 36% in 2017, before rebounding somewhat to 38% in 2018. However, investment in equipment as a share of GDP is on the wane from the 2013-2015 average (10.5%), with Romania lagging behind other countries in Central and Eastern Europe, namely 8% in 2018, compared to Czechia (11.3%), Slovakia (10.4%), Hungary (8.6%) etc. The drop in the share of equipment in GFCF in the reviewed period occurred amid the pick-up in investment in construction (from 47% of total GFCF in 2013 to 57% of the total in 2018). However, it is worth noting that construction sector growth was not driven by investment in industrial projects, but by investment in commercial spaces, office buildings and residential projects. For example, out of the building permits issued for buildings in the period 2013-2018, more than 80% involved residential buildings. Moreover, a significant increase saw the number of permits for residential buildings (13% in 2018 against 2013), while non-residential buildings (administrative and other buildings, including industrial buildings) declined (by 3%). Over the past few years, gross fixed capital formation contracted significantly in the private sector, touching a meagre 18.6% in 2018, compared to a 16-year low of 18.2% in 2002, and trailing 1.4 percentage points behind the 2013-2015 average of 20%. Investment in the public sector also remains subdued, with GFCF falling amid the fiscal easing from 4.6% of GDP in 2013-2015 to a 19-year low of 2.6% in 2018.

c) Cutting by 5 percentage points the social security contribution owed by the employer

Despite significant additional funds made available to the entrepreneurs following these measures, the positive effects of the decision targeting the performance of both the real sector and the social area were limited. Supportive of this statement is that, above all, the average number of employees increased at a relatively slow pace between 2014 and 2018. While the economic posted a cumulative real growth of 25.4% and domestic demand surged, also as a result of the wage and tax incentives granted by the authorities to households during this period, the number of employees went up by only 12%, or 560 thousand. Moreover,

the structure of employment growth was weak, as only 19% (106.6 thousand) of the newly-employed were in industry and merely 9% (50 thousand) in IT and communications. By contrast, payrolls increased largely (39%, or 221 thousand employees) in cyclical sectors, with a poor capacity to create value added such as: trade (up by 14%, or 106 thousand workers), hotels and restaurants (41%, or 52 thousand employees), transport and warehousing (+13%, or 33 thousand labourers), construction (9%, or 30 thousand employees), etc. Second, the expected beneficial impact of the measure aiming to reduce the informal sector was not achieved, even though Romania enjoyed several years of high economic growth, as recent studies (Medina and Schneider, 2018) show that the share of the shadow economy in GDP has widened since 2015 (up to 26.3% in 2017, above the EU-wide average of 17.3%).

c) Reducing taxation of dividends

The substantial reduction in taxation of dividends did not spur capitalisation of firms, but the divestment process. In 2016, when the dividend tax was lowered from 16% to 5%, a fairly high number of companies preferred to pay out substantial dividends[14], and these operations expanded by 55% versus 2015 (from lei 39.8 billion to lei 61.6 billion). Thus, instead of tax incentives to encourage a sound behaviour of saving and investment, the legislative changes enacted within a loose legal framework, with many loopholes in the regulation of companies' activity, fostered divestiture across the corporate sector. This behaviour was quite widespread in the private sector, especially in the case of SMEs, for which distributed dividends increased in the reviewed period by 2.5 times, compared to an advance of 23% in the case of corporations. Companies in Romania continued to distribute dividends in significant amounts, totaling lei 111.6 billion in 2017-2018 (of which approximately lei 61 billion in 2018, a level close to the historical peak of lei 61.6 billion in 2016), accounting for 20% of the real sector's equity, standing at only lei 552.3 billion at end-2018 (compared to a debt level of lei 1,084.1 billion). Therefore, a possible measure on fully scrapping the dividend tax, which was requested by the business environment and debated by the general public, must take into account that encouraging entrepreneurs is only beneficial to the extent that stimulation of personal interest is in line with that of the firm, i.e. to increase the value of the business and ensure an effective and sustainable business model, in compliance with commercial legislation featuring hard budget constraints. The fast-paced distribution of profits in the form of dividends indicates, however, in the case of firms in Romania, the absence of investment projects (as gross fixed capital formation fell significantly in recent years, as described above), which puts a drag on companies' future development.

Moreover, despite strong economic growth in the past 6 years, many companies

[14] The distributed dividends were estimated as the sum of net profits at the beginning of the fiscal year and the change in the result carried forward, taking into account the profit distribution reflected by the increase in legal reserves.

(228 thousand, or 33% of the total) still incur losses, which in 2018 amounted to lei 35 billion (EUR 7.5 billion, or 3.7% of GDP), a very high level for an economy pursuing fast real convergence towards the EU's developed countries. These companies erode the capital base of the economy, as the losses, both the deferred and the current ones, are reflected directly in the level of equity, reducing the company's wealth (Madgearu, 1916). Therefore, many companies are severely undercapitalised. This was also due to the further weak payment discipline at firm level, in spite of the implemented tax incentives and the fast-paced economic growth in recent years, as mirrored by the fact that, in 2018, outstanding payments in the corporate sector amounted to lei 85.5 billion (EUR 18.3 billion, accounting for around 9% of GDP). While declining as a percentage of GDP, the volume of these arrears in absolute terms, when expressed in euro, is more than 3 times higher than in the early 1990s and almost 20% higher than in the pre-crisis period. By comparison, the share of state-owned capital in the real sector was 85% in the early 1990s and at present private capital stands at 88%. It is safe to assert that, in the absence of hard budget constraints, private capital currently displays at least a similar lack of discipline as state-owned capital in the 1990s.

In these weak financial conditions, it should be pointed out that the best way for undercapitalised firms to ensure funding is, at present, the loans from shareholders and affiliates, which made up 37.6% of total balance sheet in 2018, up by 2.3 percentage points from 2015 and 7.5 percentage points from 2010, when the legal framework was amended and these operations were allowed to be recognized in the company's books.

d) Easing the taxation of micro-enterprises

The tax incentives granted by the authorities to micro-enterprises starting 2015 did not materialize, given the absence of hard budget constraints in the legislation, in notable changes in the financial standing of this category of firms, as reflected by the perpetuation of their flawed overindebtedness business model, in particular to their own shareholders, persistent loss incurrence, high volumes of outstanding payments, etc.

In 2018 (when the turnover threshold up to which a company falls into the category of micro-enterprises was raised from EUR 500,000 to EUR 1 million), similarly to the entire reviewed period, the weaknesses identified at the level of micro-enterprises persisted, in that such companies were accountable for more than 40% of the losses economy-wide (lei 14.5 billion, out of lei 35.1 million) and a similar proportion of outstanding payments (lei 35 billion, out of lei 85 million), amid weak capitalisation: the debt-to-equity ratio for micro-enterprises is close to 12 (six times higher than the 1.96 average economy-wide) and the companies reporting earnings below EUR 1 million owned only 5% of the equity stock of the real sector (despite their substantial number), but a significantly higher percentage of debt volume (29% of total). Indeed, these companies are characterised by a greater appetite for financing via loans from shareholders and affiliates, as shown below. Second, the fiscal incentives granted to micro-enterprises with at least one employee failed to boost employment as well. For example, in 2018, the micro-enterprise

sector did not record a faster growth rate than the rest of firms in terms of employment, as the number of employees of the businesses with earnings lower than EUR 1 million and of the real sector as a whole increased at a similar rate (3.1%). Third, micro-enterprises continue to report poor efficiency, with a less productive business model, focusing on areas characterised by low technology and knowledge levels and involving activities with a low degree of complexity. Precisely, this category of companies, although particularly large (91% of all firms in the economy) and comprising around one-fifth of the number of employees in the real sector account for a meagre 14% of total gross value added in 2018.

f) Incentives granted to construction firms

It is worth noting that for the companies in the construction sector the effects of fiscal incentives (minus lei 2.2 billion in tax receipts, equivalent to EUR 0.5 billion) and of the minimum wage increase were positive. They became manifest clearly starting 2019, the year when they took effect, as follows: (i) in the first three quarters, the volume of construction works rose markedly from the same year-earlier period (23%), the second fastest rate of increase in the EU (3%, on average), also driven by higher household income; (ii) the number of construction workers augmented January through November 2019 by 3.8% (15,000 employees) against the same year-earlier period, pointing to a near-quintupling compared to the real sector performance (+0.8%, or 41,000 employees).

3.2. Assessment of fiscal incentives' effects on the financial performance and payment discipline

Contrary to classical economic theory, recent developments in Romania show that, by easing fiscal policy in a bid to foster a positive behaviour of entrepreneurs as concerns investing in their own businesses, no substantial progress was made in terms of economic performance, capitalisation and payment discipline of firms. This is because the entrepreneurs have not used the additional resources (approximately lei 70.3 billion, or EUR 15.5 billion) made available following the implementation of the fiscal incentives in order to improve the financial standing of their firms or to adopt beneficial economic decisions (e.g. expansion and modernisation of equipment, purchase of new technologies, etc.). Precisely, looking at the firms operating[15] in the market in the period 2012-2018, the following unfavourable issues were detected:

[15] The companies that submitted financial statements to the Ministry of Public Finance in both 2012 and 2018 were taken into account. They total 374,000 units (55% of the 684,000 registered at end-2018). The difference of 230.500 firms in operation in 2012 but no longer in the economy, currently refers to the erased or absorbed businesses, or which were subject to mergers, etc. The option for analysing the companies in operation between 2012 and 2018 was based on the need to assess as accurately as possible the effects of fiscal incentives granted to firms. These companies were in business prior to the implementation of fiscal easing measures, so that the influence of facilities on their financial standing can be better estimated.

- The debt-to-equity ratio for these companies steadied at a high level of 1.9, despite the substantial increase in cash holdings available to company owners and the economic growth recorded in the past years
  - This owes to the fact that the lei 135.4 billion (EUR 24.9 billion) upswing in the equity of the existing firms in both 2012 and 2018 was countered by the brisker increase in absolute terms of these companies' debts (especially to shareholders, suppliers, as well as the government budget and banks), by lei 229.4 billion (EUR 41.2 billion, up 33%).
  - Moreover, the advance in capital stock of firms in the sample overshadows heterogeneous developments between: (i) the firms with responsible capitalisation behaviour, making up 52% (193,000) of the number of companies under review; they increased their equity by 128% (lei 278.5 billion, or EUR 57.2 billion), on average by lei 1.4 million (EUR 296,000) per unit, and (ii) the companies in which capitalisation worsened, accounting for 48% of total (181,000), where the capital stock almost "vanished", recording a decline by 97% (lei 143.1 billion, or EUR 32.4 billion), i.e. a contraction, on average, by lei 792,000 (EUR 179,000) per unit.
  - Out of the companies that experienced decapitalisation from 2012 to 2018, the overwhelming majority (more than 90%) are SMEs and domestically-owned firms, so that these two categories of businesses were responsible for 78% (lei 111.4 billion, or EUR 24.6 billion) and 59% (lei 84.9 billion, or EUR 19.3 billion) respectively of the capital stock contraction. Foreign-owned firms, albeit small in number (8% of decapitalised companies), also posted a substantial decline in the capital stock economy-wide (lei 47.3 billion, or EUR 10.6 billion). Worth mentioning is that the firms whose capital stock decreased between 2012 and 2018 were financed by their shareholders mainly via loans. Thus, the share of this source in those companies' balance sheet doubled (by 10 percentage points) from 10% to 20%, as the volume of these loans surged by 63% (from lei 45.3 billion to lei 74 billion, up by lei 28.7 billion, or EUR 5.6 billion). This inadequate financing model was manifest especially among micro-enterprises.
  - turning to the companies that increased their capital (in the amount of lei 278.5 billion, or EUR 57.2 million) in the period 2012-2018, it notes that the favourable development is concentrated in only a few firms. Out of the companies that strengthened their capitalisation over the reported period, corporations (about 1,300, accounting for merely 0.6% of the number of such firms) had the most significant contribution, namely 40% (lei 105.7 billion, or EUR 21 billion) of the increase in the capital stock. Furthermore, the breakdown by shareholder origin shows that 44% (lei 124.4 billion, or EUR 25.6 billion) of the rise in the capital stock from 2012 to 2018 was accounted for by foreign-owned companies, even though they make up only 6.4% (12,300 out of 193,000) of the number of firms that upped capitalisation.

- Against this background, indicating that (i) on the one hand, a relatively small number of firms (mostly corporations and foreign-owned firms) showed, following the implementation of fiscal incentives, a sustainable approach to the financing model via substantial capitalisation in the period 2012-2018 and (ii) on the other hand, a negative *modus operandi* persists, particularly across small-sized and domestically-owned firms, translating into subdued capital injections and, in many cases, chronic divestment, the analysis reveals that the need for recapitalisation of the companies in operation during the period 2012-2018 augmented substantially from lei 87.9 billion (EUR 19.8 billion) in 2012 to lei 137.5 billion (EUR 29.5 billion), namely by more than 50% (up by lei 49.6 billion, or EUR 9.7 billion).
- In the economy as a whole, considering all companies, the number of firms that do not comply with the legal requirements for capitalisation is quite high (38% of total, i.e. 259,500 firms, out of which 252,100 are bankrupt because they report negative net worth, i.e. their liabilities exceed their assets). At the same time, the need for recapitalisation expanded more than 15%, from lei 132.4 billion (EUR 29.9 billion) in 2012 to lei 158.5 billion (EUR 34 billion) in 2018.

Hence, bearing in mind the low level of the government's capacity to ensure a level playing field by imposing firm payment discipline, the positive effects of the fiscal incentives benefitting entrepreneurs have been limited. As such, other relevant studies (Guda, 2019) also show that in 2018 the financial standing of companies worsened from the previous years, since: working capital turned negative (-2% of the balance sheet compared to +4% in 2007), the degree of capitalisation dropped to only 28% (from 35% in 2007), the share of short-term debt in total liabilities increased to 75% (compared to 58%) and fixed assets contracted to only 48% of the firms' balance sheet (from 63%).

Against the backdrop of asymmetrical trade, tax and accounting legislation, with benefits leaning towards financially reckless economic operators (Georgescu, 2018), many local entrepreneurs proceeded to "draining" significant amounts of money from the firms' capital and cash resources, including through legislated fiscal incentives, into their personal wealth. It is noteworthy that the ratio of domestically-owned firms' capital to personal wealth (net financial assets) worsened from 64% in 2012 to only 51% in 2018. The significant worsening of this ratio (-13 percentage points) testifies to the extent of the "optimisation" undertaken by Romanian entrepreneurs between the firm's capitalisation and the expansion of their own household's wealth, in favour of the latter[16]. These findings show that, in the local economy, there is disrespect of the principle set out by Madgearu (1944), according to which "the enterprise forms a sui generis body, which has its own existence, distinct from the entrepreneur's household".

[16] The analysis was conducted on the basis of data on net financial assets at aggregate level, as there is no detailed information available by holder, thus preventing an analytical correlation between personal financial wealth and the owners of undercapitalised firms.

Adding to this unfavourable situation is the fact that fiscal easing in favour of consumers, given the scant increase in domestic production capacities, translated into negative macroeconomic developments, resulting in an unsustainable boost to imports, which has caused the trade deficit and the current account deficit to widen. Thus, the increase in households' disposable income amid the measures implemented by the authorities caused the consumption factor to become the main driver of economic growth in the reviewed period, while investment saw a weaker-than-expected performance. Under the circumstances, domestic supply could not accommodate the demand surplus, as reflected by a fast-paced increase in the negative balance of net exports, which eroded real GDP dynamics starting 2014, with a sharper trend in the period 2017-2018 (negative contribution to the GDP dynamics by -1.4 percentage points and -1.7 percentage points respectively). Given that household consumption picked up at a substantially brisker pace than that of investment in the economy (average annual growth of 5.3%, compared to an average annual growth of gross fixed capital formation of 0.8% in the period 2013-2018), the trade deficit widened from 4% of GDP (EUR 5.8 billion) in 2013 to 7.5% of GDP (EUR 15.1 billion) in 2018. Consequently, the current account deficit reached 4.4% of GDP in 2018 (from 0.8% in 2013), one of the highest levels in the EU, thereby exceeding the 4%-of-GDP alert threshold set out in the European Commission's scoreboard for the regular surveillance of the Macroeconomic Imbalance Procedure.

4. Concluding remarks

The analysis of the effects exerted by the active fiscal and income policy implemented 2013 through 2019 on the economic performance, capitalisation and payment discipline of firms in the real sector leads to the following conclusions:

- Given the demand shortfall and households' weak purchasing power at the time of launching these policies, we can state that the set of adopted measures was appropriate and necessary, also from the perspective of the fundamental principles of the economy. The neo-Keynesian (demand-side economics) and neoliberal (supply-side economics) theories assume, however, that, ex-ante, the market economy witnessing policies such as those implemented in Romania from 2013 to 2019 is characterised by level playing field, hard budget constraints, clear rules on market entry and exit, as well as a high degree of fiscal compliance. Mention should be made that A. Smith (1759) himself understands the functioning of the "invisible hand" of the market and achieving the personal interest in capitalism only in an environment of full fairness (honesty) and based on the enforcement of firm legal norms, underlining the importance of justice in all its forms and the fact that it represents a key building block of the capitalist society.
- In the case of Romania, however, against the background of loose commercial and tax legislation, the entrepreneurs that benefited by additional financial resources did not invest in raising the capital of their underfinanced firms, but instead frequently extended loans to them. In the absence of a strong capital base,

domestic supply did not match the pace of growth of domestic demand, owing both to the failure to reform the post-privatisation real economy (the Senate passed the law on recapitalisation of commercial companies as late as September 2019), as was the case in other former communist countries (Poland, Hungary, etc.) and to the non-commissioning of the Development and Investment Sovereign Fund, which was foreseen to be operational since 2018. Although both measures had been included in the governing programme of decision-makers that adopted the fiscal incentives and the rise in citizens' income, amid a tense political climate, they did not come into force. It should be noted that, according to our calculations, in the economy there are funding sources accounting for 30% of the amounts required to improve the financial standing of undercapitalised firms. And this is because the loans extended by shareholders to undercapitalised companies amount to lei 46.9 billion (EUR 10 billion), whereas the recapitalisation requirement to meet the legal conditions is of lei 158.5 billion (EUR 34 billion).

- Under the aforementioned circumstances, we believe that, compared to citizens' consumption and investment needs, households "have not been given too much", unduly expanding domestic demand, but rather, on the one hand, entrepreneurs have insufficiently increased domestic supply, amid the absence of structural reforms in the real economy, especially in the agri-food production subsector, which boasts a high development potential, and, on the other hand, in Romania high income and large wealth are taxed too little (budget collection being even lower).
- At the current juncture, when the domestic economy is riddled with countless imbalances and dysfunctions, we see only two alternatives for the state's position: (i) either it no longer acts proactively via policies fostering both domestic supply and demand so as not to create fresh vulnerabilities for the economy, but running the risk of getting stuck in the Middle Income Trap (MIT)[17], a peril already taking shape in Romania (Georgescu, 2015), (ii) or it promotes certain incentives such as those mentioned in this paper, but only in tandem with the stepped-up implementation of in-depth structural reforms, creating a firm legal framework in the commercial field, as well as the transmission channels in the firms' administration of the entrepreneurs' cash holdings with a view to capitalising the firms and, hence, increasing the volume and competitiveness of domestic output.
- The chronic payment and financial indiscipline allows for the existence in the Romanian economy of too many "free lunches" that do not encourage the entrepreneurial spirit (in 2018, Romania recorded the lowest number of SMEs

[17] The Middle Income Trap is generally defined as the risk that the economy experiences a flattening-out in the middle income area or a halt in convergence in relation to developed countries, amid stagnant productivity and a loss in competitiveness owing to poor investment, weak industrial diversification and unfavourable labour market conditions (including fast wage growth), unable to keep up the pace with more advanced economies, especially as regards the developments in high value added product markets.

among EU Member States, i.e. 2.9 per 100 inhabitants, half of the EU average of 5.8 firms); the propensity for investment is manifest in an economic environment characterised by firm rules, not by discretion, which ushers in rent seeking, monopolies and sinecures in lieu of business risk-taking. Therefore, it is our opinion that Romania requires a substantial improvement of the current economic culture and the option for the principles of the Northern and Central European philosophy, in the sense of adopting, as behavioural fundamentals, the values of: (i) work in a level playing field, based on clear rules; (ii) firm adherence to contracts; (iii) furthering of structural reforms, thereby ensuring better resource allocation and use in the economy.

- Stimulating domestic demand via fiscal and income policies triggers imbalances in a market economy that is only partly functional, small and open, as Romania, where, among the requirements set by the EU for a functioning economy, important criteria –regarding the enforceability of contracts for the payment of goods and services, the efficiency in enacting the law on commercial companies and the bankruptcy procedure – are marred by serious flaws.
- The 1.5 percentage point compression (from 27.8% to 26.3%, significantly below the European average of 40.3%) in tax revenues as a share in GDP from 2012 to 2018 was brought about by the previously-described fiscal easing measures, partly offset by both the sizeable hike in the volume of wages as a share in GDP – representing a significant base for direct taxation – and the relative, albeit insufficient, increase in the effectiveness of collection of VAT and social security contributions.
- A counter-cyclical fiscal policy is difficult to implement and is hardly effective in the presence of the flat tax rate, because the operationalisation of automatic fiscal stabilisers, as an essential mechanism for promoting counter-cyclicality, is achieved solely on the basis of personal income tax progressivity. Thus, tax progressivity (Auerbach and Feenberg, 2000; Veld *et al.*, 2012) makes fiscal policy have a stabilising effect on GDP via at least two transmission channels: one consisting in the effect on aggregate demand (with marginal progressive rates reducing the magnitude of disposable income fluctuations and hence the impact of positive demand-side shocks) and the other through labour supply (during downturns, also marked by income reduction, lower tax rates for smaller income tranches foster a rise in labour supply, which *caeteris paribus* increases the quantity used at the level of the labour factor and hence the level of GDP). Tax progressivity is the main determinant of effectiveness of the automatic stabilisers, because during upturns their functioning creates fiscal space, which is used subsequently, in the recessionary phase, to alleviate it, thus conferring a counter-cyclical nature to the fiscal policy.
  - In this vein, for an improved contribution of the fiscal component within a coherent economic policy mix, the tax authority needs to accurately know the income of all citizens, which can only be achieved by enhancing the present fiscal regime, namely by shifting from the flat tax rate to the progressive

income tax, via several tax deduction schemes for individuals, according to the best practices in the developed countries. Mungiu-Pippidi (2020) came to a similar conclusion, in the sense that income taxation via the flat rate "has long reached its limits" and tax progressivity is warranted. Together with this change in the fiscal regime, we believe it is also necessary to introduce the statement on personal assets, alongside the stepped-up completion of the National Cadaster. Thus, an accurate progressive taxation of property will be achieved, via a model used by a Western country and deemed adequate for Romania. Moreover, this will ensure a considerable reduction in tax evasion, by enabling the correlation of annual income (flow) with the evolution of personal assets (stock).

- we believe it is objectively necessary to implement tax progressivity on personal income and wealth, because: (i) the functioning of the flat rate cannot ensure the putting in place of a counter-cyclical fiscal policy, since – being a proportional tax in relation to the income level – it does not flatten out earnings in times of economic growth, failing to create the fiscal space that may be used during recessionary phases. At the same time, applying the flat tax rate also contradicts (ii) the marginal utility principle[18], in the sense that for high-income earners the utility of one leu paid as tax is substantially lower than in the case of lower income earners, which renders the flat tax both economically inefficient and deeply unfair from a social perspective. Moreover, (iii) Hayek (1932) claims that another argument in favour of direct tax progressivity is the offsetting of the inherent regressivity of indirect taxation.

- The current public finance tenseness reflect the existence in the Romanian society of a strong distributional conflict (Piketty, 2019) as regards (i) the options for achieving a sustainable budget position and (ii) improving the distribution of the newly-created value in the future, which – unless a solution is found through dialogue and talks between social groups, also by activating the redistributive function of public finance – leads to the suboptimal alternative of achieving economic balance via high inflation rates and domestic currency depreciation.

5. REFERENCES

[1] **Auerbach, A., J. and Feenberg, D. F. (2000), *The Significance of Federal Taxes as Automatic Stabilizers***; *Journal of Economic Perspectives*, 14 (3): 37-56;

[2] **Cazacu, A. M. (2017), *The External Competitiveness of the Romanian Economy*;** *Central Bank Journal of Law and Finance*, Vol. 4 (1);

[18] The concept of marginal utility was formalised through mathematic tools by Léon Walras, William Jevons and Carl Menger. The marginalist revolution that they started had a profound influence on economics, with the concept of marginalism being applicable not only to utility functions, but also to consumption, capital, labour force, output, costs, etc.

[3] **Georgescu, F. (2015),** ***Capitalul în România anului 2015*****,** speech occasioned by the awarding of the diploma "Virgil Madgearu cu medalie de aur", The Bucharest University of Economic Studies, Bucharest, 24th of November;

[4] **Georgescu, F. (2018),** ***Capitalul în România postcomunistă*****;** *Publishing House of the Romanian Academy,* Bucharest;

[5] **Guda, I. (2019),** ***România. Mediul de afaceri și contextul macroeconomic*****;** Annual Conference of Financial and Bank Analysts in Romania, 28th of November;

[6] **Hayek, F. A., Gregory, T. E., Plant, Arnold and Robbins, L. (1932),** ***Spending and Saving - Public Works from Rates*****,** in *The Times*, UK, 19 October;

[7] **Heemskerk, F., Voinea, L. and Cojocaru, A. (2018),** ***Busting the Myth: The Impact of Increasing the Minimum Wage: The Experience of Romania*****.** Policy Research working paper no. WPS 8632, Washington, D.C.: World Bank Group;

[8] **Isărescu, M. (2019),** speech held at the Annual Conference of Financial and Bank Analysts in Romania, 28 November, Bucharest;

[9] **Madgearu, V. (1916),** ***Studiu practic al întreprinderilor comerciale şi industriale*****,** in *Revista Cursurilor Academiei de Înalte Studii Comerciale şi Industriale*, 26 May;

[10] **Madgearu, V. (2014) [1944],** ***Curs de economie politică*****;** *Humanitas Publishing House*, Bucharest;

[11] **Medina, L., Schneider, F. (2018),** ***Shadow Economies Around the World: What Did We Learn over the Last 20 Years?,*** IMF WP No. 17;

[12] **Mungiu-Pippidi, A. (2020),** ***Cine să plătească pensiile și alocațiile? Sare în ochi!*****,** ***România curată*** website, 23 January 2020;

[13] **Piketty, T. (2019),** ***Capital et Idéologie*****,** É*ditions du Seuil, Paris;*

[14] **Saunders, P. (1998) [1995],** ***Capitalismul. Un bilanț social*****;** *Du Style Publishing House,* Bucharest;

[15] **Smith, A. (2017) [1759],** ***Teoria sentimentelor morale*****;** P*ublica Publishing House,* Bucharest;

[16] **Văcărel, I., Bistriceanu, G. D., Bercea, F., Anghelache, G., Moşteanu, T., Bodnar, M. and Georgescu, F. (2007),** ***Finanţe publice*****;** *Didactic and Pedagogic Publishing House*, 6th edition, Bucharest.

[17] **Veld, J., Larch, M. and Vandeweyer, V.** (2012), *Automatic Fiscal Stabilisers: What they are and what they do*, European Economy - Economic Papers 2008 - 2015 452, DG ECFIN, European Commission