GENERAL MACROECONOMIC CONTEXT AS ADDITIONAL MOTIVATION FOR THE ROMANIA PERSONAL INCOME TAXATION REFORM

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Abstract: In general, the main consideration is that at the level of the national economy, the main decisions are based on the analysis of internal developments. However, the international context must be monitored very carefully, the last major crises, the financial crisis of 2008-2009 and the COVID-19 crisis have shown that the dangers come from outside. Having said that, the article tries to discern what the international expectations for the next period are and how they can have an impact domestically, on the Romanian economy and especially on the Romanian taxation system. Particular attention is paid to the personal income tax system, taking into account that the discussions of the last period reflect the concerns regarding the return to a progressive tax system. The article does not try to give a verdict on what should be done, but it wants to establish the framework of the limits of the perspectives and help in outlining some correct macroeconomic policy measures, especially fiscal policy, for the future.

Keywords: international context, perspectives, forecasts, expectations, fiscal reforms

1. Introduction

The general economic framework is often perceived as only one of the factors in changing the conduct of macroeconomic policies. However, in reality, especially in the case of an external shock, the general context can substantially affect budget revenues and expenditures, and substantial changes in economic activity, labour market movements, but also adjustments to fiscal legislation can have a substantial impact on budget receipts and especially on tax revenues.

Most of the time, there is a gap between the policy measures and the visible impact in society. Also, the ability or inability to calibrate in real time can make the economic policy decision, and especially the fiscal policy effective or ineffective. Sometimes in times of crisis, economic policy decisions are pro-cyclical, taxes and duties are increased such as the increase in the VAT rate, new bank taxes or property taxes are introduced, other times they are anti-cyclical, as in the case of the COVID-19 pandemic. However, even in the context of anti-cyclical policies, there is an accumulation of expenses, a management fatigue, which doubled by other crises, such as the war in Ukraine, pressure on resources (including energy) and explosive inflation, leads to a lower efficiency of fiscal policy measures and implicitly a downward pressure on budget revenues. In this context, the paper reviews a series of global and regional developments, specifying a series of forecasts for the future, which should be taken into account also in the case of decision-making regarding the Romanian income tax system.

2. Motivation, literature review and description of the problem

In general, the idea of fiscal reforms starts from the fact that in recent decades the budget deficit and public debt (the accumulation of budget deficits) have grown substantially in almost all Western economies, and the Eastern economies, although to a lesser extent, are also beginning to face more often with these problems. These developments take place against the background of a consumer culture in which the increase in production and the positive evolution of the GDP no longer have an equivalence at the national level in the increase of the revenues of the general budget, and the budget expenditures remain permanently over-proportional in relation to the revenues. In the short term, increasing tax rates can be a solution, but in the medium and long term it inhibits economic growth, a more appropriate solution being often considered to be the reduction of government spending. However, reducing government spending could imply a recessionary phenomenon, and then governments might consider themselves tempted not to do so in order not to generate bankruptcies and the loss of jobs for a good part of the employees of that economy. Therefore, fiscal reform and consolidation must be carefully discussed and communicated, economically but also socially grounded, otherwise fiscal consolidation in an unfavourable period (deep recession) could create the perception that some temporary losses of income and capital could become permanent , and the behaviour of the business environment, but also of the population regarding the employment of the workforce to be similar, creating that phenomenon of hysteresis (De Long and Summers, 2012). According to EY(2018), a series of elements of the recent tax reforms aim at greater transparency, a better harmonization of the differences between the tax systems of the countries and an increasingly coordinated policy at the international level to combat tax evasion, but also harmonization of taxation systems.

Thus, numerous studies outline the potential stabilizing or less stabilizing effects of taxes in the economy, thus Duncan and Sabirianova (2012) note the fact that progressivity can reduce the inequality observed in net and gross incomes, and analyzing the impact of proportional taxation on inequality in Romania, Voinea and Mihăescu (2009) notes that the single tax causes an increase in social inequality, proposing to replace it with progressive taxation for a better automatic stabilization of incomes and capitals.

A series of studies consider that economic integration at the European level generates scale effects, with positive effects on all member countries (Abramowitz, 1986, Henrekson, Torstensson and Torstensson, 1997), and the new member states seem to understand better the mistakes of the old ones member states and to respond directly, through more appropriate solutions, to these challenges (Varblane and Vahter, 2005). In the case of the new countries integrated into the EU, there were two trends, manifested by the individual options of the countries: some wanted and achieved a faster integration and successfully joined the euro zone (e.g. the Baltic countries), others (e.g. . the southern and eastern flank of the new member states) have considered and continue to consider the need for deepening the absorption of foreign capital, European funds, information and technological knowledge, improving the internal economic structure (e.g. Bulgaria, Hungary, Romania, etc.). Most of the time, the positive expectations in the economy and in the budgetary field were not confirmed among the countries that remained with a single rate tax regime.

Regarding developments, deficits and debt in many countries surged during the pandemic, leading to large deviations from fiscal rule limits, and return to the debt limits and deficits within the parameters of fiscal rules may prove difficult. However, if these fiscal rules were previously respected, during the period of manifestation of shocks and crises, the ability to respond can be very good (Davoodi et al., 2022).

3. Methodology and data sources

The analysis is based on a comparative study of international and European data, the forecast period is the next three years, 2023, 2024, 2025. To highlight the current developments, the data focuses on the years 2019/2020, 2021 and 2022 (there where available). The monitored indicators are the general macroeconomic indicators, such as economic growth, inflation, the unemployment rate, the current account deficit and the budget deficit. At the same time, a series of indicators of the labour market and the budgetary fiscal system are followed in the analysis in order to outline the possible directions of the reforms that should be carried out in the near future.

4. Results

The global economy is still reeling from the pandemic crisis, Russia's invasion of Ukraine and the rising cost of living. Global economic growth remains uneven and sluggish, forecast to reach 3% in 2023 and 2.9% in 2024, while inflation is expected to gradually come under control, from 9.2% in 2022 to 5.9 % in 2023 and to 4.8% in 2024 (IMF, 2023). Within the advanced economies, the US surprised positively with resilient consumption and investment, while activity in the Euro zone was revised downwards (and due to dependence on energy resources provided in passed by Russia), a situation also valid for China's emerging economy which is facing weakening investor confidence and a real estate crisis.

Amid the slowdown in manufacturing activity, the services sector is weakening, and service-driven inflation is also expected to moderate in 2024, which will affect the labour market and overall economic activity. Another factor in the slowdown of global activity is the restrictiveness of monetary policy in combating inflation, affecting both real estate markets and investments through stricter credit conditions. Employment and labour force participation rates are projected to exceed pre-pandemic trends in advanced economies but remain significantly below them in emerging and developing market economies, reflecting more severe output losses and a much weaker social protection. Despite signs of easing, labour markets in advanced economies remain buoyant, with historically low unemployment rates helping to support activity. This situation will probably be found in the future, for example in the United States the estimated increase in unemployment is very modest, from 3.6 to 3.9 percent until 2025 (IMF, 2023).

Global risks include: - the possibility of a deepening of the real estate crisis in China, - the possibility of an increase in the volatility of commodity prices against the background of renewed geopolitical tensions and climate change, - the possibility of general inflation and core inflation still being high, despite expected decreases and, fourthly – the possibility of increasing fiscal vulnerability amid the erosion of fiscal reserves in many countries, with slowing economic activity, rising financing costs and high debt levels, but above all with a growing mismatch between requirements ever greater at the address of the state and available fiscal resources (IMF, 2023). In this chapter, the danger is likely to arise amid a sudden reassessment of risk for emerging markets, with capital outflows following the appreciation of the dollar, leading to increased borrowing costs.

Against the background of a strong post-pandemic economic expansion (2021-2022), the EU economy lost momentum, with real GDP contracting slightly in the fourth quarter of 2022 (European Commission, 2023b). At the level of the European Union, the economy registered a modest growth in the first part of 2023, according to Eurostat, the growth was 0.1%, reaching a halt in economic growth in the second and third quarters, against the background of the reduction in demand and production industrial due to geopolitical tensions and especially the war in Ukraine. At the same time, the volatility of commodity prices, the increase in energy prices, expanding interest rates, the currency depreciation of Asian currencies, decreasing labour productivity, the reduction of industrial activity and international economic relations,

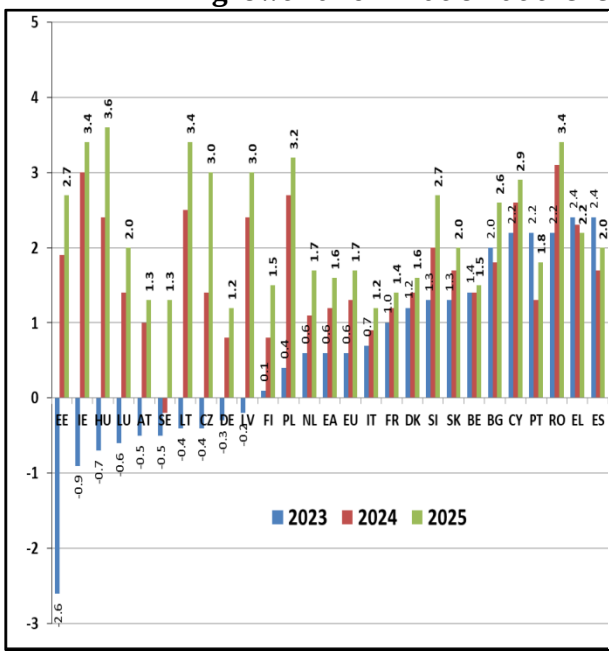
are some other general aspects that strain the realities at the level of the Union European. Despite some positive expectations regarding the recovery of household spending and international commercial activity, forecasts remain reserved for the next period as well, with 2024 marking an economic growth of 1.4% in 2024 at the EU27 level, according to Business Europe Economic Outlook Autumn 2023.

As inflation moderates, economic growth is likely to pick up again in the spring and gradually pick up pace in 2024. To shape the future somewhat, a number of questions can be asked. A first question concerns the decline in the prices of energy and petroleum products, whether it will continue or not. If we can answer yes, then the current geopolitical tensions may not put too much at risk of tempering inflation and the absorption of inflationary price increases in core inflation.

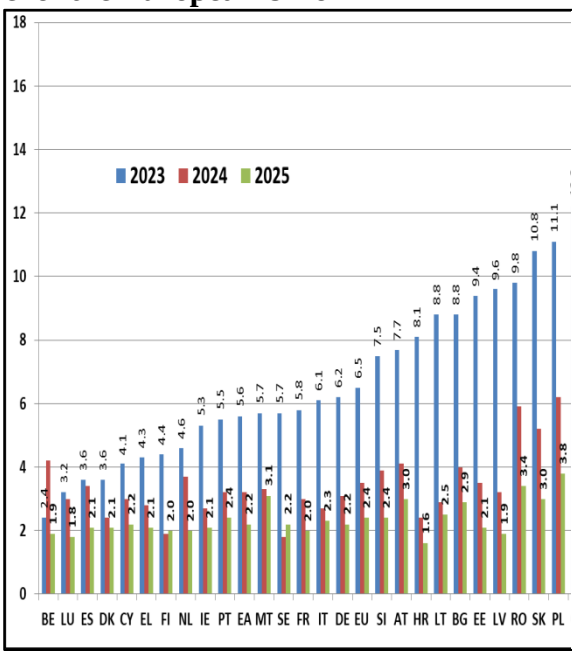
If the answer is rather no, then core inflation will fairly accurately reflect global and regional price increases and then the resilience of the European economy to shocks will be further weakened, economic growth will slow down or remain anaemic, the rate of household savings will continue to decrease, and consumption will be further affected, investments will decrease, ultimately leading to the moderation of industrial production and the external competitiveness of European Union products and goods.

According to the European Commission (2023a), inflation seems to have already reached its peak, and the favourable developments on the energy markets foreshadow further sharp declines, the moderation occurring as a result of the mitigation of the energy component, against the background of the decrease in consumption and the diversification of supply sources. In terms of non-energy commodity prices, the picture is mixed, with price declines for a wide range of agricultural products, but also price increases for industrial products, likely on the back of a strong resumption of construction activity in China.

Figure 1 – Forecast for the period 2023-2025 regarding the evolution of economic growth and inflation at the level of the European Union



Forecast regarding the evolution of real GDP growth (%) in the EU27 countries



Forecast regarding the evolution of inflation (%) in EU27 countries

Source: European Commission 2023b; values shown are forecasts for the years 2023 and 2025

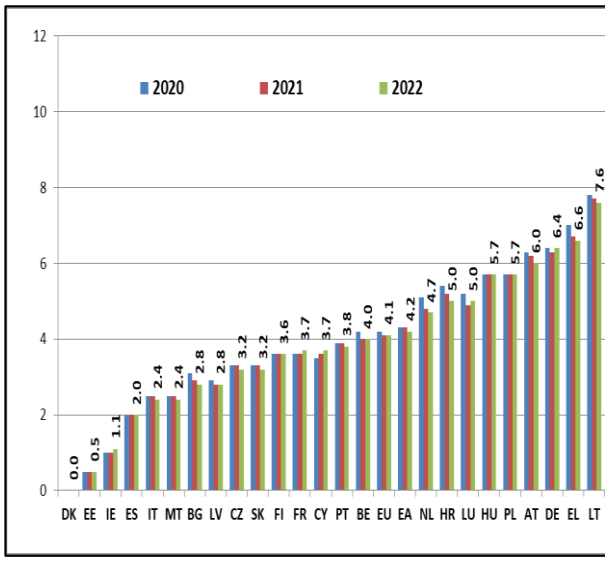
The European Commission's interim winter forecast (European Commission, 2023a) raises the growth outlook and slightly lowers inflation forecasts, GDP will grow by 0.8% in 2023 (autumn forecast - European Commission, 2023b - adjusting downwards to 0.6% for both

the EU and the Euro zone) and 1.6% in 2024 (0.9% and 1.5% in the Euro zone), being close to the values and other international reports. Looking ahead, economic growth is expected to pick up slightly as consumption returns to an upward trend, with real wages rising, foreign demand to pick up, and investment likely to remain favourable. Economic growth is forecast to reach 1.7% in 2025 in the EU, and in the euro area, GDP growth is forecast to be slightly lower, at 1.6% in 2025 (European Commission, 2023b). According to the autumn report (European Commission 2023b), in the EU, headline inflation will decrease from 6.5% in 2023 to 3.5% in 2024 and 2.4% in 2025, and the euro area is expected to decrease from 5.6% in 2023 to 3.2% in 2024 and 2.2% in 2025.

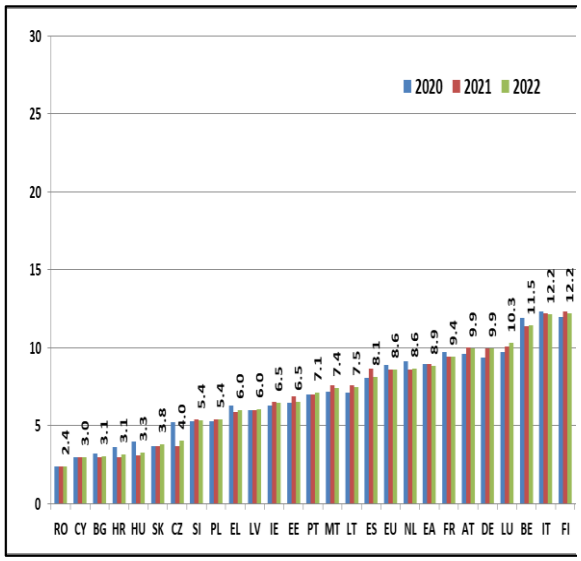
On the manufacturing side, gross value added in the industry was hampered by high energy costs and weak demand. Although their dynamics were very volatile in the member states, investments, both public and private, also increased only marginally in the first half of 2023. The labour shortage, along with financing problems, affected construction. However, IT and business services, which account for almost a fifth of the EU's gross value added, have enjoyed continued expansion. At the same time, short-term real interest rates in the euro area are expected to turn positive towards the end of the year and gradually increase to 1% by the end of 2025, while long-term (10-year) nominal rates of interest rates in the euro area are expected to remain at around 3.4% over the forecast horizon (European Commission 2023b).

Considering the labour market, the unemployment rate is expected to continue to decline, outlining a better economic outlook than previously foreshadowed. The EU labour market continued to perform strongly in the first half of 2023, and in the second quarter of this year, the activity and employment rates reached high levels, simultaneously with a record low in September 2023 of unemployment rate. The coexistence of low unemployment and a high share of job vacancies, but also a shortage of skilled labour points to a labour market still in a state of constraint, especially in industries such as: healthcare, hospitality, construction and ICT. Employment growth is forecast at 1.0% in the EU in 2023, partly due to gains at the end of 2022, before slowing to 0.4% in both 2024 and 2025 (European Commission 2023b).

Figure 2 –The developments in recent years of employees' social contributions and personal income taxes at the level of the European Union



Compulsory employees' actual social contributions, Percentage of gross domestic product (GDP)



Taxes on individual or household income, Percentage of GDP

Source: Eurostat and European Commission, Directorate-General for Taxation and Customs Union; values for 2022.

In 2022, according to Eurostat, at European (EU) level the share of net social contributions in total tax revenue decreased (from 14.2 % of GDP in 2021 to 13.9 % of GDP in 2022) and current taxes on income, wealth increased less from 13.3 % in 2021 to 13.4 % of GDP in 2022. If we look at Romania's level, expressed as a percentage of GDP, the employee's contribution to social insurance, the share of the contribution is huge, 9% of GDP, bringing Romania to the first position in the EU27. This aspect transforms the Romanian employee into one who bears a huge fiscal pressure in relation to his earnings from work.

Regarding current taxes on income, wealth, in 2022, we can see that Denmark raised the equivalent of 27.5% of GDP from these taxes. This aspect is due to the fact that in Denmark most social benefits are financed through taxes on income, social transfers being funded mainly through tax revenue, thus net social contributions are very low relative to other countries. In the top of these gains from income and wealth taxes, other north-western countries such as Sweden, Finland, Luxembourg, and Belgium can be observed, and at the bottom of the ranking are countries such as Romania, Cyprus, Bulgaria, Croatia and Hungary, having relatively small revenue from these taxes. Although taxation, taxes and public debt benefit from inflation, the same cannot be said about employees and the population. At the current level of taxes and fees, inflation can be perceived as an additional tax, putting pressure on the way of managing the consumption expenses of the population.

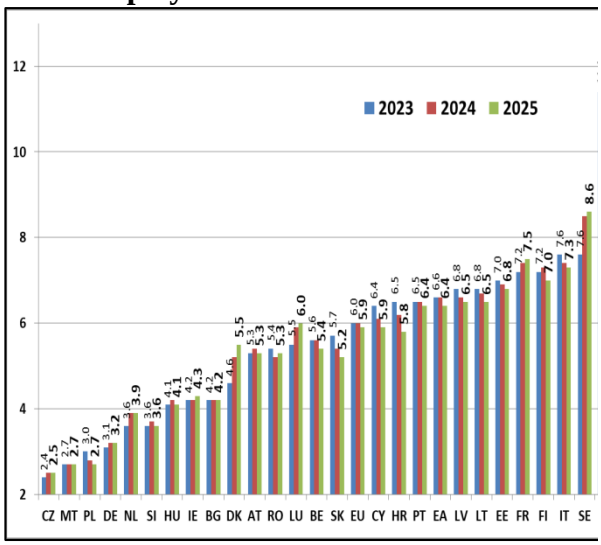
As long as nominal wage increases are outstripped by inflation, labour market pressures may prove strong in adjusting wages and implicitly inflation in the near term. The central banks of the European Union, implicitly the ECB, could find themselves forced to adjust monetary policy rates upwards, which would lead not only to the restriction of credit, but also to less positive perspectives on investment and consumption, and therefore on economic growth , overall. It should be noted that the reduction in lending is also based on lower demand, difficulties in supply and the tightening of lending standards for both businesses and households. With regard to bank loans for the euro zone, it was possible to see a decrease in lending flows to the private sector, in several member states in recent months net lending flows even became negative (European Commission 2023b). However, the outlook is aimed at reducing production constraints and implicitly at investment support. Investment growth in the EU is expected to reach 1.5% in 2024 and 2.3% in 2025, although these rates are lower compared to the average of the 2015-2019 periods, amid the reduction in housing investment (European Commission, 2023b). Consequently, the monetary policy response to high inflation makes its presence felt in the economy, and fiscal support is partially removed.

Regarding the unemployment rate, we note that the prospects are still not encouraging for countries such as Spain, Greece, Sweden, Italy and Finland, while for other countries such as the Czech Republic, Malta and Poland, the unemployment rate is forecast to be below 3%. If a high unemployment rate poses problems from the perspective of budgetary support of unemployment expenses, but also dangers in the sphere of crime, in the case of a modest unemployment rate, the dangers translate into pressure on wages and the dynamics of the labour market.

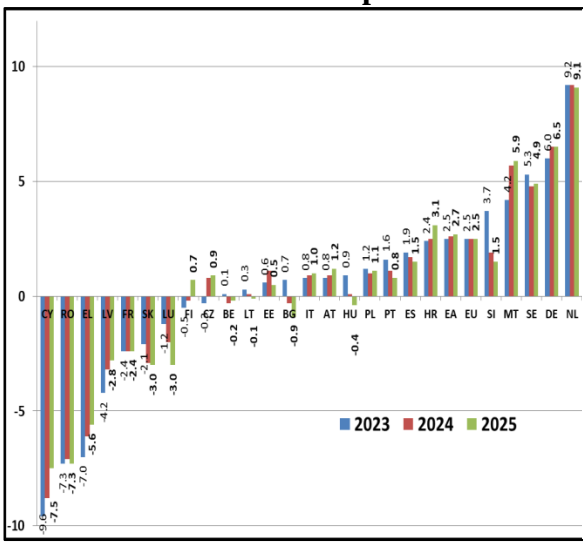
At the EU27 average level, the current account balance was pushed up on the back of the return of the goods trade balance, on the back of the improvement in the terms of trade after the decline of this indicator in 2022. The improvement of the goods balance was reflected in the increase of the current account balance, which reached a surplus of EUR 73 billion (1.7% of GDP) in the second quarter of 2023. For 2023 as a whole, the trade balance is expected to reach 1.8% of GDP and increase to 2% of GDP by 2025. In 2025, the slight increase in the balance of goods and services is expected to offset the larger marginal deficit in primary income and current transfers. The EU's current account surplus is set to improve in 2023 and stabilize over the forecast horizon. The rebound in the goods trade balance is expected to push the current account balance up to 2.5% of GDP in 2023, a level that will also be maintained in

2024 and 2025, on the back of relatively flat terms of trade and energy prices which will still remain quite high affecting the balance of goods in the EU (European Commission, 2023b).

Figure 3 – Forecast for the period 2023-2025 regarding the evolution of the unemployment rate and the current account at the level of the European Union



Forecast regarding the evolution of the unemployment rate (%) in EU27 countries



Current account evolution forecast (% of GDP) in EU27 countries

Source: European Commission 2023b; values shown are forecasts for the years 2023 and 2025

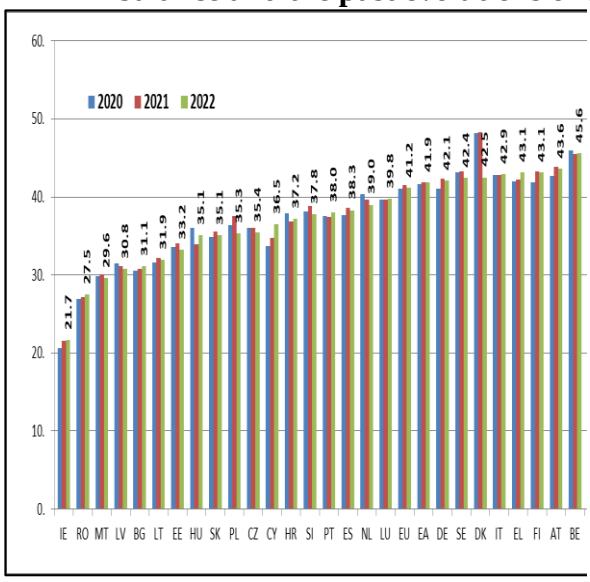
The EU government deficit is projected to fall slightly further in 2023 to 3.2% of GDP, below the level in 2022. Due to the phasing out of temporary pandemic measures, discretionary fiscal support is projected to have fallen significantly, amid a reduction in subsidies for private investment and a lower net budgetary impact of energy-related measures. This downward trend in discretionary support is expected to continue, leading to a narrowing of the budget deficit to 2.8% of GDP in 2024 and to 2.7% in 2025. However, higher interest expenditure and the economic environment less favorable will have a deficit-increasing impact on the EU's aggregate deficit in 2023. In the absence of policy changes, the forecast for 2025 indicates a slightly contractionary EU fiscal position, and fiscal policies from 2023-2025 appear to have a neutral, as they neither support the economy, nor are they expected to fuel inflationary pressures. The public debt-to-GDP ratio in the EU27 will continue to decline to 83% in 2023 due to inflation, and in 2024 and 2025 the debt ratio is expected to stabilize broadly, but above the 2019 level of around 79% (European Commission, 2023b).

For Romania, real GDP growth is forecast to decline to 2.2% in 2023 amid weak external demand, tight financial conditions, slowing retail sales, industrial production and services, but mostly due to high inflation. High inflation is generally reflected in constraints on real disposable incomes, despite the fact that the structure of the labour market has allowed for high wage pressures. Wage developments will continue to be elevated both at the end of 2023 and in 2024, against the backdrop of a labour market that increasingly reflects unfavourable demographic trends. Against the background of improving market conditions, consumption, real disposable income, but especially investments, it is expected that the evolution of real GDP will show recoveries in 2024 and respectively in 2025, to 3.1% and 3.4% respectively (Commission European, 2023b). The tightening of financing conditions and monetary policy for Romania led to a sharp slowdown in the growth of private credit, and implicitly of private investments. Improving the terms of trade and narrowing the negative impact of net exports are expected to lead to a reduction in the current account deficit to around 7.3% of GDP in 2023, 7.1% in 2024 and 7.3% in 2025 (European Commission, 2023b).

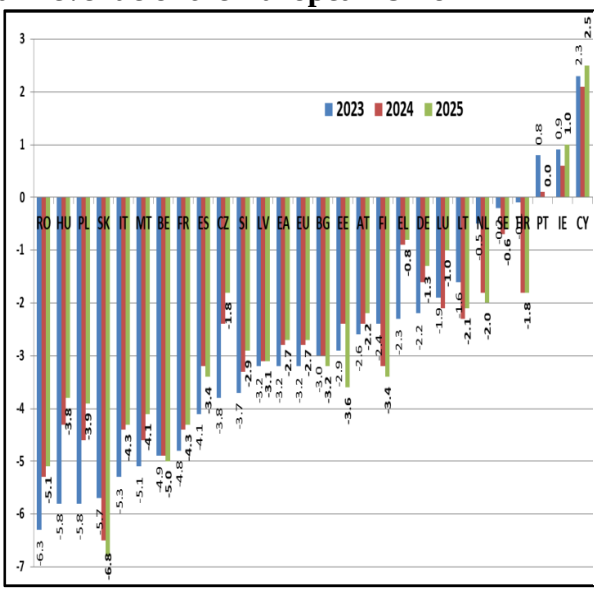
With regard to tax revenues, expressed as a percentage of GDP, in 2019, tax revenues in the euro area exceeded EU tax revenues, and in 2020 and 2021 tax revenues increased substantially both in the euro zone and in the EU. This aspect was also due to the measures to combat the effects of the COVID-19 pandemic, especially measures to protect jobs and support businesses affected by the pandemic. Against this background, although the level of income taxation and social contributions did not increase, government expenditures increased substantially, increasing the budget deficit. In 2022, an influencing factor in terms of increasing tax revenues and social contributions was due to inflation, against the background of the outbreak of the war in Ukraine.

In 2022 tax revenue (as % of GDP) (including net social contributions), representing almost 90% of the total revenues of public administrations in the EU27, accounted for 41.2% of GDP in the European Union (EU). According to Eurostat, tax revenues increased by €480 billion, against the backdrop of a less severe impact as a result of COVID-19 than in previous years (2020 and 2021). Not only the pandemic but also the increase in the prices of energy products have led to pressure to reduce taxes and fees, but the decision seems to be reversed among European countries. At the EU27 level, in 2022 current taxes on income, wealth stood at 13.4% of GDP, while net social contributions stood at 13.9% of GDP. According to Eurostat, in the period 2021-2022, among the EU27 countries, the strongest increase in absolute tax and social contribution revenue was observed by Hungary (+24%), Bulgaria (+22%) and Romania (+20%). However, in this context for Romania, we note that tax revenues place us at the bottom of the European ranking, 20.5 pp below the EU average, emphasizing more and more that not only budget expenditures must be adjusted, but above all a reform of budget revenues are necessary.

Figure 4 – Forecast for the period 2023-2025 regarding the evolution of the budget balance and the past evolutions of tax revenue of the European Union



Total receipts from taxes and social contributions (including imputed social contributions) after deduction of amounts assessed but unlikely to be collected Percentage of gross domestic product (GDP)



Forecast regarding the evolution of the budget balance (% of GDP) in EU27 countries

Source: European Commission 2023b and Eurostat; values displayed are the forecasts for the year 2023 and 2025 and for the year 2022 for the period 2020-2022

For Romania, the public deficit is estimated to reach 6.3% of GDP in 2023, before falling to 5.3% in 2024 and 5.1% in 2025, amid fiscal consolidation measures worth approximately 1, 2% of GDP, and public debt is forecast to reach 50.5% of GDP in 2025, reflecting still high

deficits and slower nominal GDP growth in the coming years. The spring 2023 forecast (4.7% of GDP) for the budget deficit has been revised down, although it was initially within the government's targeting range (4.5% of GDP), due to higher-than-expected government spending (especially in personnel and goods and services expenditure) and slower income growth amid weaker economic activity. However, the recent fiscal consolidation measures aim, on the expenditure side, in particular measures to make public administration more efficient and tougher conditions regarding the eligibility of civil servants for allowances and food and holiday vouchers, and on the revenue side, the measures include increasing corporate taxation, the gradual elimination of preferential tax regimes for sectors such as construction and agriculture, the elimination of reduced VAT rates for certain goods and services (European Commission, 2023b). These fiscal consolidation measures will be partly mitigated by the substantial increase in personnel expenditure, and the measures and implicitly the forecast do not take into account the potential costs of pension reform.

5. Conclusions

The evolution of the international macroeconomic framework highlights a series of dangers, but also opportunities for a national economy. Among the dangers, regional geopolitical tensions, the fight for resources (including energy) and price increases can be observed. Internally, the reflection of these dangers can translate into costs (large current account deficits, substantial budget deficits, high pressure on budget revenues, etc.) but also opportunities (e.g. the revitalization of some strategic industries, the reform of the budget system, the implementation of a fiscal regime more flexible, with progressive rates, etc.). Observing but especially understanding these shortcomings can transform the unfavourable developments of the past into advantages for the future.

The increasing challenges in the international sphere bring into question the resilience of a country's internal framework. If a country is frequently faced with fiscal-budgetary imbalances and does not have a suitable strategy for remedying the gaps in a relatively short time horizon, it may find itself in the situation that when the international macroeconomic context suddenly deteriorates it cannot face the challenges. This aspect underlines for Romania the importance of making good decisions now. Among these are the reduction of corruption, the reduction of tax evasion, the massive digitization of state institutions including the control ones (especially the National Fiscal Administration Agency), good communication between institutions so that the state-citizen relationship returns to normal, the transparency of the spending of public money, the restructuring of the budget apparatus, and finally, after reducing slippages and income leakages, in order to reduce social inequity, the introduction of a moderately progressive fiscal regime.

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