

Fiscal Adjustment Must Be Simple, Efficient, and to Support Economic Growth

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Summary:

Romania's economy continues to slow down, and the fiscal measures currently being discussed seem to focus mainly on a series of tax increases. These could significantly accelerate this deceleration. A fiscal package that includes a temporary increase of at least 3 percentage points in the effective VAT rate, alongside a reduction in public spending—especially investment-related—would be a viable solution. These are simple measures with immediate impact. This option maintains the fragile growth prospects for this year, bringing the budget deficit to -7.8% of GDP in 2025 (ESA basis), a realistic level. Conceptually, any increase in taxes on capital or labor is suboptimal, with a high cost-benefit ratio for the economy at this time. The fiscal package can include contingency clauses so that, depending on economic developments this year, the fiscal reform can address these aspects if necessary. Simulations for the 2025–2031 horizon show that the budget deficit can be brought below 3% of GDP by the end of the period in the proposed form.

A fiscal package that simultaneously increases taxes on consumption, capital, and labor lacks economic logic, deepening the economic downturn and unnecessarily jeopardizing the premises for recovery. Romania needs to remain fiscally competitive. In 2026, there is room for a marginal reduction in social security contributions by one percentage point and for capping them at a reasonable number of average wages (e.g., five) for other types of income. There is also room to eliminate the turnover tax, the pole tax, and additional energy taxes. These measures would generate more budget revenue, driven by the economic growth they stimulate.

It is necessary for the VAT increase to be accompanied by efficient, immediate measures to reduce the VAT gap. These measures will marginally reduce consumption, positively impacting the current account deficit. The signal sent by lowering social contributions will encourage labor, increase competitiveness, and partially offset the loss in purchasing power caused by a higher VAT rate. Overall, the budget deficit is on a downward trajectory, even under conditions of positive economic growth, slightly below the 2024 level of 0.8%.

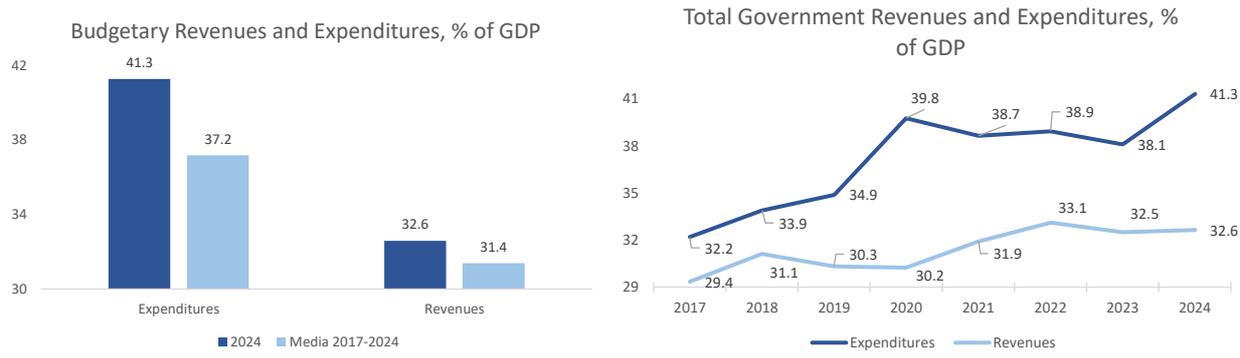
Lastly, the fundamental issue of non-compliance with the fiscal responsibility law adopted in 2010 must be addressed. The legislative framework needs to be quickly revised so that exceptions to this law are made only in exceptional cases and within a certain limit, to prevent such deviations in the future.

Context

In the past four years, Romania has experienced record-high twin deficits—i.e., both the budget deficit and the current account deficit—averaging -7.2% and -7.9% of GDP, respectively. At the same time, economic growth has continuously decelerated. In 2024, the economy advanced only due to net

taxes, while the average value added across all sectors was virtually zero. The correction that global financial markets would normally impose on such large and persistent macroeconomic imbalances in any other country has been postponed, primarily due to the existence of the National Recovery and Resilience Plan (NRRP).

The budget deficit reached its 2024 level due to a sudden, uncontrolled increase in expenditures. In 2024, these expenditures rose by 4.1 percentage points of GDP compared to the 2017–2024 average, while revenues increased by only 1.2 percentage points. Although recent years' data have been influenced by NRRP funds, the gap between expenditures and revenues has become excessively large



Sursa: Ministerul de finanțe

Economic Rationale for Fiscal Adjustment

Romania needs to maintain its competitiveness to support medium and long-term economic growth. Two action plans are necessary. One, immediate, over a three-week horizon, to reduce the budget deficit. The second, over a 12-18 month horizon, for fiscal reform, which should address significant changes in the structure of revenues and budget expenditures due to, among other things, the increase in the number of retirees and the impact of climate transition/defense measures.

The measures suggested here address the first action plan. Thus, the first step is to reduce budget expenditures by freezing some and reducing others, especially those related to investments. The efficiency of these types of expenditures is low. Introducing the payment of CASS for pensions above a certain high level is also to be considered. Increasing indirect taxes, specifically VAT, has the least negative impact on economic growth. Higher temporary inflation would significantly help reduce real expenditures in 2026. In parallel, reducing/limiting CASS on salaries and other associated incomes would lead to increased competitiveness, also supported by a potential marginal continuation of the depreciation of RON.

There is a current of opinion that emphasizes the indiscriminate increase of taxes on capital, labor, and consumption as the main action for budget recovery. This would be a suboptimal strategy, significantly affecting economic competitiveness in an unfavorable external context, with uncertain net results. Historically, Romania has not consistently managed to collect over 33% of GDP even when it had high rates on income/profit tax and/or social contributions. After two rounds of fiscal packages in 2023 and 2024, almost entirely focused on increasing taxation, their effect on revenues

is minor. The level of budget expenditures is today too high to be corrected in a short term, mainly through tax increases.

Lesson from the 2010 fiscal package

The measures were applied in the second half of 2010. The significant structural adjustment of the budget was achieved mainly through the reduction of budgetary expenditures and less through the increase of revenues, although VAT was increased by 5 percentage points. Paradoxically, calculations made with the final GDP data show that budget revenues as a percentage of GDP actually decreased in 2011 compared to 2010! By the end of 2011, the budget deficit was reduced by -2.2% of GDP, with the reduction in expenditures generating -1.9% of GDP based on estimated data and -2.4% of GDP based on final data.

Comparative differences, expressed as % of GDP, 6 months and 1 year after the implementation of the fiscal adjustment measures in 2010. The calculations for 1 year were made in 2 variants. The first, with the GDP values available at that time (i.e., the authorities' estimate from the last month of that year). The second, with the final GDP data – which were higher in nominal terms than the estimated values:

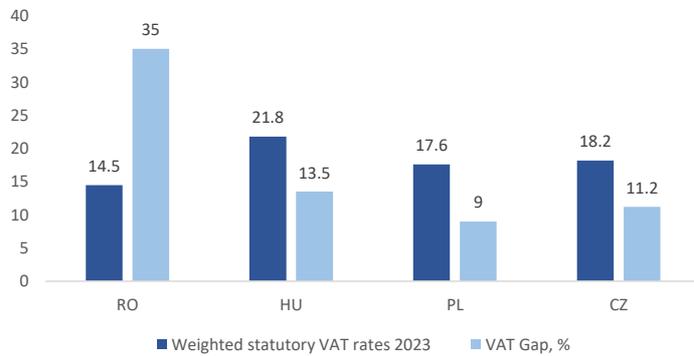
	6 months			1 year, GDP estimated value at that date			1 year, GDP definitive value		
	2011 (a)	2010 (b)	differences (a)-(b)	2011 (c)	2010 (d)	differences (c)-(d)	2011 (e)	2010 (f)	differences (e)-(f)
Revenues	15.6	15.1	0.5	33.1	32.8	0.3	31	31.2	-0.2
Expenditures	17.7	18.6	-0.9	37.5	39.4	-1.9	35	37.4	-2.4
Budget deficit	-2.1	-3.5	1.4	-4.4	-6.6	2.2	-4	-6.2	2.2

The lesson from the 2010 VAT increase is that it has an immediate, short-term impact on budget revenues. However, this effect dissipates later, possibly due to increased tax evasion. Therefore, to be effective, any VAT increase must be complemented simultaneously with measures to reduce the VAT gap. Recent discussions aimed at criminalizing VAT non-payment can be a step forward.

What potential optimal action strategies exist, besides cutting budget expenditures?

The effective VAT rate is the lowest in the region. Potentially, the effective VAT rate could increase to the lowest level of the countries in the area, i.e., by 3 percentage points. However, only in parallel with the implementation of much more effective measures to reduce the VAT gap than in the past, which requires more political will. With existing computerization, targeted efforts by ANAF, and prioritizing the state's effort to significantly improve collection, this gap will decrease. Additional measures, such as imposing a deposit (Czech Republic) as a fiscal guarantee when establishing companies with high evasion potential in certain sectors – for the payment of VAT and CAS/CASS in case of non-payment – could be a solution to reduce the VAT gap (CAS/CASS).

Effective VAT Rates and VAT Gap in the Region, %



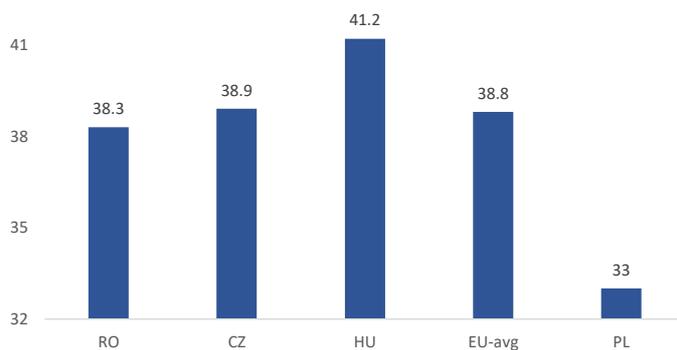
Source: Authors' estimates and the European Commission (RO - Romania, HU – Hungary, PL - Poland, CZ - Czech Republic)

Macroeconomically, a VAT increase would reduce consumption and, implicitly, the current account deficit. However, it would temporarily increase inflation for one year (for example, in 2010, the VAT increase raised annual inflation from 4.4% in June to 7.1% in July 2010, and then it decreased to 4.9% in July 2011). Although the initial inflationary effect will be subsequently mitigated by reduced demand. Possibly – depending on the evolution of other variables, the interest rate may also marginally increase (the monetary policy interest rate was still kept at 6.25% from May 2010 to October 2011) – and thus the state's financing costs.

Currently, wage growth is above the inflation rate. In the absence of additional increases in labor taxation, the impact of VAT on inflation could maintain real wage growth, and thus purchasing power, in 2026. The measure can be complemented with deductions for those with low wages.

An additional tax on labor – whether it refers to income or contributions – is not a solution now. Romania already has a high tax burden (i.e., the percentage of gross income paid as taxes and contributions), given the stage and prospects of economic development:

Tax Wedge in 2024, %

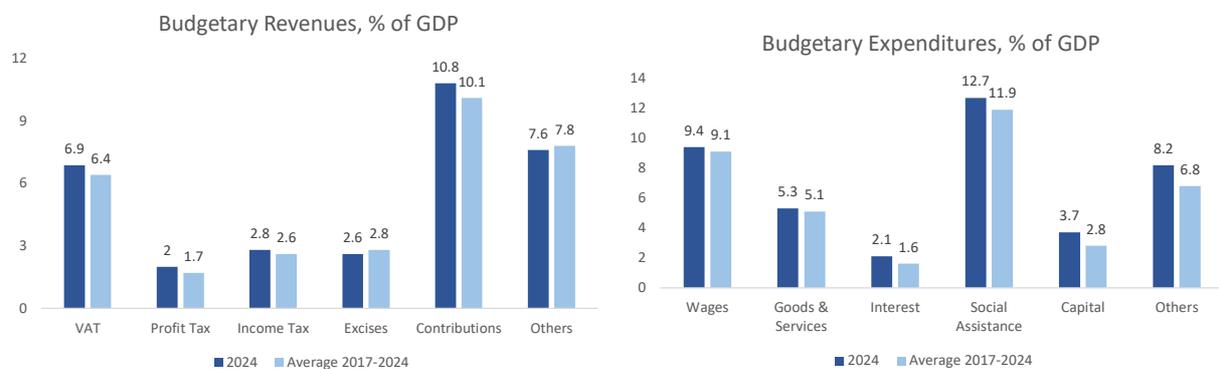


Source: Eurostat. For a single person, without children.

A potential increase in the tax burden would quickly begin to diminish Romania's competitiveness compared to the countries in the region.

To counterbalance the negative effect of the VAT increase, a solution is the simultaneous reduction of social contributions by 1 percentage point and limiting the payments of contributions on other incomes, except salaries, to 5 minimum wages. Thus, the contractionary effect is partially mitigated, also helping competitiveness.

Profit tax – modifying it is not a solution. The context is unfavorable, the growth of gross value added (GVA) in the economy in real terms was virtually zero in 2024 and has been on a downward trend since 2021. Therefore, company profits are rapidly declining, caused by rising labor costs and demand uncertainties (compared to 2021, the gross operating surplus increased in real terms by 8.2%, and employee remuneration by 20.3%). Moreover, a series of recently imposed taxes already impact capital: turnover tax, special construction tax, dividend tax.



Source: Ministry of Finance

The projections of budget revenues and expenditures for the 2025-2031 horizon are below. The working hypothesis is that the fiscal package measures will be applied starting from July this year or from the beginning of next year. The figures are expressed as a percentage of GDP.

Revenues, % of GDP, historical and projections, 2025-2031:

	2024	2017- 2024, average	2025	2026	2027	2028	2029	2030	2031
VAT gap, cumulative gains (A)			0.15	0.4	0.5	0.6	0.9	1.1	1.5
VAT increase 3pp on effective (B)			0.56	1.12	1.12	0.56	-	-	-
VAT standard, currently collected (C)			6.8	6.8	6.8	6.8	6.8	6.8	6.8
VAT, (A)+(B)+(C)	6.9	6.4	7.5	8.3	8.4	8.0	7.7	7.9	8.3
Profit tax	2	1.7	2	2	2	2	2	2	2
Income tax	2.8	2.6	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Minus turnover tax				-0.37	-0.37	-0.37	-0.37	-0.37	-0.37
Property taxes				0.2	0.2	0.3	0.3	0.5	0.5
Excise duties	2.6	2.8	2.6	2.6	2.6	2.7	2.8	2.8	3
Others	7.6	7.8	8.6	8.6	7.6	7.6	7.6	7.6	7.6
Insurance contributions – current (D)	10.8	10.1	10.7	10.7	10.7	10.7	10.7	10.7	10.7
Insurance contributions – reduction (E)				-0.6	-0.6	-0.6	-0.5	-0.5	-0.4
Insurance contributions (D)+(E)			10.7	10.1	10.1	10.1	10.2	10.2	10.3
Revenues	32.7	31.4	34.2	34.3	33.4	33.1	33.0	33.4	34.1

The impact on VAT revenues is net on total revenues, estimated with elasticity coefficients derived from Romania's experience. The VAT gap remains above the current EU average in 2031. Property taxes are increased only gradually, up to being doubled in 2030. Excise duties do not increase in the medium term – as a percentage of GDP, the introduction of a pollution tax, according to the PNRR, could lead to their increase, leaving room for maneuver. They will increase anyway from 2027 due to the gases from Neptun Deep – this impact is not included here. The reduction of insurance contributions by one percentage point is compensated by their increase on very high pensions. Over time, more complex simulations will need to be made for these due to the changing distribution of the number of employees/pensioners. Other revenues remain at a high level in 2025 and 2026 due to the impact of PNRR tranches – part of tranche 3 has just been accessed.

Expenditures, % of GDP, historical and projections, 2025-2031:

	2024	2017-2024 average	2025	2026	2027	2028	2029	2030	2031
Salaries	9.4	9.1	9.3	8.7	8.6	8.4	8.3	8.2	8.1
Goods and services	5.3	5.1	5.1	5	5	5	5	5	5
Interests	2.1	1.6	2.8	3	3.2	3.3	3.2	2.7	2.3
Social assistance	12.7	11.9	13.5	13.1	12.6	11.8	11.7	11.7	11.6
Capital	3.7	2.8	3.2	3	2.8	2.8	2.8	2.9	3
Others	8.2	6.8	8.1	8	7.4	7.3	7.2	7.1	7.1
Expenditures	41.3	37.2	42.0	40.8	39.6	38.6	38.2	37.4	37

Adjustments are needed on the expenditure side for salaries, goods and services, and capital expenditures. These adjustments are generated by the impact of pension increases, with the full effect materializing in 2025. Social assistance expenditures also decrease – as a percentage of GDP – towards the average of recent years. Even so, total budget expenditures remain, as a percentage of GDP, marginally above last year's levels, and by 2031 they will reach the average of the last eight years.

The budget deficit can reach -3% of GDP in 2031, as negotiated with the European Commission (EC), with an effort to control expenditures and without additional increases in labor or capital taxes.

Budget deficit projections, % of GDP:

	2025	2026	2027	2028	2029	2030	2031
	-7.8	-6.6	-6.2	-5.5	-5.2	-4.0	-2.9

Communication with the European Commission and financial institutions/rating agencies will be a central element in the successful implementation of this plan.

Appendix - General Remarks on Fiscal Measures

An analysis by the IMF (2012) shows that changes in the structure of the tax system influence the degree of economic distortion. For example, income, profit (or turnover) taxes, and social contributions tend to have a negative effect on labor supply and private investments. In contrast, consumption taxes and property taxes are less distortive because they have a lesser impact on production and capital allocation decisions. On the expenditure side, public spending directed towards infrastructure and human capital investments is generally considered the most productive, having a positive impact on productivity and economic competitiveness. In contrast, social spending and subsidies, although necessary for social protection, must be carefully managed (i.e., through targeted measures) to avoid discouraging labor market participation and entrepreneurial initiatives.

According to economic principles and IMF recommendations, the least distortive taxes that can be increased are:

- **Consumption taxes, especially VAT and excises** – VAT is considered less distortive because it affects consumption proportionally, without discouraging work or investments.
- **Property and real estate taxes** – These are among the least distortive because they do not affect short-term production and consumption decisions. They can be adjusted based on the market value of properties and provide a stable source of revenue for the government without discouraging productive investments.
- **Natural resource and pollution taxes (environmental taxes)** – These have a dual role: generating budget revenues and contributing to reducing the negative environmental impact. They are less distortive and can also correct negative externalities, encouraging efficient resource use.

In contrast, increasing income tax, profit tax, and social contributions can reduce incentives for work and investments and affect the competitiveness of firms. Given the high labor taxation in Romania, it is recommended to even reduce social contributions and lower labor costs, which can encourage employment and increase disposable income at the population level.

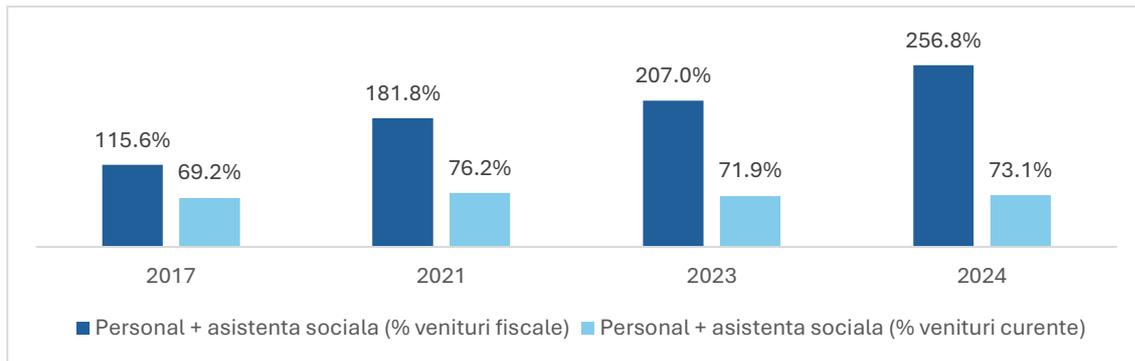
Reducing capital taxation (i.e., eliminating the special construction tax, turnover tax, energy tax) will be redistributed to the private sector for investments, which, on average, have a higher multiplier than public investments. In the context of a negative fiscal impulse, growth sources can be potentiated by European funds and private investments (domestic, foreign) that also need additional measures to create a favorable framework.

Evaluation of Fiscal Risks in Romania (2017-2024)

In 2017, fiscal revenues represented a relatively stable base for financing current expenditures. However, by 2024, the situation had become alarming. The reliance on borrowing to cover the budget deficit has increased, amplifying refinancing risks and vulnerability to interest rate fluctuations, as well as affecting the credibility of the Romanian government from the perspective of rating agencies.

Escalation of Social Assistance and Government Personnel Expenditures

Social assistance and personnel expenditures have seen accelerated growth, reaching 256.8% of fiscal revenues in 2024, compared to 115.6% in 2017. This dynamic reflects an unsustainable expansion of rigid budgetary obligations, which limits the government's fiscal maneuverability. In a context of volatile economic growth, this structure of public expenditures increases the risk of abrupt fiscal adjustments, either through tax increases or austerity measures that can affect economic and social stability, a situation in which Romania currently finds itself.



Sursa: Ministry of Finance Budget Executions 2017-2024

Public Expenditure Reform: Efficiency and Prioritization

A primary direction of action is the rationalization of public expenditures, ensuring they are allocated efficiently and contribute to long-term economic objectives. It is necessary to optimize current expenditures through a review of public sector salaries, subsidies, and government transfers. Reducing these costs, without compromising the provision of essential services, is a key element of fiscal consolidation.

In parallel, attention must be given to prioritizing public investments. They should be directed towards infrastructure and projects with multiplier effects, which can stimulate economic development and attract private capital.

Measures are needed to prevent excessive debt accumulation and avoid arrears. Eliminating unproductive bureaucratic expenses and overpriced contracts can improve fiscal efficiency without affecting economic growth.