

# THE IMPACT OF THE VAT REDUCTION ON FOOD IN ROMANIA

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## Abstract

*Fiscal policy is a means through which government representatives adjust a country's expenditure and tax rates. The first purpose of a fiscal policy is to review and influence a country's economy, while the ultimate purpose of a fiscal policy is to ensure fiscal efficiency as well as a greater yield on tax revenue collection for the state budget. There are several types of fiscal policies, depending on the state in which a country's economy is currently in: a county can be either in recession, it can have a period of economical stability or its economy may very well be expanding. In light of this, state authorities can adopt various measures to stimulate the economy in times of recession, or to temper excessive demand in times of an economic boom, the goal being that of obtaining economic stability in the long-haul. Nowadays, the measures proposed for fiscal loosening in Romania represent a controversial topic, the main concern being the ability to offset the negative impact the new tax code will have on the state budget. Amongst these recently adopted fiscal policies is to lower the value added tax (acronym V.A.T.) on foodstuffs, specifically from a 24% rate to a 9% rate. This paper will provide a detailed analysis of the effect that this reduction will have on the budgetary balance for 2015. The analysis is based on information from various sources such as the European Union Statistical Database, respectively ec.europa.eu/Eurostat, The Ministry of Public Finance of Romania, The National Institute of Statistics and the Fiscal Council of Romania.*

## Keywords

*value added tax, budget, food industry, fiscal policy, sustainability, gross domestic product*

## Introduction

On February 18th 2015 The Romanian Government proposed „The Fiscal Reform – Measures and Outcome”. The presentation highlighted a series of measures which were to be implemented by amending the current Tax Code and Procedural Tax Code. The above mentioned measures aimed, among other things, to lower the VAT rate for all goods as well as services from the existing 24% rate to 20%, to lower the VAT rate for the following foodstuff: meat, fish, vegetables and fruit from the existing 24% rate to 9%, starting with January 1st 2016, to lower the flat tax for income/profit, to lower the excise taxes, to modify the taxes applied for social security, or to apply taxes on buildings depending on their destination.

By applied the above mentioned fiscal measures, the Government aims to improve the economic stability in Romania, to improve the competitiveness of the Romanian economy in view of entering the euro zone in 2019, to strenghten the autonomy of local authorities, to eliminate discrimination arising from the current tax system, to encourage new investments, both private and foreign, to reduce tax evasion as well as the underground economy.

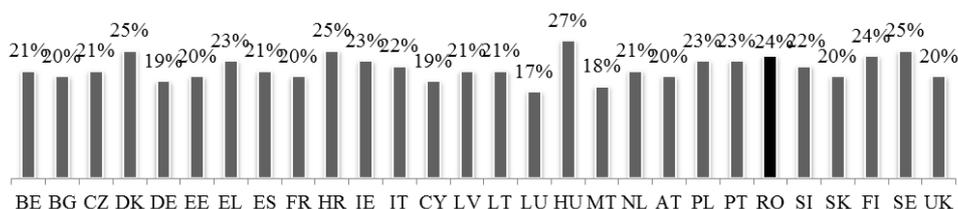
According to the analysis presented on the Ministry of Public Finance (MFP)'s website, the arguments which sustained the proposal for the reduction of the value added tax were the following:

- a) The standard value added tax in Romania is the fifth highest value in the European Union, in terms of percentages (24%). Higher values are found in Hungary, Denmark, Croatia and Sweden, as shown in the following graphic:
- b) The sum of money collected by use of the value added tax is less than the nominal growth of the gross value added (also known as GVA – it represent the unit used to measure the value of either goods or services produced or acquired in a certain area, industry or sector of an economy);
- c) The effective VAT rate is far below the average. By computing an average VAT rate per consumption shopping cart (which would contain various, most commonly bought products per household, different VAT rates for different products, and so forth) you will notice that when the standard VAT rate was 19%, the average VAT rate for the average shopping cart was 17,5%. In 2010, when the standard VAT rate was raised to 24%, the average VAT rate reached 22%, according to Ionuț Dumitru, head of the Fiscal Council of Romania;
- d) Personal consumption has increased by an average of 1% each year from 2011 to 2012, however income has increased by an average of 2%;
- e) With the increase of the standard VAT rate, tax fraud levels have skyrocketed from 3,4% of the gross domestic product (G.D.P.) in 2010 to 6,3% of the GDP in 2012, after which it decreased slightly by 0,6%, specifically to 5,7% of the GDP in 2013;

**Table 1 Fiscal relaxation plan for Romania 2016-2020**

Tax rate / year	2015	2020
VAT	24%	18%
Flat tax rate	16%	14%
Dividend tax	16%	0%
Special construction tax	1%	0%
State social security contributions	Employer– 15,8% Employee – 10,5%	Employer – 13,5% Employee – 7,5%
Income tax on small enterprises	3%	1% - 3%
Local taxes	0,1%	0,08 – 0,2%

Source: Draft “Fiscal reform – Measures and outcome”, [www.mfinante.ro](http://www.mfinante.ro)



Source: Draft “Fiscal reform – Measures and outcome”, [www.mfinante.ro](http://www.mfinante.ro)

**Fig. 1 Standard VAT rate in EU member states**

Details regarding the VAT reduction from the standard 24% to a lower 9% rate were announced by Government representatives on June the 1st 2015, specifically the fact that the lower rates will not just apply to basic food divisions, but for all food products, soft beverages and public food services, without distinction. The above mentioned lower VAT rate will be applied mainly for milk and dairy products, eggs, live (domestic) animals and poultry intended for food consumption or the production of processed food, meat and organs, fish,

crustaceans, molluscs, natural honey and other edible products of animal origin, fruits, vegetables, plants, edible roots, live plants used as food or raw material for food, coffee, tea, spices, cereal (with the exception of those used for farming) and non-alcoholic beverages. This category also includes milling and bakery products, which have been benefiting from a 9% VAT rate since september 2013.

### **1. Compensating the budgetary deficit by streamlining the collection of taxes**

The total revenue and budgetary expenditure, by its size and core, has the ability to reflect and influence the financial policy applied by public authorities. Thus, the measure to lower the VAT rate for food and food products was applied in advance, starting June 2015, due to the existing budgetary surplus recorded in the beginning of the year 2015. This surplus is considered more than enough in covering the possible budgetary loss that might appear as a consequence of adopting the lower VAT rate.

According to information published by the Ministry of Public Finance on their website [www.mfinante.ro](http://www.mfinante.ro), the budget excess from Q1 of 2015 is roughly around 4.9 billion lei, which adds up to about 0.7% of the country's GDP. It is the highest surplus registered in Q1 in the last ten years, according to an article published in the newspaper Ziarul Financiar, on their website [www.zf.ro](http://www.zf.ro).

Following a thorough examination of the consolidated general budget of Romania for the period of January up to March of the year 2015, the subsequent aspects can be highlighted in comparison with the first three months of 2014):

- Revenues are increased by 12%;
- Capital expenditure (otherwise known as investments) dropped by 25%;
- Revenues from VAT collection increased by 20,8% (approximately 2,5 billion lei extra);
- Revenues from excise tax increased by 11,4% (a plus of almost 600 mil. lei);
- Revenues from income tax and payroll tax increased by 14,6% (822.4 mil.lei);
- Other Non-tax revenues increased by 21,2%.

According to letter no.71450/08.06.2015, drafted by Secretary of State from the Ministry of Finance, Mr. Attila György, the negative budgetary impact of reducing the VAT on food products for the estimated first six months of 2015 is already at about 2,8 billion lei. Contrary to the previously mentioned forecast, this budgetary loss is already covered by the budget surplus.

On the same note, it is worth mentioning that the National Agency for Fiscal Administration (ro. ANAF) underline the following structural measures:

- Reducing the fiscal gap in VAT collection;
- Extending at national levels the project for the prevention of undeclared or subdeclared labour;
- Changes in the new insolvency law, that created a downward trend in the number of new insolvency cases filed in court;
- The positive development of voluntary tax compliance.

The investigation and control actions initiated by the General Directorate for Tax Fraud, or Anti Fiscal Fraud Directorate (ro. DGAF), institution which operates under the umbrella of the National Agency for Fiscal Administration, are also of significant importance when discussing the increase of tax revenue yield.

The Antifraud Directorate was established on June the 26th 2011, by the Government Emergency Ordinance no.74/2013, approved by the Law no.144/2014. Its main objective is to fight against tax evasion and tax and customs fraud. The activity of fraud investigation and of dismantling of illegal and/or fictive transactional chains established with the intent to

withdraw from tax compliance, is of invaluable importance, both financially and socially. The institution strengthens the confidence in the safety and integrity of the fiscal system. Budgetary revenues increased in 2015, in contrast to the same period from 2014, mainly due to the essential investigations initiated by the antifraud inspectors of the Anti Fiscal Fraud General Directorate, within ANAF.

In order to prevent tax evasion, in the first nine months of 2015, anti-fiscal-fraud inspectors have checked 26.214 legal entities, selected following a fiscal risk analysis. As a result of the investigations, the inspectors of the General Directorate for Anti Fiscal Fraud have established over 3 billion lei in amounts that were due to be paid to the consolidated budget. Tax evasion within the food industry is one of the most common in Romania. The gross value added of the hidden economy (according to estimates made by the National Institute of Statistics – INS – for the year 2013), VAT tax fraud accounts for approximately 28%, while that of households (especially from undeclared agriculture) represents approximately 17%. By reducing the VAT for food products, these two tax evasion sectors are mostly kept under control.

According to secretary of state, Mr. Attila György, the great advantage of lowering the levels of VAT applied on food and other food products, is that there is no longer a distinction made regarding the type of product/service. In previous measures, separate VAT rates were applied depending of product/service type or category. A well known example was the different VAT rates applied for bread and bakery products. Now, the lower VAT rate is applied to the whole economic chain, ranging from production to distribution. Therefore, it does not matter whether a farmer sells cowmeat to a local butcher or the butcher sells the processed product (example: salami) to a hypermarket, because both sales are charged at the same 9% VAT rate. The effect of this will be a more fluid manufacturing circuit of food products. As a bonus, it is estimated that tax evasion in the food industry will drop substantially over the course of the following months, because the risks will be too high compared to the small benefits of fraud. Despite the many benefits listed above, The Fiscal Council of Romania noted the following conclusion regarding the new Tax Code in their presentation „The Opinion of The Fiscal Council regarding the review of the Romanian Tax Code”, which can be accessed from <http://www.consiliulfiscal.ro/Opinie-Cod-Fiscal-final.pdf>: „Given the exceptionally high probability that the enforcement of the draft of the new Tax Code could lead to major transgressions regarding the medium-term budgetary targets, the Fiscal Council of Romania does not approve of the above mentioned legislative proposal”.

## **2. Higher levels of personal consumption**

One of the supporters of the VAT reduction, Mr. Daniel Constantin, the Romanian Minister of Agriculture, highlighted the fact that a lower value added tax could prompt increased levels of personal consumption per household, and thus, yield economic growth in the long-run. In light of this, Mr. Eugen Teodorovici, the Romanian Minister of Finance at the present moment, made note of the increase in consumer spending which will be mirrored in increased budget revenues by approximately 0,6% of GDP in the year 2015 alone.

Financial rating agency Standard&Poor's (S&P) estimates that Romania's economy will increase on average by about 3% per year between 2015-2018, growth supported by domestic consumption.

Romania's Fiscal Council estimates that the overall fiscal deficit will reach the negative value of 3,7% of the GDP until 2019, which would come into conflict with the principles and rules stipulated by the Fiscal and Budgetary Responsibility Law (ro. LRFB) no.69/2010 and Fiscal Governance Treaties at EU level, triggering the excessive deficit EU procedure (the deficit limit being at a 3% level of the GDP).

Contrary to Romania's Fiscal Council's opinion, S&P agency does not take into consideration all fiscal relaxation measures and, implicitly their negative impact on budgetary revenues, since these measures are still subject to parliamentary approval.

In 2015 a research study, titled „INSCOP.05.2015 – The VAT diminution and fiscal outcome due to behavioral patterns”, was carried out by a private structure of social research and marketing named „INSCOP Research”. The study, which can be found at the following link: <http://www.inscop.ro/wp-content/uploads/2015/05/INSCOP-05.2015-Reducerea-TVA-si-comportament-fiscal.pdf>, concludes that approximately 83,8% of Romanians agree with the statement „a lower VAT on food products and non-alcoholic beverages is a good measure for me, personally”, while just about 5,4% of respondents have the opposite view and about 10,8% refused to answer.

Despite the fact that the percentage is a little lower, 78,2% of respondents agreed with the following statement: „The VAT reduction for food products and non-alcoholic beverages is a good measure of the economy in general”, while 5,9% disagreed with this statement and 15,9% did not know or did not respond.

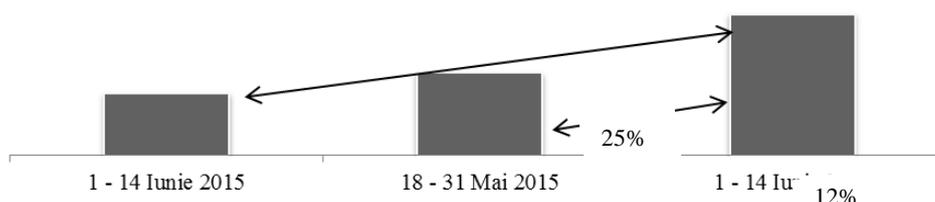
Given the large share that the expenditures with food products take up in a romanian family's budget, the results of the research study were somewhat predictable. Online publishing magazine ESM Magazine (European Supermarket Magazine) completes the analysis of the results with the following calculations: „Romanian spend about a third (37,5% according to Mr. Secretary of State Attila György) of their income on food products, compared to the EU average of 18%. For people with low incomes, the share of food expenditure exceeds 60% of total consumer spending”.

Therefore, the VAT reduction for food products and non-alcoholic beverages will result in the increase of the purchasing power of the population, which will be reflected in the increased consumption and structural improvement of the economy.

The authors Engel și Blackwell (in the book “Consumer behavior”, Dryden Press), and Kotler (in the book “Principles of Marketing”, Prentice Hall) have noted the following aspect: Attributes such as quality and price weigh most in the decision of a consumer to buy a product. Therefore, we can conclude that prices reflect an important psychological factor influencing consumer behavior. The impulse by the VAT reduction will boost offers, promotions, and will increase competition because it will reduce the phenomenon of alignment of prices will motivate Romanians to acquire more.

A company conducting market research, Nielsen Romania, the local branch of Nielsen NV (a global performance management business, that provides comprehensive understanding of consumers' views and buying patterns) found that the outcomes of reducing the VAT from 24% to 9% in the food sector, led to increased consumption by about 17% in the first two weeks of June 2015 compared to the same time frame in 2014.

According to the same research study, prices dropped on average by 11 percent in the food categories monitored by Nielsen. For instance, the average price for coffee dropped by approximately 15%, which led to an increase in sales by about 25%, compared to the same period last year (1-14 June 2014). Other dynamic categories include meat, dairy, non alcoholic beverages and snacks.



Source: Research Study by Nielsen România, 01.07.2015. “*Significant increase in sales due to the reduction of prices by 11%*”, <http://www.nielsen.com/ro/ro/press-room/2015/nielsen-impactul-scaderii-TVA.html>

### **Fig. 2 Sales of coffee between 1-14 of June 2014 and 2015**

The lower VAT rates did not influence prices as significantly as initially expected, meaning the the prices did not decrease as much. But they have dropped adequately so as to yield reasonably higher sales volumes. By use of the press and media coverage of the VAT cut, Romanians experienced an impulse to buy more, especially starting with the 1st of June when the fiscal measure was first applied by the Government.

### **3. Conclusions**

The subsequent revenues which will be collected for the consolidated general budget will continue to rise due to the economical multiplication effects of the lowered VAT rate on food products and non-alcoholic beverages, as well as due to the other fiscal relaxation measures which will be applied in the near future. These measures will translate into increased investments as well as higher purchasing power and higher employment.

The effect of the reduction of the VAT rate, be it economical or social, can certainly lead to fiscal benefits, provided that the price reduction is maintained long-term. Of course, there is anxiety, regarding the fact that sooner or later, one or more players in the food chain will try to decrease their costs and increase their profit margins, hence prices could reach, unduly, pre-June levels. The VAT reduction will also have a positive effect on diminishing the „black market” (a phenomenon present in almost all food sectors). A reduced VAT rate makes tax evasion less attractive, compared to the risks involved. Equal playing field and easier market access are also to be expected.

And finally, a better organization of the collection of tax revenue process (through the work carried out by the National Agency for Fiscal Administration, and implicitly the Anti Fiscal Fraud Directorate) will cover the shortfall caused by the reduction of VAT rate for food products, non alcoholic beverages and public food services, from 24% to 9%, the measure, thus, being a sustainable one, which encourages consumption and stimulates the economy.

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