

Chapter 3. The Role of Fiscal Policy in Poverty and Equity in Romania¹

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3.1. Introduction

Despite a decreasing trend over the past decade, Romania still finds itself among the countries with the highest absolute and relative poverty rates within the European Union. From 2016 to 2021, robust economic growth in Romania translated into a substantial decline in absolute poverty (\$6.85/day PPP) of 14.7 percentage points, reaching 7.4 percent.² Similar trends are observed in the anchored at-risk-of-poverty rate (AROP). This rapid decline was mainly due to increased employment among the less educated and those with higher pension incomes.³ Relative poverty, measured with the at-risk-of-poverty rate (AROP), has also shown a downward trend. However, relative poverty is still one of the highest in the EU, reaching 21.2 percent in 2021 (income year), with approximately 4 million individuals residing in households with disposable incomes falling below the at-risk poverty line.⁴

Poverty disproportionately affects some demographic segments, including the rural population, large families, youth, elderly individuals living alone, persons with disabilities, and those not actively engaged in the labor force, as well as some specific regions. Of particular concern is the persistently high child poverty rates, with one-third of children residing in households facing poverty. In-work at-risk-of-poverty remains prevalent, with 15 percent of the employed population earning incomes below the risk-of-poverty threshold in 2022⁵ income year despite constant wage increases driven by productivity growth and adjustments to the statutory minimum wage. Additionally, when considering multidimensional poverty, more than one-third of the population in 2022 was at risk of poverty or social exclusion, the largest in the EU.⁶

While there has been a reduction in income inequality in recent years, it remains persistently high, with a Gini index of equivalized income reaching 32 points in 2021, among the highest in the EU. Economic gains have not been evenly distributed, evidenced by a low shared prosperity premium⁷ (1.02 percent) and limited productive opportunities for the bottom 40 percent. The income quintile share ratio indicates that the wealthiest 20 percent of households possess disposable incomes six times greater than the poorest 20 percent. Urban-rural disparities are also significant, and gender disparities across several dimensions are extensive (Robayo et al., 2023).

In this context, implementing equitable fiscal policies and ensuring their effectiveness in accelerating poverty reduction and reducing inequalities are critical

¹ This chapter is founded upon a policy research background paper (Robayo-Abril, Tribin, Militaru, and Grown, forthcoming) serving as its cornerstone.

² Source: [World Bank, Romania Macro Poverty Outlook \(MPO\) 2024](#)

³ Source: [World Bank, Romania Poverty and Equity Brief 2024](#)

⁴ Source: [Eurostat 2024](#)

⁵ Source: [Eurostat, 2024](#)

⁶ Source: [Eurostat, 2024](#)

⁷ The shared prosperity premium is the difference between the growth of the poorest 40 percent and the growth rate for the entire population.

priorities for Romania. As mentioned in Chapter 2, tax collection in Romania is relatively low, resulting in one of the EU's lowest tax-to-GDP ratios, primarily due to numerous tax exemptions, policy changes, and a low administrative capacity to collect revenue. Consequently, public spending is also low compared to EU standards. The commitments to fiscal consolidation and revenue mobilization efforts looking forward could limit the benefits to the less well-off, depending on how equitable the fiscal system is before and after these reforms. From an equity perspective, a significant challenge involves managing fiscal pressures and consolidation, particularly in the short run, while addressing the persistently high poverty and inequality rates.

The body of empirical evidence on the role of fiscal policy in Romania has recently expanded; still, most studies analyze a subset of fiscal policy instruments but do not provide a comprehensive view of the fiscal system. Avram & Militaru (2016) analyze child contingent policies in Romania and the Czech Republic for their anti-poverty impact, considering population characteristics and the associated tax-benefit systems. Popescu et al. (2019) explore the impact of shifting Romania's flat-rate tax system to progressive taxation scenarios. Military et al. (2023) assess the effect of the Romanian tax-benefit system on household income redistribution using the tax-benefit microsimulation model EUROMOD. In-kind transfers (health and education) and indirect taxes are not simulated in the standard version of EUROMOD, though extensions can be used for that purpose (De Agostini et al., 2017). Therefore, the EUROMOD analysis does not take into account changes in the provision of social benefits in kind (publicly-funded health care, elderly care, education, childcare, etc.) or the role of the redistributive role of the value-added tax (VAT).

The CEQ Assessment is a comprehensive and rigorous tax and benefit incidence analysis that examines the distributional effects of individual programs and policy measures and the net effect of each country's mix of policies and programs. The assessment is based on the Commitment to Equity (CEQ) methodology (Lustig, 2018). This analysis aims to estimate the impact of taxation and social spending on inequality and poverty and how each fiscal intervention contributed to the observed changes in poverty and inequality. Unlike EUROMOD, in-kind transfers are simulated, and indirect taxes are also modeled. The World Bank conducted the first CEQ in 2017-2018, using the 2016 Household Budget Survey (HBS) and administrative data (Inchauste & Militaru, 2018). An updated CEQ was produced in 2022 to support the distributional analysis of policy reforms, using fiscal parameters from 2019 and the 2018 Household Budget Survey HBS (Badiani and Militaru, 2022).

The 2022 fiscal incidence analysis indicated that the fiscal system reduces inequality but increases poverty when using the official poverty rate. The study showed that VAT and excises had an unequalizing and poverty-increasing effects as they placed a significant burden on low-income households, which was not compensated for by pro-poor spending. According to this work, the relative poverty-increasing effect was higher in urban than rural areas. Indirect taxes significantly affected poverty, especially among households with two or more children, whereas single-parent households experienced a greater combined impact from direct taxes, social contributions, and transfers. This study also concluded that most tax and benefit system components were progressive, except for the VAT and tobacco and alcohol excises. Conversely, contributory benefits, direct cash, near-cash, and in-kind transfers were progressive, effectively diminishing poverty and inequality.

Given the significant fiscal reforms implemented since 2019, an updated CEQ was needed. Since 2019, numerous fiscal reforms and changes have affected household incomes

across the income distribution. These changes included exemptions from health insurance contributions and income tax for construction workers, extended in 2022 to agricultural and food industry workers. Moreover, reduced VAT rates, lowered from 19 percent to 5 percent since 2019, applied to transportation services, solid fuels like firewood, and thermal energy. Additionally, hotels, accommodation services, restaurants, and catering services (excluding alcoholic beverages) enjoyed the same reduced rate of 5 percent since 2019, down from a previous 9 percent. Excise taxes on tobacco, alcohol, fuel, and energy increased. The pension point underwent an almost 60 percent between 2019 and 2022, impacting all public pensions. A 5 percent indexation of the social reference indicator affected benefits linked to it, such as thresholds and amounts for support allowances for families with children, guaranteed minimum income, and unemployment benefits. The state allowance for children, the most generous noncontributory social benefit, saw over a 50 percent increase from 2019 to 2022. The child-raising incentive, targeting parents receiving child-raising allowance and leave, experienced a 131 percent increase for children under six months in 2021. Notably, within means-tested benefits, the minimum pension for low-income pensioners nearly doubled, while the educational allowance rose by 40 percent. Consequently, an updated fiscal incidence analysis was critical to comprehend the current fiscal system's potential poverty and distributional impacts of the current fiscal system.

This chapter updates the previous fiscal incidence analysis (CEQ) to provide a more recent picture of the poverty and distributional impacts of the fiscal system; it also identifies vulnerable households with different demographic profiles and assesses whether fiscal policy plays a role in reducing these vulnerabilities, or if there is scope for improvements. Choosing the same methodology enables comparisons with earlier work for Romania and benchmarking with other countries. The analysis involves (i) updating the taxes and benefits system parameters and ii) updating the CEQ using the latest available post-COVID-19 data (2021 HBS, macro, fiscal, and administrative data)⁸; iii) incorporating an extension to the fiscal incidence analysis to understand the impacts of fiscal policy on vulnerable households; and iv) simulating potential distributional impacts of fiscal reforms implemented after 2021 (not captured in the data)⁹ and potential fiscal reforms going forward, both overall and in vulnerable households. This new evidence can form a basis for simulating the potential impacts of fiscal reforms and is expected to inform the country's dialogue on inclusion.

This chapter answers the following questions:

- How much income redistribution and poverty reduction are accomplished through the fiscal system (taxes, social spending, and subsidies), and how do the results differ from the previous CEQ analysis? How equalizing and pro-poor are specific taxes and government spending?
- Before fiscal policy interventions, which household types experience the highest poverty levels? What is the role of gender, labor market status, and demographic composition (dependent children and elderly) in explaining these vulnerabilities? What is the role of fiscal policy in reducing poverty among these groups and narrowing gender gaps? Which elements of the fiscal system play a crucial role in explaining these results?

⁸ Administrative data on beneficiaries and taxpayers were sourced from EUROMOD Romania country report 2018–2021, ESSPROS, and the Romanian Ministry of Labour and Social Solidarity. Information on the tax system was obtained from the Ministry of Finance (MOF) of Romania and EUROMOD.

⁹ No more recent household-level data was available at the time of this publication. Therefore, we update the analysis with the 2021 fiscal parameters and 2021 household-level and administrative data. The key fiscal reforms implemented after 2021 are simulated in section 3.3.

- What fiscal packages can help potentially reduce poverty among the most vulnerable groups and narrow the gender gaps?

3.2. The Poverty and Distributional Impact of Romanian Fiscal Policy

Methodology

The Commitment to Equity (CEQ) Methodology is a comprehensive fiscal incidence analysis developed by the CEQ Institute.¹⁰ The CEQ methodology aims to determine how fiscal policy reduces poverty and inequality and simulates the impacts of hypothetical fiscal reforms on welfare. It assesses the incidence of many fiscal interventions, making it comparable across a wide range of countries globally.

The primary data used in the Romania CEQ analysis is the 2021 Household Budget Survey (HBS), complemented by detailed administrative and fiscal data. This includes data on the number of beneficiaries per program and taxpayers and comprehensive information on the social protection and tax systems, including detailed information on disaggregated taxes and government spending on social transfers by program, health expenditures by type of care, and education spending by levels. Descriptions of the tax policy (such as statutory rates, tax bases, and exemptions) and details about the pension system, direct transfers, indirect subsidies, public education, health systems, and other forms of social spending. Fiscal-administrative data is used to verify the consistency of household survey records with administrative records. This data is sourced from various reports and institutions, including the EUROMOD Romania country reports from 2020–2023, the European System of Integrated Social Protection Statistics (ESSPROS), the Romanian Ministry of Labour and Social Solidarity, and the Romanian Ministry of Finance.

The Romanian model includes a wide range of fiscal interventions from the expenditure and income side. On the expenditure side, the model encompasses various components, including social transfers such as conditional and unconditional transfers, such as child and family benefits, educational allowances, and social protection transfers such as guarantee minimum income, disability, survivors, non-contributory pensions, unemployment benefits, and heating aid. It also includes in-kind transfers, covering services like health and education. Indirect subsidies are not included, as there were no implicit subsidies for gas and electricity in 2021. Contributory pensions are accounted for in the model. On the income side, the model encompasses various sources, including tax revenue, such as direct taxes (Personal Income Tax (PIT))¹¹ and other direct taxes) and indirect taxes on consumption, such as Value-Added Tax (VAT)¹² and excises on alcoholic beverages, tobacco, fuel, and energy. Non-tax revenue sources

¹⁰More info can be found at www.commitmenttoequity.org

¹¹ We assume informality on personal income taxes and social security contributions. This is estimated based on findings from a tax compliance study that compares income distributions derived from household surveys with those obtained from tax administration data (Robayo et al., forthcoming) and a probit model is utilized to model informality within the Household Budget Survey (HBS) dataset to account for informal employment, employing matching variables for this purpose. Variation of tax compliance across the HBS income distribution ranges from 94 to 99 percent.

¹² VAT is applied based on the statutory tax rate without accounting for potential evasion, as location of purchase, a usual proxy of informality, is not observed in the household survey. However, survey data closely approximates the ratio of total tax collections to household private consumption, aligning with effective rates seen in national accounts. Indirect effects of VAT exemptions are not considered.

include social contributions, which cover contributions to social insurance and health insurance (fully paid by the employee), and work insurance (paid by the employer).

The model encompasses around 71 percent of overall revenue and 51 percent of expenditure recorded in the official statistics and significantly larger shares of tax revenue and social spending. We assess the performance of the model and its assumptions by comparing the aggregate amount of each tax and transfer captured in the analysis with the same category from the official statistics. On the revenue side, it captures 71 percent of total government revenue, equivalent to 22.7 percent of GDP. Our analysis focused on the significant tax items, namely personal income taxes, VAT, excise taxes, and social insurance contributions.¹³ These items cover about 86 percent of all tax revenue in 2021, with notable accuracy in critical areas such as social insurance contributions and personal income tax, but less so for excises due to incomplete data. Regarding expenditure, the model captures 51 percent of overall expenditures and 96 percent of social expenditure alone. It performs relatively better in capturing family and child benefits, pensions, and guaranteed minimum income than education and health benefits.

Several assumptions underpin the CEQ methodology. The economic burden of personal income taxes is assumed to fall on workers, while employees bear social security contributions, and consumption taxes fall on consumers. These assumptions are based on the premise that labor supply and consumer demand are perfectly inelastic, which, while strong, are considered reasonable approximations in the literature. Regarding tax evasion, the methodology compares income distributions from surveys and tax administration data to model informality using a probit model in the Household Budget Survey (HBS). For indirect taxes, the statutory VAT rate is applied without considering evasion, although survey data provides a good approximation of the effective rate observed in national accounts.

The methodology uses the "cost to the government" approach for in-kind transfers such as public education and health spending. Education benefits are imputed based on government spending per student, and health benefits are imputed using per capita government spending by type of service, categorized using the COFOG classification.

The CEQ methodology considers two extreme scenarios for contributory old-age pensions: pensions as deferred income (PDI) and pensions as a government transfer (PGT). Pensions are included in the pre-fiscal income aggregate in the PDI scenario, and contributions are treated as savings. In the PGT scenario, pensions are considered direct transfers, and contributions are treated as direct taxes. The PDI scenario is used as the baseline in this analysis.

Despite its usefulness, some caveats apply to this analysis. The accounting method employed does not factor in behavioral or general equilibrium effects. Intertemporal effects are not captured as the analysis is conducted at a specific point in time. Due to limited coverage of high incomes in household surveys, supplementing with tax administrative data could improve accuracy, as household surveys only sometimes do not generally capture top incomes. Additionally, taxes associated with legal entities are not covered as the survey focuses solely on households. Specific fiscal interventions cannot be factored into the analysis due to challenges in allocation based on available data, such as corporate profit tax and VAT paid by the government or institutional consumption. Some government interventions are either not specified in surveys or are grouped broadly, while others, though identified, do not align closely with administrative data. Taxes on land, buildings, vehicles, and services or activities are aggregated into a single

¹³ Corporate taxes were excluded due to the challenges in accurately attributing the tax burden to individual households.

category. Certain benefits like unemployment, temporary work incapacity, maternity benefits, child-raising incentives, scholarships, minimum social pensions, and heating aid show lower amounts in surveys than in external statistics. Additionally, indirect effects of subsidies, particularly those related to hydrocarbons, are omitted due to the unavailability of implicit subsidies in the baseline year 2021, necessitating simulation for inclusion. Finally, comparing the pre-COVID-19 and post-COVID-19 periods using the previous CEQs is not feasible, as they use different poverty lines based on the 2011 PPP and 2017 PPP, respectively.

What Is the Overall Net Impact of Fiscal Policy on Poverty and Inequality in Romania?

In Romania, the fiscal system reduces inequality, particularly in recent years, where its impact has become slightly more pronounced. The CEQ methodology is used to estimate the overall impact of fiscal revenue collections (taxes) and expenditures, including direct cash and near-cash transfers and in-kind benefits, on inequality through pre- and post-fiscal income measures. Figure 3.1 panel a) shows the change in the Gini coefficient across different income measures, starting from households' market income (which treats pensions as deferred income.¹⁴) to final income (including in-kind transfers). In Romania, the Gini coefficient of pre-fiscal income was 0.346 and decreased by 0.07 points after taxes and transfers were introduced. Direct taxes and transfers and public spending on education and health contribute nearly equally to reducing inequality, while indirect taxes have an unequalizing impact, though relatively smaller.

These findings align with the 2022 fiscal incidence study, which yielded similar results. In both studies, the reduction in inequality is primarily attributed to direct taxes and cash and in-kind social transfers, while indirect taxes exacerbate inequality. However, it is important to note that the results of the current and earlier studies are only partially comparable due to methodological differences.¹⁵

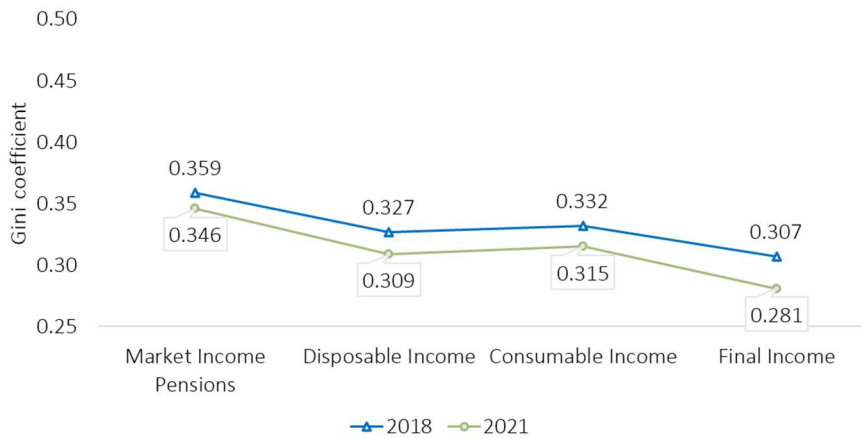
Despite improvements over time, Romania's fiscal system exhibits a notably lower redistributive effect than other countries in Europe and Central Asia, including regional peers Bulgaria and Poland. While fiscal policies generally reduce inequality across countries, Romania's comparatively limited redistributive impact stands out. The tax and transfer system contributes to a decrease in the Gini coefficient by only 0.065 points, contrasting with Bulgaria and Poland, where significant reductions occur, with a decline of 0.132 and 0.121 points, respectively (figure 3.1, panels b). This is primarily due to the limited redistributive role of direct taxes and transfers, which is significantly lower than for other countries in the region (figure 3.1, panels c).

¹⁴ In this baseline scenario, pensions are included in the pre-fiscal income aggregate, and contributions are treated as individual "savings."

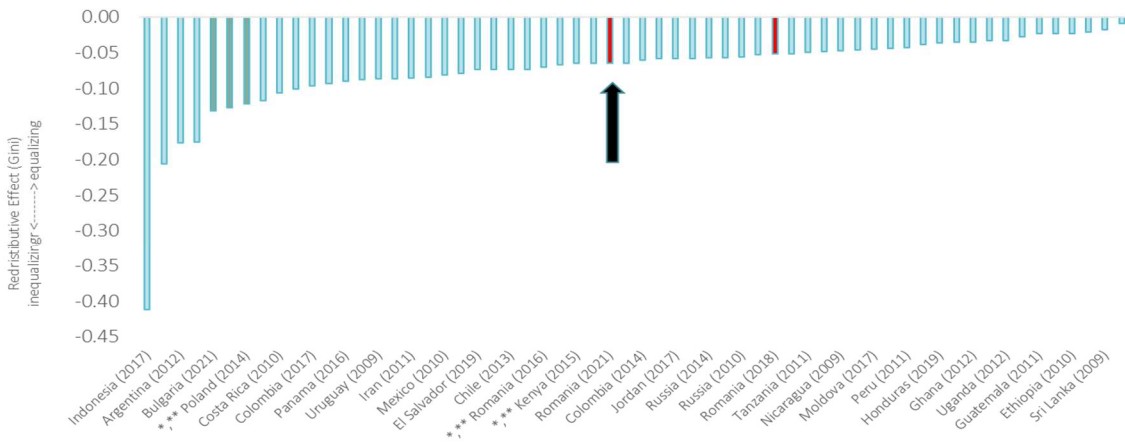
¹⁵ First, the current study accounts for informality in employees' payment of social insurance contributions and income taxes, whereas the previous study assumed no informality. Second, in the previous study, the redistributive effects were calculated based on per capita income, while the current study uses equivalized income in accordance with the Eurostat methodology for calculating monetary poverty.

Figure 3.1: The 2019 fiscal system reduces inequality in Romania, but less so than in other countries

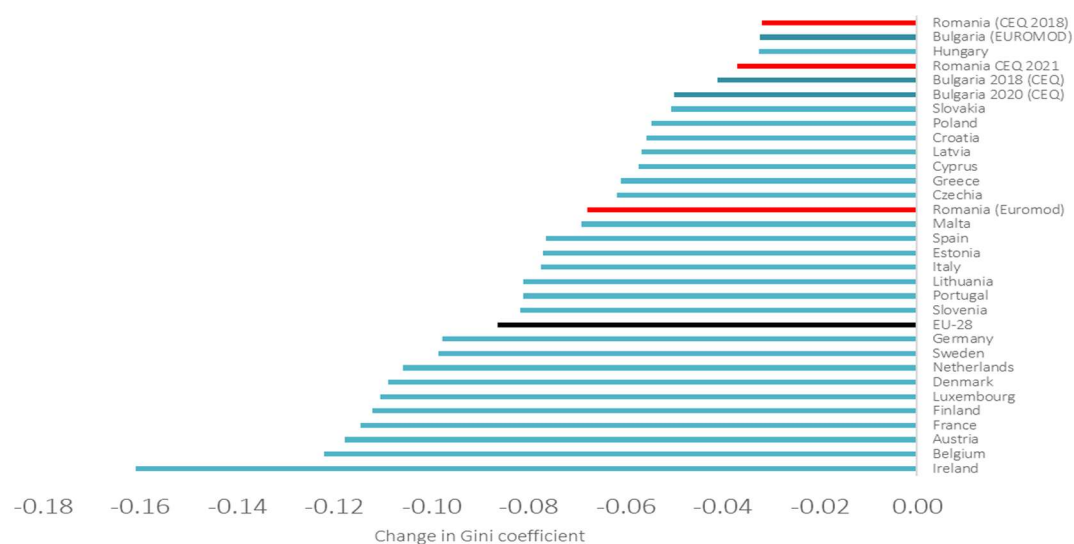
a. Redistributive effect (Gini coefficient), changes from market plus pensions to final income, Romania



b. Redistributive effect (Gini), changes from market plus pensions to final income, selected countries



c. Redistributive effect (Gini), changes from market plus pensions to disposable income (accounting for direct taxes and transfers), selected countries



Sources: Panel a): for 2018 (Badiani and Militaru, 2022); for 2021: World Bank estimates using the 2021 HBS. Panel b): World Bank estimates using the 2021 Romania HBS. Panel c): for Romania 2018 (Badiani and Militaru, 2022); for Romania 2021: World Bank estimates using the 2021 HBS; for Bulgaria 2018 (Vaughan and Cabrera, 2023); for Bulgaria 2021 (Robayo-Abril and Cabrera, 2024); for other EU countries: EUROMOD.

Note: Market income plus pensions refers to income before taxes and transfers are accounted for. Panels a) and b) capture changes in Gini between market income plus pensions and final income. In contrast, panel c) captures changes between market income plus pensions and disposable income, so inequality reduction in both panels is not strictly comparable.

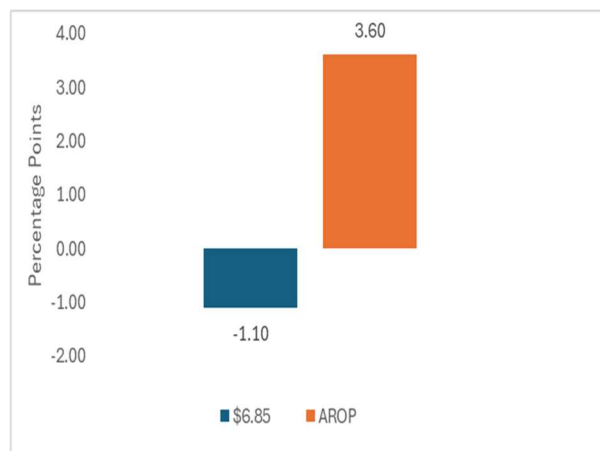
Findings indicate that, while the fiscal system still exacerbates poverty according to the at-risk-of-poverty (AROP) line, it has the potential to alleviate poverty among lower-income deciles when considering lower poverty lines. These results align with previous CEQ fiscal analyses. Although the net effect of direct taxes and transfers is equalizing, the fiscal system increases the at-risk of poverty rate increases by 3.6 percentage points, given the burden of taxes on income at the bottom of the distribution (figure 3.2).¹⁶ However, the fiscal system reduces poverty when using a lower poverty line (6.85\$), capturing that households in the first decile are net beneficiaries of the fiscal system.¹⁷

The most significant rise in poverty stems from shifts between disposable and consumable income, primarily driven by indirect taxes that are not entirely offset by transfers. While direct transfers initially helped to reduce poverty, as seen in the transition from market income to disposable income, this effect was later counteracted by the negative influence of the indirect taxes on the consumable income (figure 3.3).

¹⁶ According to the literature and examples from other countries, the poverty effect of in-kind transfers is not computed, given that households do not observe the monetary value of health and education spending.

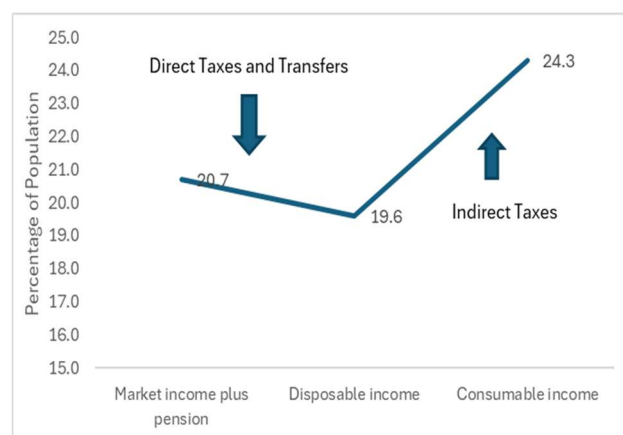
¹⁷ The poverty line of US\$6.85 is considerably lower, leading to a disproportionate inclusion of households that benefit more from the system than they contribute to it. On the other hand, the AROP poverty line is higher and encompasses more beneficiaries who contribute more to the fiscal system than they receive.

Figure 3.2: Change in poverty headcount at \$6.85 and AROP official poverty lines (from market income to consumable income)



Source: World Bank estimates using the 2021 HBS.

Figure 3.3: Poverty headcount (using AROP official poverty lines) from market to consumable income



Source: World Bank estimates using the 2021 HBS.

What Is the Impact of Individual Taxes or Transfers on Poverty and Inequality?

How do individual fiscal interventions contribute to changes in poverty and inequality? Analyzing the progressivity of a tax or transfer in isolation can lead to wrong conclusions about whether a tax/transfer is equalizing, as the impact of a specific fiscal intervention may vary depending on the overall effect of the net fiscal system (Huggins, 2016). To estimate this, we examine the marginal effect¹⁸ of each fiscal component on the Gini coefficient and the poverty headcount. A tax or transfer significantly impacts poverty and distribution if it is heavily targeted toward those at the bottom of the income distribution (as indicated by the concentration coefficients) and constitutes a substantial portion of their incomes (as indicated by size).

Taxes (Direct and Indirect) and Social Security Contributions

Direct taxes (personal income tax and other) and social security contributions are progressive in Romania; however, they contribute little to inequality reduction. While direct taxes (PIT) in Romania exhibit some progressivity, with wealthier individuals contributing a more significant portion of the total collected amount (51 percent of PIT revenue comes from those in the top quintile compared to 3 percent from those in the bottom quintile), their progressivity is notably less pronounced than in other European countries, as evidenced by a lower Kakwani index¹⁹ (figure 3.4 panel a). The extremely low progressivity of the PIT is consistent with findings from previous studies (IMF, 2022). As a result, they contribute little to inequality

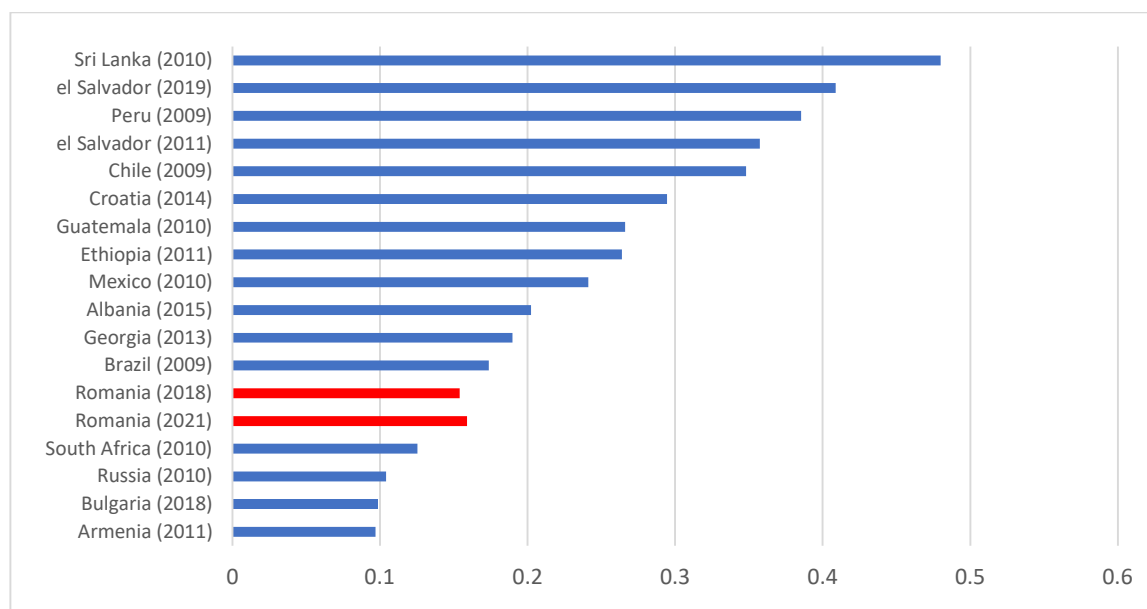
¹⁸ The marginal effect is the change in market income plus pensions due to adding or subtracting only the given benefit or tax from market income plus pensions.

¹⁹ A useful summary statistic to measure progressivity, the Kakwani index for taxes is defined as the difference between the concentration coefficient of the tax and the Gini for prefiscal income; for transfers, it is defined as the difference between the Gini for prefiscal income and the concentration coefficient of the transfer. A Kakwani index for taxes is positive (negative) if a tax is globally progressive (regressive). A Kakwani index for transfers is positive if a transfer is progressive in relative terms.

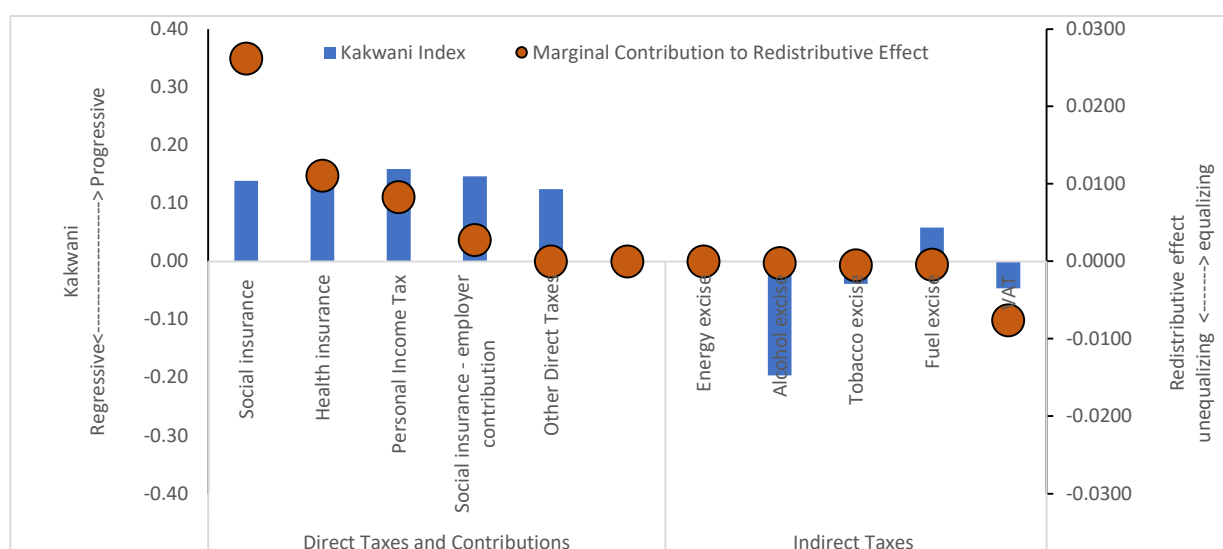
reduction (0.083 Gini points).)²⁰ The low progressivity nature of the PIT is likely related to the need for lack of a progressive tax structure (since 2018, the tax rate has been flat at 10 percent) and the exemptions, which are specific to economic sectors but not income-related. Tax evasion seems to explain less of these results. Social insurance contributions paid by employees also exhibit progressivity and the largest redistributive effect among all direct taxes and contributions (0.03 Gini points), primarily due to their larger size (figure 3.4 panel b).

Figure 3.4: Progressivity and redistributive impact of direct taxes and contributions, 2021

Panel a. Kakwani Coefficient, Personal Income Tax, Romania vs selected countries.



Panel b. Kakwani Index and Marginal contribution to redistributive effects, Direct and Indirect Taxes and Contributions, Romania



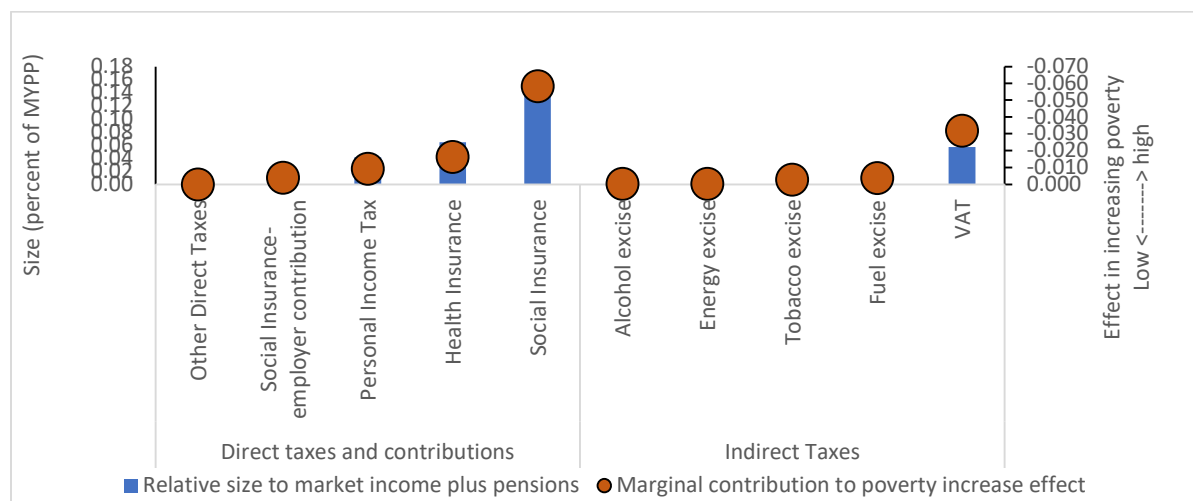
²⁰ The redistributive effect captures the marginal contribution of the net fiscal system element(s) to the Gini coefficient of inequality. The marginal contribution is the difference between the Gini coefficient with and without the tax or transfer. If positive, it captures a redistributive effect that will be reflected by a decline in the Gini.

Sources: Panel a. Sources: Armenia (Younger et al., 2014), Brazil (Higgins and Pereira, 2014), Romania (Beneke et al., 2015), Ethiopia (Woldehanna et al., 2014), Georgia (Cancho and Bondarenko, 2015), Guatemala (Cabrera et al., 2014), Mexico (Scott, 2014), Peru (Jaramillo, 2014), Russia (Lopez Calva et al., 2015), Uruguay (Bucheli et al, 2014), South Africa (Inchauste et al, 2015), Bulgaria (Robayo and Cabrera, 2024). Romania: own estimates based on 2018 CEQ and 2021 CEQ. Note: contributory pensions are treated as part of market income.

Panel b. World Bank estimates are based on the 2021 HBS and administrative data, following the CEQ methodology. Note: Social insurance is paid entirely by the employee. Employers only pay work insurance (here, “Social insurance-employer contributions”).

While direct taxes are progressive, they contribute to an increase in poverty, albeit the impact is small. For instance, direct taxes lead to a rise in the poverty headcount ratio of approximately 0.94 percentage points when using the national poverty line (Figure 3.5)²¹. This increase, however, pales in comparison to the marginal contribution to poverty attributed to social insurance contributions paid by employees (5.85 percentage points) due to their significantly larger size.²² These large social insurance contributions can also create financial disincentives for formal employment.

Figure 3.5: Effect of taxes and contributions on the at-risk-of poverty, 2021



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology. MYPP denotes market income plus pensions.

Most indirect taxes, including the Value-Added Tax (VAT), are regressive and exacerbate inequality, with the VAT having the most pronounced unequalizing effect. The Value-Added Tax (VAT) exhibits regressivity, as a negative Kakwani index indicates. Only 58 percent of VAT tax revenue is paid by the wealthiest two income quintiles, while 24 percent comes from the bottom two poorest quintiles. All indirect taxes, except the fuel excise, demonstrate regressivity and contribute to rising inequality, with VAT being the primary contributor (0.076 Gini points) (figure 3.4 Panel b).

²¹ The poverty reduction effect captures the marginal contribution of the net fiscal system element(s) to a poverty headcount defined at a particular poverty line. Again, the marginal contribution is the difference between the poverty rate with and without the tax or transfer. If positive, it captures a poverty reduction effect, which translates into a decline in poverty.

²² The size relative to market income is large, as these contributions represent a significantly larger share of employee gross wages (ranging from 21.25 to 25 percent), compared to PIT (flat 10percent rate).

The VAT also significantly increases poverty, particularly in Romania, mainly due to its substantial size relative to market income. Despite the progressivity of the direct taxes, the direct transfers included in the analysis are insufficient to offset the negative impact of indirect taxes, exacerbating poverty effects. According to estimations based on national poverty lines, indirect taxes can raise the poverty headcount by 3.2 percentage points, a relatively large increase (figure 3.5). In essence, VAT pushes some households into poverty to the extent that direct transfers cannot fully compensate. It's important to note that these results may be sensitive to the informality assumption and the use of income vs. expenditure-based measures of progressivity, and our results on poverty and inequality may be overestimated.²³ As shown in section 3.3, some of the more recent fiscal reforms, which involve expanding social transfers, are making the fiscal system more pro-poor.

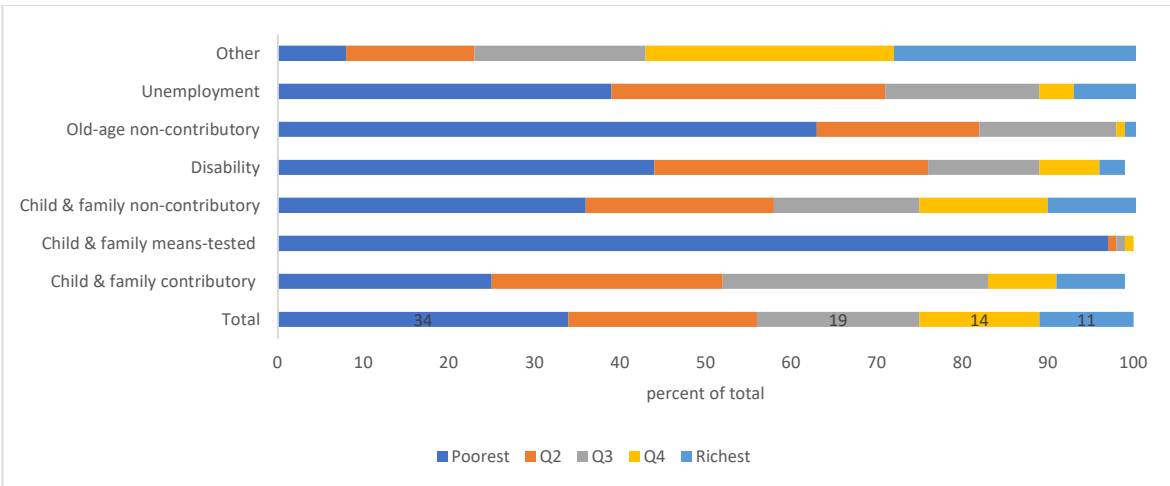
Direct Transfers and In-Kind Benefits (Health and Education)

Direct transfer programs exhibit varying degrees of progressivity, as indicated by a positive Kakwani coefficient, but their impact on inequality remains limited due to their relatively small size. While between 8 percent and 97 percent of benefits from these programs reach the poorest quintile, suggesting potential leakage to wealthier households, about 44 percent of total social transfer benefits are captured by the top 3 income quintiles. Notably, means-tested benefits for children and families and non-contributory old-age benefits predominantly benefit the bottom decile (figure 3.6 panel a). Although these programs show progressivity, indicated by a positive Kakwani index, their effectiveness in reducing inequality depends on their size and resource allocation. With transfers ranging from 0 to 2.0 percent of households' market income plus pensions and an overall size of 3.6 percent for all transfers combined, their contribution to inequality reduction is minimal. The heating aid stands out as one of the most progressive programs but is minimal in size, limiting its potential distributional impact. Among these programs, the State Allowance for Children, one of the programs with the largest budget, accounting for 0.9 percent of GDP in 2022, stands out for its substantial size and moderate progressivity, resulting in the most significant impact on reducing inequality. However, the redistributive effect of each program individually is modest, ranging from 0.0001 to 0.0129 Gini Points, contributing to an overall reduction of 0.0198 Gini Points (Figure 3.6 panels b and c).

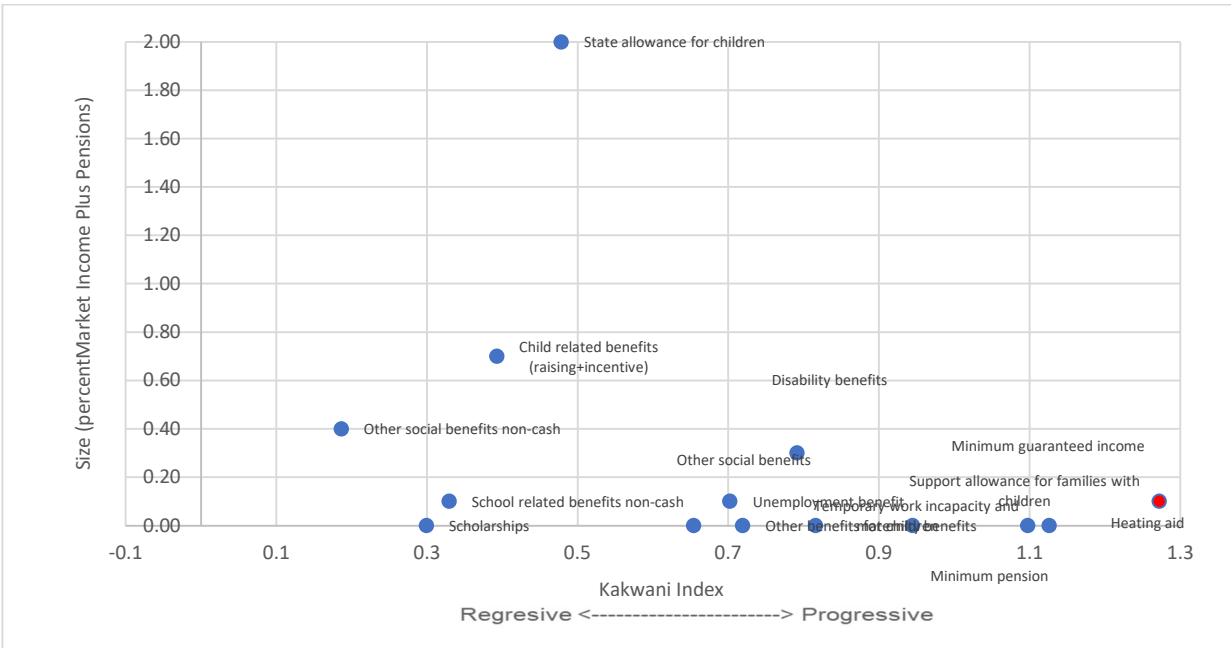
Figure 3.6: Progressivity and redistributive impact of direct transfers, 2021

Panel a. Incidence of Direct Transfers by income quintile

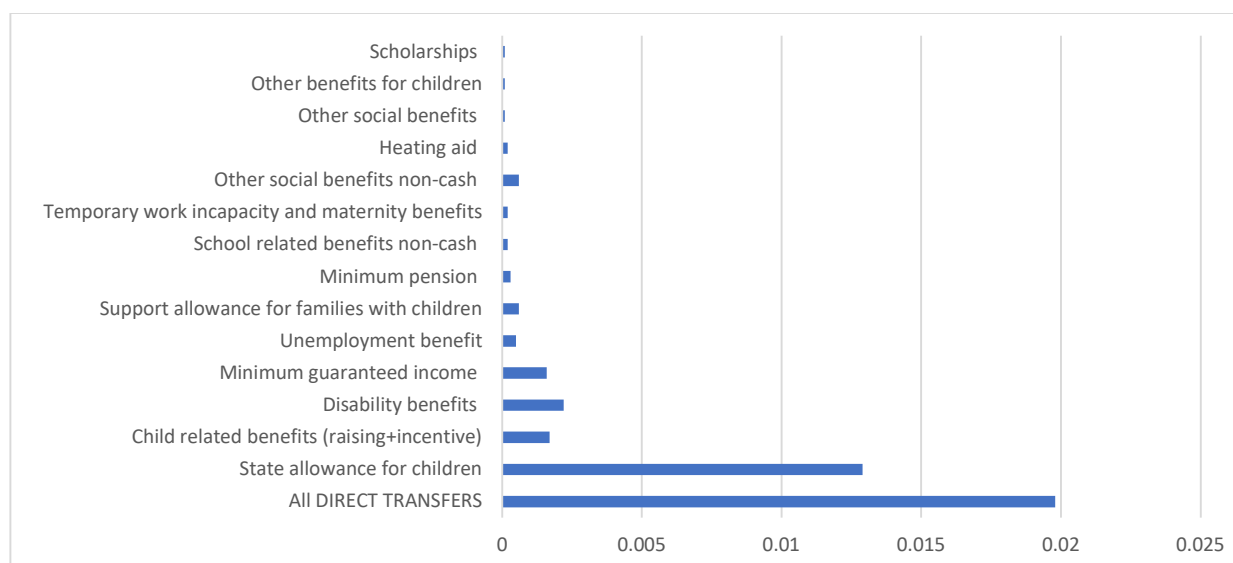
²³ For instance, VAT tax evasion is not accounted for, as the HBS lacks information on the place of purchase (a usual proxy for informality in consumption). If informality is larger at the bottom of the income distribution, the VAT can become less regressive or even progressive, and the impact on poverty can be lower in magnitude (Jenkins, 2006; Bachas et al. forthcoming). Moreover, progressivity of indirect taxes is measured based on disposable income and not consumption, following the previous CEQ studies conducted in Bulgaria, Romania, Poland and Croatia (Robayo & Cabrera (2024), Inchauste & Militaru (2018), Badiani and Goraus (2021), Badiani & Militaru (2022), Nguyen & Rubil (2021). Some recent empirical studies for OECD countries (Thomas, 2022; Bird & Smart (2016) and IFS (2011) show that if the VAT progressiveness is measured with expenditures to account for the role of savings, the VAT becomes roughly proportional or even slightly progressiveless. Finally, cascading effects related to exempt items in the VAT structure are not considered.



Panel b. Social Transfer Programs, Size, and Progressivity



Panel c. Marginal Contribution to Redistributive Effect

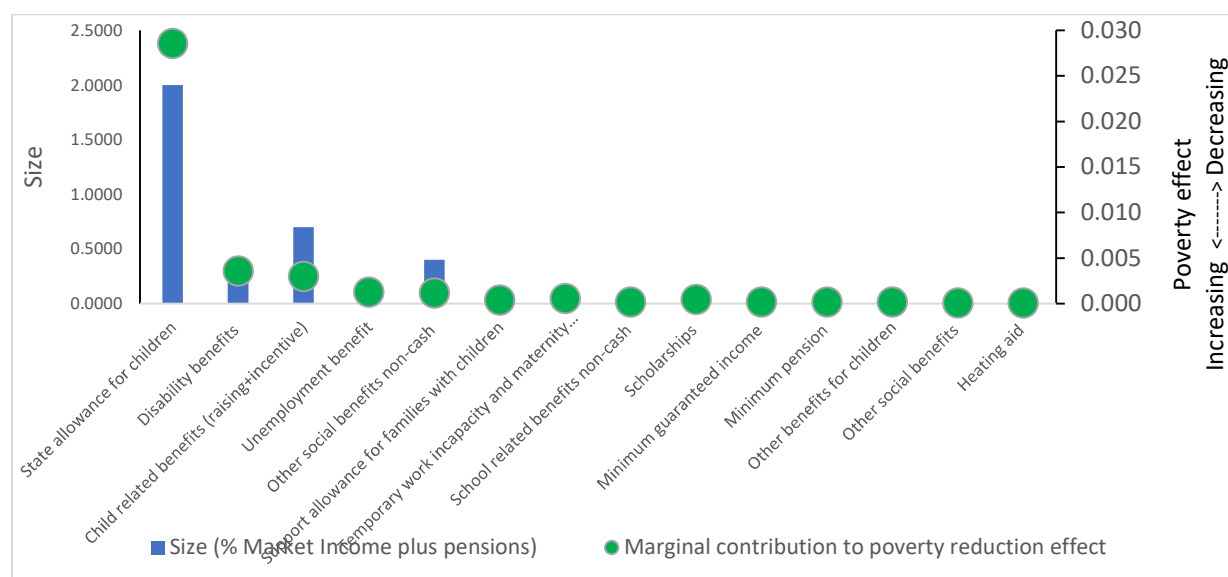


Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Note: Social transfers are grouped in panel a.

Although direct transfers collectively have a significant impact on poverty reduction (3.9 percentage points), the individual contributions of each program to poverty reduction are limited, ranging from 0.01 to 2.4 percentage points. While most transfers aim to assist poor or vulnerable groups, such as families with unemployed, disabled members, and families with children, their effectiveness varies widely, with many programs being relatively small in size. Consequently, the poverty alleviation effect of each program remains modest, ranging from 0.01 to 2.4 percentage points. The Guaranteed Minimum Income (GMI) program and heating aid exhibit relatively better targeting, but their small size results in minimal impact on poverty reduction compared to other direct transfers (figure 3.7). Among the programs with the most significant poverty reduction impact is the state allowance for children, albeit their impact is relatively modest at 2.86 percentage points.

Figure 3.7: Effects of direct transfers on poverty, 2021



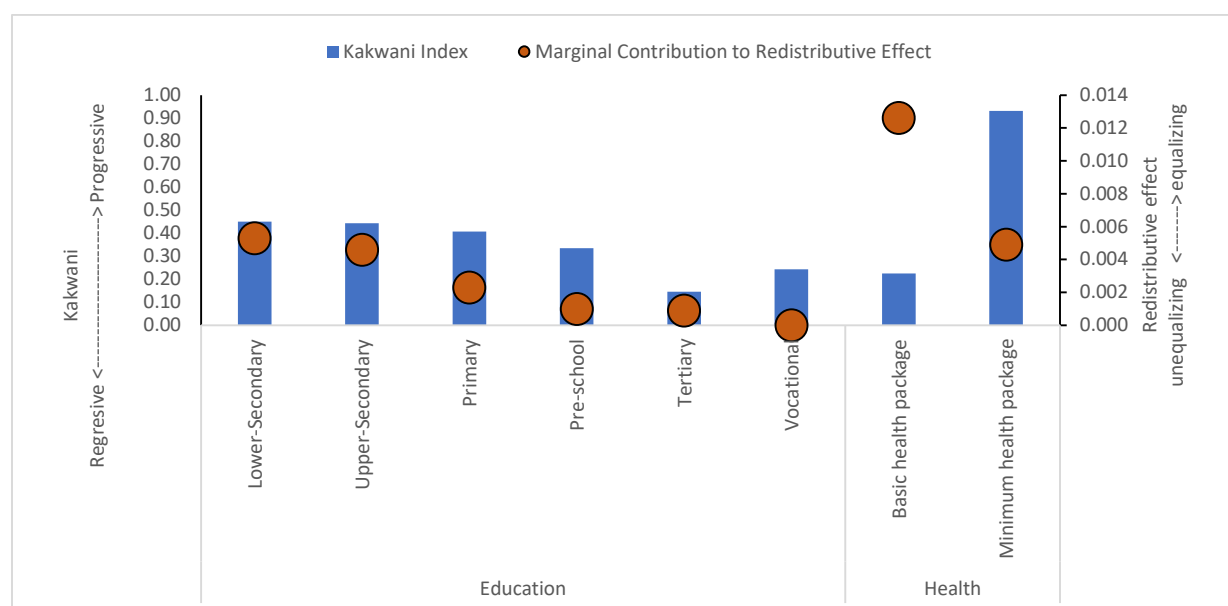
Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Education and health spending are progressive and equalizing, except for tertiary and vocational education, which contribute little to inequality reduction. Most in-kind transfers related to education and health demonstrate a progressive pattern and contribute to reducing inequality. However, tertiary and vocational education programs are exceptions, as they do not significantly reduce inequality. While all in-kind transfers in education and health²⁴ are generally progressive and inequality-reducing, tertiary education exhibits less progressivity and has a neutral redistributive effect, likely because it benefits individuals from higher-income families. Similarly, while slightly more progressive than tertiary education, vocational education also lacks a redistributive effect (figure 3.8).

Lower secondary education contributes the most to inequality reduction among all in-kind transfers, but some equity challenges persist. Although secondary education in Romania is compulsory, net enrollment rates are below EU levels and declining, with associated expenditures accounting for 1.3 percent of GDP in 2022 compared to 1.7 for the EU average. Furthermore, children ages 18–24 from households in the bottom 40 percent of the income distribution are significantly more affected by early school leaving (Robayo et al., 2023). Thus, the fiscal system could be even more equalizing if some of these equity challenges (i.e., high school dropout rates among the lower-income groups) were tackled with policies to reduce early school leaving, particularly among the poor.

In terms of health benefits, public health spending, especially on basic health services, has the potential to benefit the poor and contribute significantly to reducing inequality. However, it is important to acknowledge several limitations, particularly regarding the impact of education and health spending on inequality. This study adopts a user approach to estimate in-kind transfers in health, which may inadvertently portray households that use public health services as better off.

Figure 3.8: Progressivity and redistributive impact of in-kind transfers, 2021



²⁴ The education benefits modeled are preschool (grades 1–3), primary (grades 1–9), secondary (grades 1–3), and tertiary education levels. In-kind health benefits include two levels: primary care (outpatients) and hospitalizations.

Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

What aspects of the fiscal system have the most significant impact on inequality?

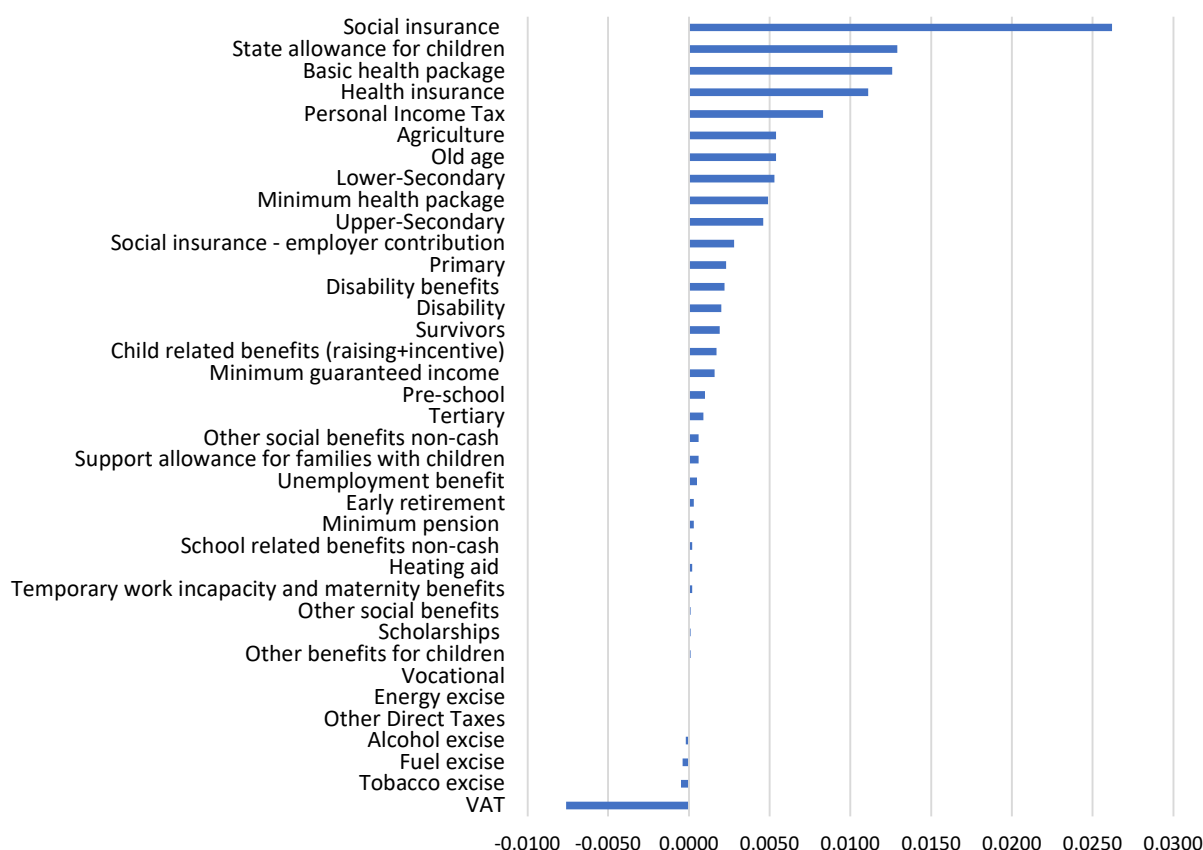
Social insurance paid by the employee, state allowances for children, and the basic health package are key interventions that most decrease inequality. Those with higher incomes are significantly more likely to be formally employed, thus contributing more to the social insurance system. Conversely, the Value Added Tax (VAT) is a fiscal measure with the largest negative impact on inequality (figure 3.9).²⁵

Old-age pensions present a significant positive marginal contribution to redistribution. Pensions are an important source of income for households with elderly members. They play an important role in poor households due to relatively high levels of coverage (75.5 percent of the population 65+ (62+ women) in the bottom-income quintile are covered by pensions, and above 96 percent in upper-income quintiles). Pension adequacy among the bottom quintiles is also high, representing more than 95 percent of the beneficiaries' income in a population group (65+). Following the CEQ methodology, pensions can be treated as transfers (scenario-PGT) or deferred income (scenario-PDI, our baseline scenario).²⁶ Both scenarios may help estimate the distributional impact of the Romanian pension system. Old-age pensions are progressive and contribute moderately to inequality reduction (figure 3.9).

²⁵ In the Contributory Pensions as Deferred Income (PDI) scenario, pension system income is treated as (Market) income earned previously deferred until today, while pension system contributions are treated as mandatory savings (income deferred to one's future self). In contrast, in the contributory Pensions as Government Transfer (PGT) scenario, the pension system income is treated as a pure transfer, while the pension system contributions are treated as a tax. In the PDI scenario, pensions are prefiscal income, while in the PGT scenario, the public contributory pension system is a fiscal tax and transfer system that redistributes income from today's working-age population to today's pension-age population.

²⁶ In the Contributory Pensions as Deferred Income (PDI) scenario (our baseline scenario), pension system income is treated as (Market) income earned previously deferred until today, while pension system contributions are treated as mandatory savings (income deferred to one's future self). In contrast, in the contributory Pensions as Government Transfer (PGT) scenario, the pension system income is treated as a pure transfer, while the pension system contributions are treated as a tax. In the PDI scenario, pensions are prefiscal income, while in the PGT scenario, the public contributory pension system is a fiscal tax and transfer system that redistributes income from today's working-age population to today's pension-age population.

Figure 3.9: Marginal contribution of fiscal interventions to inequality reduction, 2021



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

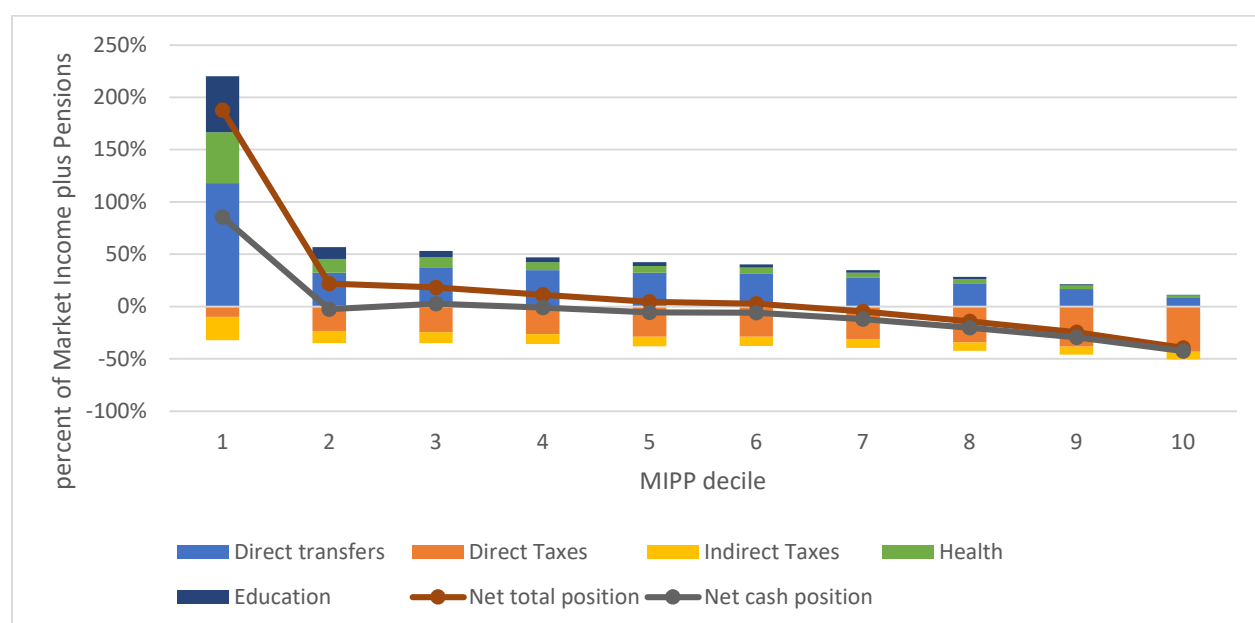
Zooming in on the elements of the fiscal system across the income distribution provides a better understanding of the distributional effects. Our assessment focuses on how the 2021 overall Romanian fiscal system impacted households across the income spectrum. The analysis divides the population into ten deciles based on market income plus pensions (prefiscal income). Each decile's bar graph illustrates the incidence of fiscal interventions relative to market income plus pensions. Interventions that increase household income, such as direct transfers, in-kind education, and health benefits, are depicted above the zero axis. In contrast, those that decrease household income, such as direct and indirect taxes, are displayed below the zero axis. The net cash position represents the aggregate sum of all cashable interventions (including all taxes and direct transfers) for each decile. In contrast, the total cash position encompasses all cashable interventions plus in-kind benefits. Figure 3.10 shows the share of broad categories of taxes and transfers in prefiscal income (market income plus pensions) by income decile.²⁷

From the expenditure side, direct transfers and education and health benefits are relatively more concentrated in the bottom decile; from the income side, direct taxes

²⁷ This section relies on the scenario PDI. The net cash position captures the difference between market income plus pensions and consumable income (equivalent to all payments of taxes and cash benefits) as a share of market income plus pensions.

are more concentrated in the upper part of the income distribution, while indirect taxes are more concentrated at the bottom. This key finding explains the progressivity and inequality-reducing effect of in-kind transfers, which is important, given that Romania still reports lower education and health coverage levels than other EU countries. Direct transfers constitute a significant portion of household income for the first income decile, indicating reasonably effective targeting, although program-specific exclusion and inclusion errors vary considerably. In-kind health and education benefits are substantial for most deciles, particularly those at the bottom, gradually declining as income increases. However, these households pay a proportionally higher share of their income in indirect taxes (22.5 percent of income in the bottom decile). In contrast, households in higher-income quintiles tend to pay significantly more in direct taxes and contributions (43 percent of income in the top decile).

Figure 3.10: Distribution of taxes and transfers across income deciles, 2021



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Note: The figure reports households' net cash position as the difference between cash transfers received and taxes paid. MIPP refers to Market Income plus pensions.

While the poorest Romanians are net beneficiaries of social benefits, individuals from the fourth decile upwards (and also the second decile) become net contributors to the fiscal system, as their direct and indirect tax payments surpass the cash benefits they receive (resulting in a negative net cash position²⁸). When looking at the net cash position, that is how much cash is left in households' pockets after paying all taxes and receiving all cash transfers; the results show that households in the poorest income decile and those in the third decile receive slightly more direct transfers than they pay in taxes and contributions. All the other households are net payers in the fiscal system. This is consistent with previous CEQ findings and the fact that the fiscal system increases the risk of poverty when households transition from disposable to consumable income as households become net contributors to the fiscal system. A

²⁸ The net cash position captures the difference between market income plus pensions and consumable income (equivalent to all payments of taxes and cash benefits) as a share of market income plus pensions.

different picture emerges when looking at the net total position, which includes the monetized value of in-kind benefits from public health and public education. The first six deciles are net receivers in the fiscal system, reflecting the solid equalizing effect of education and health (Figure 3.10).²⁹

How does the overall fiscal system impact poverty among households with different socioeconomic profiles?

Recent evidence on gender (Robayo et al., 2023) has identified significant gender gaps in the country compared to other EU countries, particularly in economic opportunities and poverty. Little is known about the potential use of fiscal policy instruments to reduce some of these gender gaps. Demographic factors such as dependent children and older persons and the labor market status of adults in the household can also significantly influence a household's vulnerability to poverty before and after fiscal policy.

We extend the CEQ methodology by constructing household typologies based on sociodemographic profiles. Household typologies and quintile information provide a helpful picture of the differential impact of tax/transfer systems on poverty among households with different sociodemographic profiles. Following previous evidence (Grown & Valodia, 2010; Greenspun and Lustig, 2013; Aziz et al., 2013; Greenspun (2019); Robayo et al., 2023), we compare “female” versus male households across different household types using gender typologies specific to Romania, including distinctions such as the head of household by sex, demographic composition (e.g., number of adults per sex), and income contribution (e.g., earners being a female majority or earning more than 50percent). Additionally, we consider sole earners, single parents, and mixed typologies with varying dependents, such as dependent children and elderly individuals.

Our objective is to identify which households experience the highest poverty levels before fiscal policy interventions and the roles of gender, labor market status, and demographic composition. We also investigate how fiscal policies contribute to poverty reduction and narrowing gender gaps, identifying the critical elements of the fiscal system influencing these outcomes. Moreover, we explore potential areas for improvement, examining fiscal packages that could effectively reduce poverty among vulnerable groups and further narrow gender disparities.

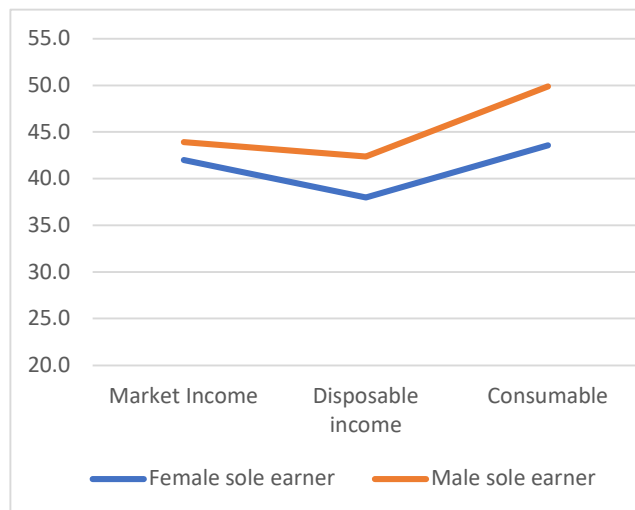
Our findings indicate confirm the following priorities:

Before fiscal interventions, sole earners and single parents faced significant challenges with high poverty rates. Our analysis shows that fiscal policies tend to exacerbate these existing high poverty rates for most sole earners and single parents, except for female single parents (Figures 3.11 and 3.12). Interestingly, female single parents experience a slight reduction in poverty rates due to direct taxes and transfers, which highlights the potential positive impact of targeted social assistance programs.

Therefore, from the poverty perspective, the main goal should be to reduce economic hardship among sole earners, single-parent families, and families with three or more children. These families experience extremely high poverty rates before fiscal policy and do not receive sufficient fiscal support, as fiscal policy exacerbates poverty among these groups.

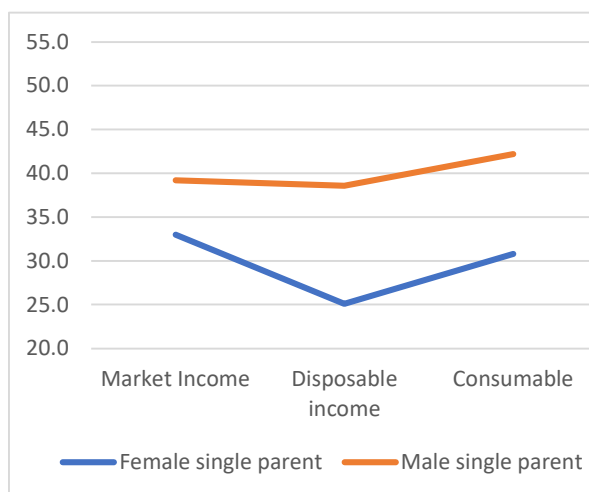
²⁹ Nevertheless, our findings may vary for lower-income segments if indirect subsidies (established after 2021) and the expansion of social transfers linked to the SRI were included in the incidence analysis, as the combined impact of direct transfers and indirect subsidies would further reduce poverty incidence.

Figure 3.111: Poverty rates before and after fiscal policy, AROP (percent), Sole Earners



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

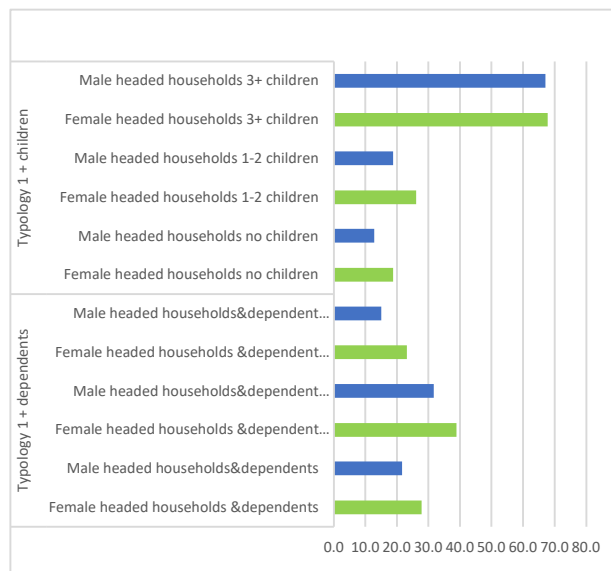
Figure 3.112: Poverty rates before and after fiscal policy, AROP (percent), Single Parents



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Additionally, before fiscal interventions, households with three or more children exhibit exceptionally high poverty rates regardless of the gender of the household head (figure 3.13). Despite fiscal policy interventions, poverty remains a persistent issue for both male-headed and female-headed households with three or more children. Although fiscal policies manage to reduce poverty among female-headed households with three or more children, resulting in a reverse gender gap in poverty rates, both groups continue to grapple with poverty rates well above 50 percent (figure 3.14). This underscores the need for more comprehensive and effective measures to address the unique challenges large families face, regardless of the gender of the household head.

Figure 3.113: Poverty Rates, Before Fiscal Policy (AROP), percent



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Figure 3.114: Poverty rates before and after fiscal policy, AROP (percent), Households with three or more children

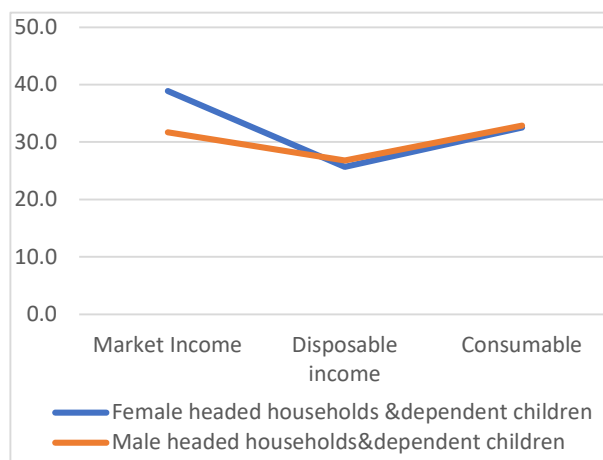


Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

When considering a gender perspective, two additional objectives emerge. First, effort should be placed on supporting female-headed households with elderly dependents. Before fiscal policy, gender disparities between male-headed households (MHH) and female-headed households (FHH) were particularly pronounced within households with dependents, especially those caring for elderly individuals aged 65 and above and those with children. While fiscal policies contribute to narrowing the gaps among households with children, they do not have the same effect among households with elderly dependents (figures 3.15 and 3.16).

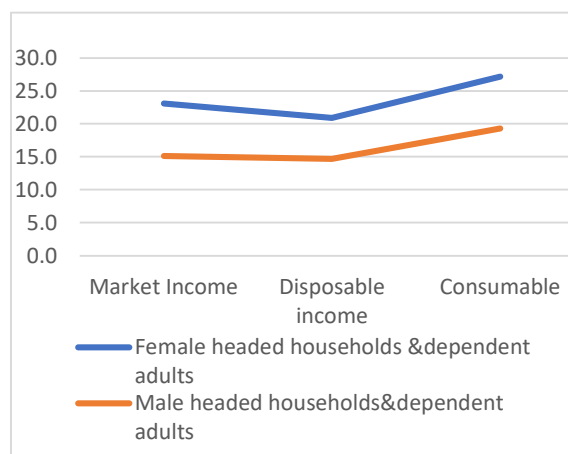
Second, acknowledging the diversity within sole-earner families, efforts should prioritize reducing gender disparities within this group. Before fiscal interventions, while gender poverty gaps among male and female sole earners are generally small, they widen significantly when considering households with dependent children or elderly members. Although the fiscal system has narrowed gender gaps among households with sole earners and dependents, these gaps remain significant, especially among those with dependent children. Particular attention should be directed towards enhancing welfare among female sole earners who have dependent children or elderly relatives under their care (figures 3.17 and 3.18).

Figure 3.15: Poverty rates before and after fiscal policy, AROP (percent), Households with dependent children



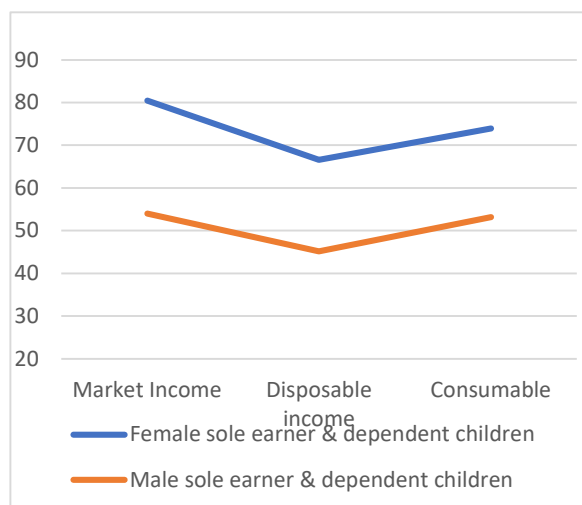
Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Figure 3.16: Poverty rates before and after fiscal policy, AROP (percent), Households with dependent elderly



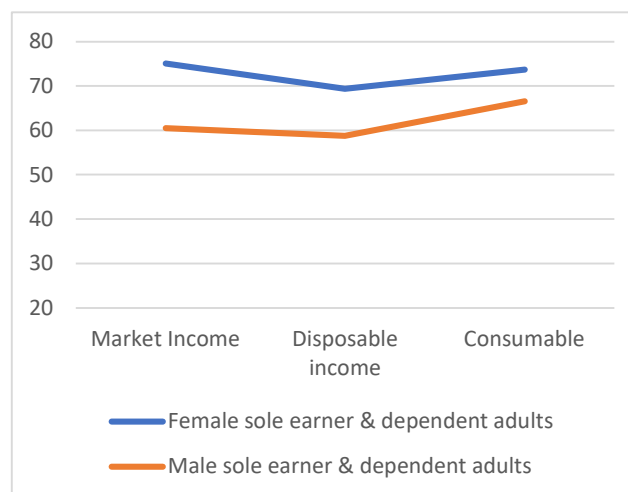
Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Figure 3.17: Poverty rates before and after fiscal policy, AROP (percent), Households with sole earners and dependent children



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Figure 3.18: Poverty rates before and after fiscal policy, AROP (percent), Households with sole earners and dependent elderly



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

3.3. Simulations of Fiscal Policy Reforms

In addition to offering a static portrayal of the distributional effects of the fiscal system, the model facilitates simulations of fiscal policies. The preceding results offer a comprehensive insight into the net poverty and distributional consequences of the Romanian

fiscal system, including the potential effects of specific taxes or transfers. Moreover, this methodology can simulate reforms implemented after 2021 and prospective fiscal policy reforms, offering valuable insights for stakeholders engaged in the ongoing fiscal policy discourse. Using the 2021 model, we estimate these impacts by adjusting the pertinent parameters linked to each policy, thereby isolating any other changes that might have influenced income distribution.³⁰

This section outlines the primary findings of two sets of policy simulations, focusing on their implications for poverty and equity. The first set examines the major fiscal policy changes enacted by the government from 2022 to 2024. The second set of simulations explores an additional set of policy measures beyond those already implemented by the government, which have the potential to improve poverty and enhance equity.

Simulation Scenario 1: Package of government reforms implemented between 2022 and 2024

Simulation Scenario 1 involves a package of fiscal reforms involving revenue and expenditure measures (detailed below) implemented between 2022 and 2024.

Revenue Measures

From the revenue side, these reforms have primarily aimed to reduce the budget deficit and ensure long-term financial stability..

Changes in PIT Exemptions and Expansion of Tax Allowance

Changes in Personal Income Tax (PIT) exemptions have been implemented across various sectors, and tax allowances have been raised. Employees in the construction sector became exempt from personal income tax for monthly wages below 30,000 RON starting in 2019, while those in the agriculture and food industry gained exemption in 2022 under the same conditions. However, the threshold for exemption was reduced to 10,000 RON in August 2022. Employees in the IT sector have enjoyed exemptions for certain occupations since 2001. In October 2023³¹, a new reform was introduced, effective from November 1, 2023, subjecting the previously exempt IT sector to PIT for specific categories of employees with salaries exceeding 10,000 RON (approximately Euro 2,000 per month). Additionally, some additional tax relief measures have been introduced. Tax allowances were raised, with the maximum deduction ceiling rising by 39% and the maximum deduction itself increasing by 18%, and two supplementary deductions have been introduced (one for young employees and another for parents).

Overall, these measures are expected to enhance PIT progressivity and slightly reduce poverty and inequality. Introducing new tax exemptions in agriculture and food is expected to benefit economic sectors, particularly those where low-income workers are concentrated. Tax allowances also benefit more low-income workers. Conversely, the increased tax burden in the IT sector will likely affect higher-income earners more significantly. Simulation results indicate that these reforms will enhance progressivity, as evidenced by an increase in the Kakwani index from 0.159 to 0.194. However, the anticipated impact on reducing inequality is expected to be minimal, with the Gini coefficient expected to decrease slightly from 0.0083 to

³⁰ As a caveat, it's crucial to recognize that this estimate relies on a static incidence analysis. The simulations do not account for potential alterations in taxpayer behavior resulting from changes in taxes or transfers.

³¹ Law 296, 2023, enacted in October 2023. The new provisions will apply starting with the income for the month following the one in which the law is published, so starting with the income for November 2023.

0.0086. Despite the higher personal income tax (PIT) burden in the IT sector and construction, this is offset by the more generous tax allowance and reduced tax burden in the construction and food industry, resulting in a slight reduction in poverty, with the marginal contribution to poverty decreasing from 0.94 to 0.61 percentage points.

Increase in VAT preferential rates.

Recent VAT reforms have brought increases to some preferential rates. While the standard VAT rate remains 19%, some goods benefit from reduced rates of 5% and 9%, while others are exempt. In 2022, firewood and thermal heating saw a reduced rate of 5%. However, in 2023, the VAT rate for restaurant food and hotel accommodation increased from 5% to 9%. Meanwhile, food, specific housing sales, renewable energy systems, and selected recreational activities remained subject to the 9% rate. Reduced rates persist for books and entrance fees to historical and cultural sites, zoos, and botanical gardens. In 2024, the VAT rate for food products with added sugar and non-alcoholic beer rose to 19% from the previous 9%, alongside the use of sporting facilities and tourism and leisure-related transport services, which were also raised from 5%.

These reforms are expected to increase the progressivity of the VAT, contribute to a slight reduction in inequality, and have muted impacts on poverty. Changes in the VAT structure are expected to affect households across income distribution. The still lower rates for firewood are anticipated to prevent a heavier tax burden for certain households, particularly those with low incomes residing in rural areas. However, eliminating reduced VAT rates for sugar-added food represents an additional burden for them. Higher-income households also bear the burden of rate increases³². Simulations show that, with the reform, value-added taxes become less regressive, as measured by the Kakwani index (from -0.047 to -0.033), so the top deciles contribute more overall under the new VAT scheme. It is expected to make the VAT slightly more equalizing (with the marginal contribution to redistribution increasing from -0.0076 to -0.0067 Gini points), but it does not affect poverty; before and after the reform, the VAT still contributes to a 3.2 percentage point increase in poverty.

Introduction of health contributions

The 2023 reform introduces health contributions for previously exempt economic sectors, namely agriculture, construction, and food processing, which may increase poverty³³. The health insurance contribution rate is 10% from 2020 to 2023, with some sectoral exemptions in construction, agriculture, and food processing since 2019.³⁴ The 2023 reforms eliminate the exemptions in these three sectors starting in November 2023. The baseline analysis shows that health contributions are progressive (with a Kakwani index of 0.138) and redistributive (with a marginal contribution to equity of 0.011), but they also increase poverty (with a marginal contribution to poverty of 1.63 percentage points). Introducing health contributions in sectors where the working poor are overrepresented may reduce the disposable income of vulnerable

³² For example, the increase of rates for the use of sporting facilities, and tourism and leisure-related transport services, food designated as “high quality”, entry to fairs, entertainment venues, recreational parks, exhibitions, cinemas, cultural events and sport events, food in restaurants, hotel accommodation, etc.

³³ Workers in the construction sector have been exempt from social health insurance since 2019 if their income exceeds the statutory gross minimum wage in the construction sector.

³⁴ Since 2019, employees in the construction sector earning below 30,000 RON per month have been exempt from paying this contribution. Starting in 2022, this exemption also applies to agricultural and food processing employees. In August 2022, the wage ceiling for this exemption was lowered to 10,000 RON per month.

households and have a small negative effect on the poor. However, the poverty impact is expected to be contained, as the measure affects a small portion of the poor population, leads to a moderate reduction in disposable income for the affected households, and causes a relatively small percentage of them to fall into poverty. Only a relatively small share of the poor (6.1%) are affected by the policy (i.e., are employed and work in the sectors that were previously exempt from health contributions earning less than 10,000 RON). Moreover, the introduction of health contributions is expected to reduce the disposable income of the affected households by 5.5%. While this is not a small reduction, only a small percentage (3.7%) of those affected by the policy fall are expected to fall below the poverty line as a result of the income reduction. This indicates that while the policy does push some individuals into poverty, the overall impact is contained. Simulations show that introducing health contributions in exempt sectors would make these contributions slightly less progressive (with Kakwani decreasing from 0.138 to 0.14) and slightly increase poverty (with a marginal contribution to poverty increasing from 1.63 to 1.78 percentage points).

Increase in Excise on alcohol, tobacco, and fossil fuels

The 2023 reform increased excise tax rates on alcohol and tobacco products, and fossil fuels³⁵ starting in January 2024, with additional increases planned for July 2024. Excise taxes for various energy products will also increase, including heating oil, liquefied gas, natural gas, kerosene, coal, coke, and electricity. Given that alcohol and tobacco excises are regressive and poverty and inequality increasing, these changes are expected to increase poverty and inequality. However, the impact is expected to be small due to the relatively small size. Simulations show that increasing excises on tobacco and alcohol have a small impact on the marginal contributions to poverty reduction. Moreover, due to the high inflation, after deflating the excises for tobacco and alcohol, most of them are lower than the excises in 2021, which is shown as a negative impact on fiscal revenues. Despite the progressivity, fuel excise contributes slightly to higher poverty and inequality. Overall, the welfare impacts of these fuel excise changes are expected to be small; therefore, they were not included in simulations.

Expenditure Measures

In 2022-2024, social transfers expanded, and implicit energy subsidies were introduced.

Expansion of State Allowance for Children and GMI

The new regulations implemented the single anti-poverty program VMI (Minimum Inclusion Income Program – or Venitul Minim de Incluziune) with its planned single eligibility criteria and the rise in the social reference indicator (SRI)³⁶ to incorporate indexation affected the benefits tied to it. These include support allowances for families with children, guaranteed minimum income (GMI), and unemployment benefits in terms of income thresholds and benefit amounts. In 2022, the increase in the state allowance is tied to the adjustment of the Social Reference Index (SRI), with its coefficient also experiencing an increase. Beginning in 2023, the allowance is provided as a fixed nominal amount. Compared to 2021, the current state allowance (for children over two years) has risen by 36%, while for children under two years, it has increased by 68%. We simulated the Guaranteed Minimum

³⁵ To support the transition to electric transportation and fiscal adjustment, excise taxes on gasoline and diesel will rise gradually in 2024, reaching 3,640 RON per ton (for gasoline) and Ron 2,584 RON per ton (for diesel) by July.

³⁶ The SRI increased from 525.5 RON to 598 RON.

Income (GMI) and support allowances for families with children in line with the new Minimum Income for Inclusion (VMI). The revised GMI now aligns with the VMI, while the support allowance has been discontinued. A food voucher program was also introduced in 2022. Still, they were not included in the simulations due to the difficulty of assigning a monetary value to this in-kind food assistance.³⁷

These changes are expected to increase the progressivity of the state allowance for children, with the Kakwani index increasing from 0.478 to 0.488. Given the size and progressivity of this program, this measure is expected to have a more significant impact on poverty, with the marginal contribution to poverty reduction increasing from 2.86 to 3.0 percentage points. The reform makes the GMI slightly less progressive (with a Kakwani declining from 1.272 to 0.957). However, given the still small size, it is expected to have marginal impacts on poverty and inequality.

Introduction of Implicit Energy Subsidies

From August to December 2022, a one-year cap on electricity and natural gas prices was implemented, with reduced rates for residential customers below market prices.

A governance ordinance was enacted to manage the price gap, with utilities sold at restricted rates compensated by the government. The price ceiling was extended until August 2023, while vulnerable customer price caps were extended until 2025. This results in consumers paying less for electricity than the actual cost of production and distribution, effectively subsidizing their usage indirectly (implicit subsidy). Estimating the fiscal cost of untargeted price caps in Romania is challenging; available estimates suggest the associated fiscal cost of these implicit subsidies is high. Estimates from Autoritatea Nationala de Reglementare in Domeniul Energie (ANRE) indicate the annual fiscal cost of price caps to be close to 6.6 billion lei (1.4 billion euros).³⁸ Estimates from the Ministry of Labor suggest that, in 2022, implicit energy subsidies in Romania amounted to 1.177 billion RON for natural gas and 2.73 billion RON for electricity.

Though progressive, implicit electricity subsidies contribute minimally to poverty and inequality reduction. They are progressive in relative terms, as indicated by a positive Kakwani coefficient. However, they are due to significant leakage to high-income households and their small size relative to household income. Gas subsidies, on the other hand, are regressive and make minimal contributions to poverty or inequality reduction. Table 3.1 below summarizes the poverty and distributional impact of some of the policy changes described above, implemented between 2022 and 2024³⁹.

³⁷ In June 2022, the Romanian government launched the "Support for Romania" program to help vulnerable groups cope with rising energy and food prices. The program provides food vouchers for purchasing food products and hot meals, initially available from June to December 2022, and later extended through 2023

³⁸ Source: <https://anre.ro/suma-totala-verificata-de-anre-si-transmisa-spre-decontare-a-deposit-205-miliarde-ron/>

³⁹ Some additional policy changes were not included in the simulations. These include pension reforms, which entail the elimination of the correction index and modification to service pension regimes. Or other changes in tax policy for new vehicles.

Table 3.1: Simulated distributional impact of key reforms implemented in 2022-2024

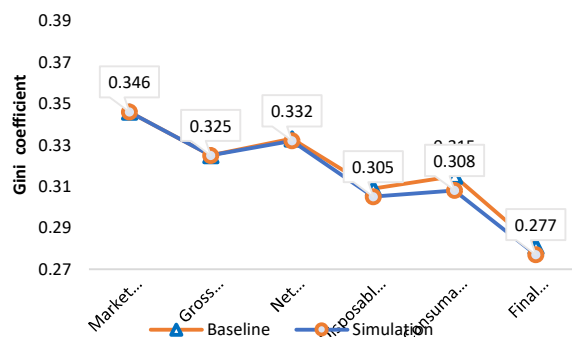
		Kakwani		Marginal Contribution to Poverty		Marginal Contribution to Redistributive Effect		Fiscal Measures	
Type of Fiscal Measure	Scenario							Change in Fiscal Revenue (Simulation-Baseline)	Change in Fiscal Expenditure (Simulation-Baseline)
		Baseline	Simulation	Baseline	Simulation	Baseline	Simulation		
Revenue-Based	PIT Exemptions & Changes in the Tax Allowance	0.159	0.194	-0.0094	-0.0061	0.0083	0.0086	-14.50%	
	VAT Increase in reduced rates	-0.047	-0.033	-0.032	-0.032	-0.0076	-0.0067	-1.10%	
	Excises on tobacco	-0.039	-0.034	-0.003	-0.002	-0.001	0	-14.30%	
	Excises on alcohol	-0.197	-0.192	0	0	0	0	1.02%	
	Health contributions	0.138	0.14	-0.0163	-0.0178	0.011	0.011	7.70%	
Expenditure-Based	State allowance for children	0.478	0.488	0.029	0.030	0.0129	0.0143		9.70%
	Implicit Electricity subsidy	na	0.240	na	0.003	na	0.0014		
	Implicit Gas Subsidy	na	-0.009	na	0.000	na	0.0001		
	GMI	1.272	0.957	0.0002	0.008	0.0016	0.0041		167.50%

Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

With this set of reforms, the fiscal system is becoming more pro-poor and slightly more redistributive. When looking at the overall impact of these reforms, they are expected to lead to a slight reduction in inequality, with the Gini coefficient for consumable income declining from 0.315 to 0.308. Reforms are expected to reduce poverty. Poverty after taxes and transfers, measured by consumable income and the AROP line, is expected to have declined from 24.3 to 21.9 percent, which is still slightly higher than the poverty rate before taxes and transfers. This is mainly led by the expansion of direct transfers, which almost fully compensate for the burden of direct and indirect taxes at the bottom of the income distribution. Figure 3.19 panels a and b show the overall impacts of these recent government reforms on poverty and inequality.

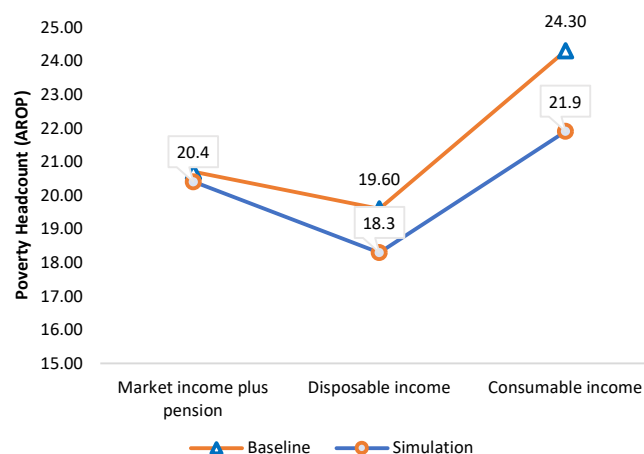
Figure 3.19: Impact of 2022-2024 fiscal reforms on poverty and inequality

Panel a. Income Inequality before and after fiscal policy, Gini coefficient, Baseline vs 2022-2024 Reforms



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Panel b. Poverty Headcount before and after fiscal policy, AROP (percent), Baseline vs 2022-2024 Reforms



Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

Simulation Scenario 2: Potential government reforms to reduce poverty and increase equity

As a result of comprehensive fiscal incidence analysis, together with the findings from Chapter 2, we simulate a fiscal package that has the potential to reduce poverty, enhance equity, and improve welfare among the most vulnerable demographics. This package aims to generate additional revenue, broaden the tax base, and allocate some of this revenue to well-targeted social protection schemes. The priority areas for intervention, based on our analysis, are reducing poverty among sole earners and single-parent families and families with three or more children, given their high poverty rates before and after fiscal policy. To address gender gaps, we propose focusing on expanding elderly care, as the most vulnerable groups are female-headed households with elderly dependents and female sole earners with dependent children or elderly dependents.

Revenue Measures

From the revenue side, we simulate various policy measures proposed in the tax chapter, and assess their distributional impacts, in addition to those already put in place by the government.

Eliminate sector-specific PIT exemptions, increase the marginal tax rates for top-income earners, and expand the PIT allowance

This reform expands the PIT base to cover all workers in agriculture, construction, and IT workers and applies a higher PIT rate of 20% to taxpayers earning above 50,000 RON (the lower limit of

the 10th richest decile), thereby targeting workers in the top-income decile.⁴⁰ Also, to protect families with dependents, we simulate an increase in the PIT allowance (both the amount and the threshold) by 10%. These measures can help raise additional tax PIT fiscal revenue (16.3 percent increase) while broadening the tax base, improving horizontal equity, and making the PIT more progressive (with the Kakwani expected to increase from 0.193 to 0.208). The reform PIT contributes more to inequality reduction (with marginal contributions to inequality changing from 0.0086 to 0.011 Gini points). However, when it comes to poverty, the impact is expected to be slightly poverty-increasing, raising marginal contributions to poverty from 0.61 to 0.82 percentage points.

Eliminate most preferential VAT Rates and exemptions

Although preferential VAT rates reduce poverty, they are not well targeted towards poor households overall, and wealthier individuals benefit considerably from them. Therefore, this reform eliminates VAT-reduced rates for all goods except food.⁴¹ Exemptions are also eliminated, keeping those on education, health, and insurance. In the medium term, eliminating the preferential rate for food can be considered while carefully balancing the potential negative impacts on poverty with well-targeted measures. The proposed VAT reform is expected to raise some additional VAT fiscal revenue (10.7% increase) and have a small effect on fiscal redistribution. Value-added taxes are expected to become less regressive, as indicated by a marginal increase in the Kakwani index from -0.0329 to -0.0271. Notably, richer households, which consume more, will face a higher burden of VAT increase. However, the overall increase in taxes paid by everyone has led to a slight increase in inequality, with the marginal contribution to inequality increasing from 0.0067 to 0.0081 Gini points. These changes are expected to increase poverty from 3.16 to 3.5 percentage points.

Introduce a refundable Earned Income Tax Credit (EITC) to support low-income workers.

EITC represents cornerstone antipoverty programs in many countries. A growing body of international evidence has shown the positive role of EITC on poverty reduction (Hoines, 2018; McInnis, 2023) and positive impacts on labor force participation among single mothers. We simulate a tax credit for low-income qualifying workers with a straightforward phase-in, phase-out design. The credit amount increases with earned income, and the number of children reaches a maximum. Then, it phases out as income exceeds certain thresholds.⁴²

Table 3.2: EITC Parameters

			Income phaseout range
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⁴⁰ High-income earners are not fully captured in households surveys. Robayo, Balavan, Wronski (forthcoming) provides some estimates for Romania. Therefore, this simulation may underestimate the amount of revenue raised by taxing the top earners.

⁴¹ Households in the first decile allocate approximately 51 percent of their overall expenditure to food; in contrast, the top decile spends only about 25 percent. Therefore, rising VAT rates on food represent significant welfare losses for low-income households, which need to be properly compensated.

⁴² The income phase-out thresholds are tied to estimates of the living wage in Romania. This living wage figure indicates the amount of labor income an average poor family in Romania needs to afford a basic basket of food and non-food items (Robayo-Abril, Avram, and Wronski, forthcoming).

no of children	percent EITC	max EITC (lei, monthly)	start (lei, gross income, monthly)	end (lei, gross income, monthly)
0	10 %	330	3300	4335
1	15 %	518	3455	4750
2	20 %	691	3455	4840
3	22 %	760	3455	4975

The credit can help offset the burden of employee social contributions, providing more take-home pay for low-income workers. Within the phase-in range, the EITC effectively offsets the 10 percent health contribution, thereby reducing the tax wedge by at least ten percentage points for these low-income workers. Additionally, it provides a financial incentive for individuals to work, as it increases as earned income increases up to a certain threshold. The measure is expected to be progressive (with a Kakwani of 0.387), reduce poverty by 1.66 percentage points and inequality by 0.0065 Gini points.

Expenditure Measures

From the expenditure side, the following measures are proposed:

Phasing out implicit subsidies for electricity and gas

Given their size, the implicit energy subsidies implemented in 2022 help alleviate poverty by enhancing the population's purchasing power; however, wealthier individuals benefit considerably, as shown by their low progressivity. Given the size of the subsidies, eliminating these subsidies is expected to raise significant fiscal revenue, which can be reallocated to create large net gains for the poorest households. When considered in isolation, this measure can slightly increase poverty and inequality by 0.3 percentage points and 0.0015 Gini points.

Expand coverage and generosity of the well-targeted Guaranteed Minimum Income (GMI) program, focused on providing more generous support to families with children.

Existing cash transfer schemes are better targeted but generally have limited coverage and size. Our analysis also demonstrates that cash transfer programs have effectively reached low-income individuals and have the potential for further enhancement. The GMI exhibits high progressivity, with a small percentage of public expenditures benefiting higher-income quintiles. Nevertheless, policymakers may consider increasing the individual cash amounts disbursed through these precisely targeted mechanisms and ensuring they are indexed to safeguard against declining purchasing power. We simulate an increase in the general Guaranteed Minimum Income (GMI) threshold by 50% overall for families with children and 25% for single elderly individuals, contributing positively to poverty and inequality reduction.

Introduce in-kind benefits for elderly care.

Given the vulnerability of families with elderly care needs, particularly those led by females, we simulate in-kind benefits for the elderly (65+), which can include services and resources to assist with care needs. Our analysis shows that female-headed households with dependent elderly (65+) are at a higher risk of poverty compared to their male

counterparts (23.1 vs 15.1 percent), and fiscal policy does not help narrow these gaps. After taxes and transfers are incorporated, these households face poverty rates of 20.6 and 13.5 percentage points, respectively. Previous evidence also suggests that care needs for those 65+ are substantial, and access to formal and informal care is limited.⁴³ Elder care benefits can help narrow these gender disparities and the development of a continuum of long-term care services, with a special emphasis on community care and an equal distribution across the country.⁴⁴ is important for reducing social inequities.

This package of fiscal measures is designed to maintain fiscal neutrality under our modeling assumptions. That is, the additional fiscal revenue from the reduction in PIT and VAT preferential rates and exemptions, the higher PIT rate for top-income earners, and the phasing out of energy subsidies is recycled to finance the more generous PIT allowance, the EITC, the increased generosity of the Guaranteed Minimum Income (GMI), and in-kind benefits for elderly care.

Considering that this reform would shift resources from wealthier to poorer households, it could reduce both poverty and inequality; our simulations show that the overall fiscal package would decrease poverty measures and inequality for the same fiscal cost. Compared to the baseline scenario, the Gini coefficient for final income decreases from 0.277 to 0.266 Gini points. When it comes to poverty, the impact of the fiscal package is expected to be poverty-reducing. Poverty after taxes and transfers, measured by consumable income and using the national poverty line, is expected to decline by 0.7 percentage points (from 22 to 21.3 percent). In addition, the poverty gap is also expected to reduce from 6.4 to 6 percent, decreasing the difference between the income levels of those living below the poverty line and the poverty threshold itself. This means that EITC and the expanded social transfers are not only sufficient to compensate for the additional burden of abolishing preferential VAT rates and PIT exemptions and the phasing out of energy subsidies, but they also help some households at the bottom of the income distribution to move up in the income ladder (some of which move out of poverty), increasing the ability of the overall fiscal system to reduce poverty and inequality.

The impacts of these policies on progressivity, marginal contributions to poverty and inequality, and fiscal revenue or expenditures are detailed in Table 3.3 below.

Table 3.3: Simulated poverty and distributional impact of potential government reforms

	Kakwani	Marginal Contribution to Poverty	Marginal Contribution to Inequality	Fiscal Measures

⁴³ About one-third of Romanians aged 65 years or older who live in their communities reported in 2019, having at least a minor care need affecting their daily life (SHARE, 2019). The proportion of older persons with reported long-term needs increases from a minimum of 21.7 percent in the age group 65–79 to 64.3 percent in the age group 80+. A considerable proportion of older people with long-term care needs do not benefit from any care service (informal or formal). This translates into pressure on family members, especially on women, poor health outcomes, the rapid decline of older persons, and an increased tendency to enter the institutionalized care path.

⁴⁴ In Romania, a small number of counties, found in the West and Center regions, plus Bucharest-Ilfov, concentrate a large part of the existing supply and beneficiaries of LTC services. Discrepancies between counties and those between development regions extend across all types of LTC services. The mix of LTC services and their rural/urban location differs substantially between counties (World Bank, 2022).

Type of Fiscal Measure	Scenario							Change in Fiscal Revenue (Simulation-Baseline)	Change in Fiscal Expenditure (Simulation-Baseline)
		Baseline	Simulation	Baseline	Simulation	Baseline	Simulation		
Revenue-Based	PIT basic allowance and PIT for top income earners (i.e., top 10 percent)	0.1936	0.2087	-0.0061	-0.0082	0.0086	0.011	16.30%	
	Refundable Earned Income Tax Credit (EITC)	na	0.3875	na	0.0166	na	0.0065	na	
	Eliminate VAT Reduced rates (except for food) and most exemptions	-0.0329	-0.0271	-0.0316	-0.035	-0.0067	-0.0081	10.70%	
Expenditure-Based	Expand social transfers (i.e., coverage/generosity of the GMI)	0.957	0.9149	0.0078	0.0108	0.0041	0.0072		87.40%
	Phasing out subsidies for electricity and gas	0.1942	Na	0.003	Na	0.0015	na		-100.00%
	Expand budget for elderly care	na	0.3876	na	0.0004	na	0.0003		na

Sources: World Bank estimates based on the 2021 HBS and administrative data following the CEQ Methodology.

The fiscal package is expected to significantly reduce poverty among vulnerable demographic groups and reduce some of the large gender gaps. Female sole earners with 1-2 children are expected to experience a poverty reduction of 4.2 percentage points. In comparison, female-headed households with three or more children are expected to see a reduction of 4.5 percentage points. Female single-parent families are also expected to experience a poverty reduction of 3.4 percentage points, with even greater reductions for those with 1-2 children (4.1 percentage points). Regarding gender gaps, the fiscal policy demonstrates increased support for female-headed households with elderly dependents, resulting in a moderate narrowing of the gender poverty gap among these households (from 7.1 to 5.5 percentage points). Additionally, female sole earners with dependent children stand to benefit significantly from the fiscal package, leading to a notable reduction in the gender poverty gap from 17.7 to 15.5 percentage points.

3.4. Summary and Policy Recommendations

Despite substantial poverty reduction, Romania still faces relatively high levels of poverty and inequality compared to other EU countries. Therefore, it's crucial to assess the equity aspects of fiscal policy, alongside efficiency, to accelerate poverty reduction and mitigate inequalities effectively. This chapter presents a comprehensive assessment of the distributional incidence of Romanian fiscal policy by applying the Commitment to Equity (CEQ) Institute methodology and survey, administrative and fiscal data for the year 2021. It also presents microsimulations of the policy reforms implemented between 2021 and 2023. It simulates a fiscal package with a combination of expenditure and revenue measures with the potential to reduce poverty and inequality.

Overall, Romania's fiscal system contributes to inequality reduction, with the impact becoming more pronounced recently. However, it has a substantially lower redistributive effect compared to other Europe and Central Asia (ECA) countries, including those of its neighbors (Bulgaria and Poland). This is partly due to the limited redistributive role of direct taxes and transfers, which are among the lowest in Europe. On the income side, direct taxes (PIT) are progressive, and relatively wealthier individuals pay a larger share of the total amount collected. However, they are significantly less

progressive than in other countries, contributing little to inequality reduction. Most indirect taxes are regressive and contribute to higher inequality, with the VAT having the largest unequalizing effect. On the expenditure side, the results indicate that direct transfers are progressive to varying degrees (as shown by a positive Kakwani coefficient) but are small. Moreover, between 8 and 97 percent of benefits accrue to the poorest quintile depending on the programs, indicating there is scope for improving leakage to the wealthiest households. As a result, each of these direct transfer programs contributes little to inequality reduction. Meanwhile, all in-kind transfers (education and health) are progressive and equalizing, as a larger share of benefits at lower education levels (pre-tertiary level) go to students at the bottom of the income distribution. Lower secondary education is associated with the largest contribution to reducing inequality.

Despite the positive impact on inequality, the net fiscal system contributes to poverty increases in Romania, when measuring poverty using the at-risk-of-poverty (AROP) poverty line; the heavy burden of indirect taxes on households plays a role. When comparing income before and after taxes and transfers using the CEQ methodology, fiscal policy leads to a moderate rise in the risk of poverty. However, the fiscal system is poverty-reducing when poverty is measured using the US\$6.85 2017 PPP per day. This reflects that households in the lower income deciles are, on average, net beneficiaries of the fiscal system; however, when moving up in the income distribution, households become net payers in the fiscal system. Poverty increases are primarily driven by a heavy burden of indirect taxes (especially the VAT) on poorer households, which is not sufficiently compensated for by direct transfers. Direct transfers tend to be well-targeted (particularly the main poverty-targeted social assistance program). Still, they are insufficient to compensate for the effect of indirect taxes, resulting in increased poverty rates.

Further analysis of household typologies and vulnerable groups helps to identify which groups of households remain vulnerable and do not necessarily receive sufficient support from fiscal policy and might deserve more attention from a social policy standpoint. Our results suggest that, from the poverty perspective, the main goal should be to reduce economic hardship among sole earners, single-parent families, and families with three or more children. Our results show that these families experience extremely high poverty rates before fiscal policy (more than 30 percent) and do not receive sufficient fiscal support, as fiscal policy exacerbates poverty among these groups.

From the gender perspective, there are two additional policy goals to narrow gender gaps. First, focus on female-headed households with elderly dependents. Gender disparities between male-headed households (MHH) and female-headed households (FHH) are more pronounced among households with dependents, especially those with elderly individuals aged 65 and above, but also those with children, suggesting that child and elder care may be playing an important role. Fiscal policy reduces the gaps among those with children but not among those with elderly. Second, in recognition of the heterogeneity of sole-earner families, effort should be put into reducing gender disparities among this group of families. A particular focus should be placed on improving welfare among female sole earners with dependent children or the elderly.

The effectiveness of the social benefits system in alleviating poverty and reducing inequality is notably limited, primarily due to the low generosity of social transfers and the irregular adjustment of benefit amounts and thresholds to reflect the real cost of living. Government spending on social protection (excluding pensions) is also low, constituting less than 10 percent of the total state budget expenditure and approximately 4 percent of the GDP. Despite some benefits becoming more generous and the Social Reference

Index (SRI) increased, some benefits are not linked to the SRI and are adjusted on an ad-hoc basis without any indexation mechanism.

Education and Health spending played a critical redistributive role. Lower secondary education in Romania significantly reduces inequality among all in-kind transfers. However, spending on secondary education is significantly below the EU average, and equity challenges remain, notably with declining net enrollment rates and high early school leaving among lower-income groups. Addressing these challenges could make the fiscal system more equalizing. Specifically, implementing policies to reduce high school dropout rates among poorer demographics would enhance equity and further reduce inequality. Targeted interventions to keep lower-income children in school are crucial for maximizing the equalizing potential of the fiscal system.

Microsimulations show that recent fiscal reforms implemented since 2021 are making the fiscal system more pro-poor and slightly more redistributive. These changes are expected to result in a modest reduction in inequality and a reduction in poverty by 2.3 percentage points. This reduction is primarily driven by the expansion of direct transfers, which effectively offset the tax burden for lower-income households.

Despite these positive developments, there is still scope for achieving a more pro-poor fiscal policy with a mix of revenue and expenditure-based fiscal instruments. This can be done by implementing tax policies that increase government revenue while ensuring that higher-income individuals bear a larger share of the tax burden and reallocating subsidy spending to well-targeted transfers and subsidies for low-income workers. A proper mix of tax credits and social transfers is important to mitigate disincentives to formal employment and labor force participation.

Poverty and inequality could be reduced more effectively if Romania reallocate spending from tax exemptions and weakly targeted indirect subsidies to targeted social transfers and tax credits targeted toward the more vulnerable and elderly care. Based on a comprehensive fiscal incidence analysis presented in this chapter, along with findings from Chapter 2, we propose a fiscal package aimed at reducing poverty, enhancing equity, and improving welfare among Romania's most vulnerable demographics. This package includes measures to generate additional revenue, broaden the tax base, and allocate funds to well-targeted social protection schemes and more generous tax credits for vulnerable groups. Key priority areas include reducing poverty among sole earners, single-parent families, and families with three or more children. Additionally, addressing gender gaps is crucial, with a focus on expanding elderly care to support female-headed households with elderly dependents and female sole earners with dependent children or elderly relatives.

On the revenue side, we recommend eliminating sector-specific PIT exemptions, increasing marginal tax rates for top-income earners, and expanding the PIT allowance. These measures will help raise additional fiscal revenue while broadening the tax base, improving horizontal equity, and making the PIT more progressive. The expected outcomes include a significant increase in tax revenue and a more equitable distribution of the tax burden. However, a slight increase in poverty may result from the lower exemptions. Furthermore, we suggest eliminating most preferential VAT rates and exemptions, which are not well-targeted towards poor households. This reform is expected to raise additional VAT revenue and make the tax less regressive, though it may slightly increase inequality and poverty in the short term. Introducing a refundable Earned Income Tax Credit (EITC) is also recommended to reduce the

tax burden among low-income workers and incentivize labor force participation, especially among single mothers.

On the expenditure side, we propose phasing out implicit subsidies for electricity and gas and reallocating the savings to more targeted social protection measures.

Expanding the coverage and generosity of the Guaranteed Minimum Income (GMI) program, particularly for families with children and single elderly individuals, is crucial. This measure will enhance the progressivity of social transfers and significantly reduce poverty and inequality. Additionally, introducing in-kind benefits for elderly care will address the vulnerability of families with elderly dependents, particularly female-headed households, and reduce social inequities. This fiscal package is expected to reduce poverty and inequality while maintaining fiscal neutrality by reallocating resources from wealthier to poorer households.

This fiscal reform aimed at redistributing resources from wealthier to poorer households while maintaining fiscal neutrality holds promise for reducing poverty and inequality.

Simulation results indicate that the proposed fiscal package would lead to a decrease in the poverty headcount and the poverty gap and a reduction in inequality at the same fiscal cost. Moreover, the reform appears capable of offsetting the financial burden associated with specific policy changes, lifting some households out of poverty, and improving their position within the income distribution. Notably, vulnerable demographic groups, particularly female-headed households with children, stand to benefit significantly from the proposed measures, indicating a positive impact on gender disparities in poverty.

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