Fiscal Council opinion on the state budget and social insurance

Budget laws for 2011

On November 30th 2010, the Fiscal Council received from the Ministry of Finance a letter requesting, under Art. 40, paragraph (2) of Law no. 69/2010, opinions on: *the draft budget law for 2011*, *the report on the macroeconomic situation in 2011 and the projection for 2010-2014*, *the draft social security budget law for 2011*, and a *draft consolidated budget*. Under article 40, paragraph (2), letter d) of the fiscal responsibility law, the Council has the legal attribution to "analyze and issue opinions and recommendations, both before Government approval, and before submission to Parliament, on the annual budget laws."

Thus, given its mandate in accordance with the law 69/2010, the Fiscal Council issues the following opinions and recommendations on the budget projection for 2011:

The draft budget is consistent with the objective of fiscal consolidation

Fiscal Council commends the Government's commitment to a fiscal consolidation path compatible with the elimination of the excessive deficit by end of 2012. However, this is conditional on the elimination of arrears, since the 3% of GDP ceiling foreseen in the Stability and Growth Pact is based on ESA95 methodology (which takes into account the budgetary commitments), while the medium-term projection of the budget law envisages for 2012 a budget deficit of 3% of GDP set in cash terms. Reducing the budget deficit to 4.4% in 2011 is achievable, since the fiscal impact of the adjustment package adopted this year will be reflected in full in 2011, and if the efforts to keep spending under control as envisaged by the draft budget would materialize.

The Fiscal Strategy has not yet been adopted by Parliament

The medium-term Fiscal Strategy was adopted (later than the legal deadline) by the Government and submitted for Parliament approval together with the Law for the approval of mandatory indicators specified in the fiscal framework. However, the fiscal strategy and the mandatory ceilings provided according to the FRL have not been adopted so far by the Parliament. This will probably mean that the fiscal strategy and the draft annual budget laws will be adopted simultaneously with the corresponding amendment of the fiscal strategy, making it impossible to assess how the fiscal rules laid in Art. 6 of the Fiscal Responsibility Law are being observed by the 2011 draft budget law. Thus, in the context of this first iteration of the budget process after the adoption of the FRL, the medium-term targets are set according to the annual budget bill, which basically means that the observance of the FRL will be postponed for next year.

The medium-term budget projection meets the fiscal rules that can be evaluated

To the extent that the medium-term projection that accompanies the draft budget will be accommodated in the Fiscal Strategy for 2011-2013 to be adopted by Parliament, the Fiscal Council considers that the fiscal rule defined by article 6 letter d) of FRL: *"for each of the three years covered by the fiscal strategy, the annual growth rate of total general government expenditure will be kept below the nominal annual growth rate of gross domestic product forecasted for the respective budget year, until the consolidated budget balance records a surplus in the year preceding the year for which the budget is drafted"* is met, given that the expenditures to GDP ratio is forecasted to decrease from 39.4% in 2010 to 35.3 % in 2013.

Ad-hoc and non-transparent formulation of fiscal policy measures should be avoided

Nevertheless, the Fiscal Council considers appropriate to compare the 2011 draft budget with the fiscal strategy approved by the Government, despite the fact that the strategy will change in its final version to be approved by Parliament. This comparison allows capturing how the principle of stability in the FRL was observed.

Between the approval of the fiscal strategy by the government and the elaboration of the 2011 draft budget, significant fiscal policy measures have occurred or are envisaged, that were not even listed in the fiscal strategy. This situation is concerning since only two months have passed since the approval of the Fiscal Strategy and there have been no revisions to the macroeconomic framework during this period.

For example, eliminating the minimum tax came two weeks after adoption of the fiscal strategy by the Government, without prior consultation of the Fiscal Council or without legislating compensatory measures, breaching the provisions of Art. 13 of FRL. Moreover, the 2011 revenue and expenditure projections is based on envisaged legislative changes that were not explicitly mentioned in the fiscal strategy, were not announced for public debate and have not even been approved by the Government (for example, the recently announced changes on the amount and period for granting maternity benefits or the legislative changes indicated by the dynamics of the revenues from health insurance contributions - as detailed below). While the Fiscal Council understands the urgency of passing the budget laws before the end of the year, it would be desirable that at the time the annual budget is elaborated, the legislative changes underlying the revenue and expenditure projections are well defined and presented in a transparent manner.

The Fiscal Council does not challenge the need / opportunity for such discretionary fiscal policy measures, but has to mention that such an ad-hoc and non-transparent formulation of budgetary and fiscal policies conflicts with the principle of stability provided in the FRL and indicates that the Government did not give the required importance to its own medium term fiscal strategy. In these circumstances, the fiscal strategy appears more as a legal burden that the Government formally acquitted, although it should be the central instrument to create the framework for a consistent, predictable and ultimately credible fiscal policy.

Insufficient transparency in substantiating the budgetary revenues and expenditures

The Fiscal Council finds that the shortcomings in the transparent substantiation of the revenue projections and expenditure program have not been properly addressed, despite previous recommendations we made in the opinion issued on the Fiscal Strategy for 2011-2013 at the moment of its approval by the Government.

Therefore, the Fiscal Council has to reiterate the general recommendations made in the context of the Fiscal strategy, namely the need to improve the transparency of the revenues projections by detailing – for each component of revenue – the relevant macroeconomic bases, the elasticity considered and the impact of new legislative measures. As an example of lack of transparency we can mention the stated intention of harmonizing the Tax Code with *Directive 2010/12/CE on the structure and rates of excise duties applied on manufactured tobacco* without presenting the specific manner of its implementation. It is important to be mentioned whether the Directive will be transposed into the national law in a single step (in 2011), or spread over a certain period (in this case, a detailed timetable for implementation would have to be presented), given the fact that the deadline for transposing the EU Directive into national law in the case of Romania, is end December 2017.

Also, the comments on the desirability of further details on the substantiation of certain categories of expenditure remain relevant, such as specifying the assumptions underlying the subsidies expenditures (recording significant declines in nominal terms throughout the forecast horizon) or an explicit presentation of the quantitative assumptions on the number of employees and average earnings in the public sector underlying the medium-term trajectory of the public wage bill.

Low credibility of sectoral policies given their lack of integration with budgetary resources

In the Fiscal Council's opinion, the report accompanying the draft budget does not provide information on the integration of sectoral policies with corresponding budgetary resources. Defining clear priorities and strengthening the links between outcomes and costs is essential to measure and benchmark performance against resources, so that the budgetary allocations truly reflect national priorities in an explicit manner. In the lack of a transparent cost assessment, the declared policy objectives cannot be considered credible. In this regard, the Fiscal Council recommends that for each sectoral objective presented to be given clear implementation deadlines, performance indicators to allow monitoring, as well as details of the financial resources involved.

Revenue projections were revised upwards due to higher than expected performance of indirect taxes

The 2011 draft budget is built on a more favorable revenue projection as compared with the fiscal strategy approved by the Government (+2,509 million lei), while the general government revenues, excluding financial assistance from the EU and other donors increased by 1.801 million lei. The upward revision is the mainly due to higher revenues from VAT and excise duties (4,053 million lei), backed up by the better performance than originally envisaged of the indirect taxes in the current year. However, the additional revenue is partially offset by the downward revision relative to the Fiscal Strategy of the corporate income tax (-1.536 million lei) – stemming from the lower than originally envisaged performance in 2010, and the elimination of the minimum tax -, and by the decline in non-tax revenues compared to the level in the Fiscal Strategy (-741 million lei).

It is necessary to clarify the assumptions underlying the dynamics of revenues from health insurance contributions[1]

Although the macroeconomic forecast has not changed and the social contribution receipts in the current year was weaker than programmed by lei 1,013 million, the social contribution revenues are forecasted to increase by lei 428 million in 2011 relative to the level foreseen in the Fiscal Strategy approved by the Government. This upward revision is due to an increase by 17 percent of the revenues from health insurance contributions, which can be explained only if a legislative measure generating additional revenue is envisaged. Based on the available input at time of writing this opinion, the dynamics of this revenue item appears to be unrealistic. The Fiscal Council recommends for the Government to clarify the assumptions underlying the projection of this revenue item. Moreover, the Fiscal Council reiterates its reservations regarding the assumptions on the gross average wage growth and the number of employees, considering they pose a risk of underperforming on the scheduled revenues.

Weaknesses in the budgetary programming still persist

The upward revision in general government revenue (excluding financial assistance from the EU and other donors) was fully reflected in corresponding expenditure increases. Thus, compared with the levels in the Fiscal Strategy approved by the Government, the expenditure on goods and services and *'other transfers'* increase by lei 1,421 million and 1,452 million respectively, while the social assistance spending is programmed to decline by lei 1,406 million. While the increase in spending on goods and services programmed for 2011 could be explained by the payment of arrears accumulated by the public health system, the fact that throughout the medium term this spending item has been revised upwards by similar amounts (about 1,400 million lei annually, exclusively for the public health

[1] Subsequent note: At the moment of the elaboration of this opinion, the Government's intention to introduce the health contribution of 5.5% on pensions higher than 740 lei was not public.

system) relative to the levels in the Fiscal Strategy, still reflects shortcomings in the budgetary programming. The Fiscal Council recommends a more rigorous substantiation of the budgetary allocations to the health sector, based on policy objectives, which should be evaluated from the cost perspective in a transparent manner and linked to clearly defined structural reforms, especially given the fact that in the past, the mere reduction of spending for this sector, unsupported by structural reforms, resulted in arrears accumulation.

The upward revision of the *"other transfers"* is mostly due to the substantial increase in 2011 of Romania's contribution to EU budget (from lei 4,657 million in 2010 to lei 6,790 million in 2011), according to state budget summary table. However, this figure is not consistent with the table detailing Romania's contribution to the EU budget included in the report accompanying the budget bill, where the same contribution is programmed at lei 5,557 million in 2011.

Social assistance spending is revised downwards based on still not clarified legislative measures

Social assistance spending shows a significant decrease from the level estimated for 2011 in the Fiscal Strategy approved by the Government based on legislative changes that are still pending decision (e.g. changes of the maternity benefits legal framework or the replacement of the reference used for computing the unemployment benefit). In the absence of clarification on the final version of such legislative measures and the transparent presentation of the corresponding impact on government spending, the Fiscal Council cannot consider realistic the level of social assistance spending foreseen by the 2011 draft budget. Moreover, the substantial changes occurring in the formulation of the social assistance policies relative to what was presented in the Fiscal Strategy, despite the short period that has passed since its approval by the Government, conflict with the stability principle that should underpin a responsible fiscal policy.

It's also worth mentioning that the figure for social assistance spending in the 2011 draft budget as well as the medium term projections are based on the draft *law on public pension reform* that was not adopted so far .

Consistent wage policy

The target for personnel spending in 2011 remains unchanged relative to the level in the Fiscal Strategy, respecting the ceiling agreed with the international organizations, i.e. 39.000 million lei (excluding social security contributions paid by employees and employers in the defense, public order and national security sectors – lei 1,574 million). Compliance with this ceiling relies on a partial reversal of the wage reductions in 2010 (15 percent wage increase in the budgetary sector envisaged for 2011), accompanied by the elimination of the 13th salary and holiday bonuses, and on the lower employment resulting from the personnel reducing measures implemented during the current year (in October, MoF reported a reduction of 88,365 occupied positions compared with the levels in December 2009). However, the laws underlying the wage policy are not yet enforced, which is likely to generate risks for the compliance with the wage bill ceiling.

More transparency is needed in the formulation of investment priorities

In 2011, public investment is projected to increase by lei 1,736 million compared to the level in the Fiscal Strategy, reaching approximately lei 36 billion. It is commendable that public investment spending is more focused in 2011 on projects financed by European post-accession funds and reimbursable external funds, suggesting that the budgetary effort is channeled to infrastructure projects with multiplying effect in the economy. However, despite previous Fiscal Council recommendations for a list of national investment priorities there is no specific reporting on how public investment is allocated between different sectors, details on priority investment projects and corresponding multi-annual allocations. In the Fiscal Council's opinion, a transparent investment budget formulation based on an analysis of existing projects portfolio and its rationalization based on priority projects, together with a multi-annual allocation is essential for the efficient use of available resources. In addition, such an approach would be consistent with the principle of efficiency defined by the Fiscal Responsibility Law, which states that *"Government's fiscal policy will be based on the efficient use of public resources, will be defined according to economic efficiency and the decisions to allocate public investment, including those financed by EU funds, will be based inter alia on the economic assessment and the evaluation of absorption capacity."*

Efforts to reduce the stock of arrears have continued

The Fiscal Council acknowledges the Government's efforts to address the issue of arrears, an important step in this direction being the revision of the legal framework governing local governments' finances in order to enhance financial discipline. In this respect, Government Emergency Ordinance no. 63/2010 provides that no new budgetary commitments can be made unless the outstanding payments are cleared, and contains provisions that prevent the overestimation of own revenues by local authorities. However, one area where progress has been slow so far is related to the performance of state owned enterprises. Many of them still report very large losses and accumulate arrears. Efforts towards increasing effectiveness and financial discipline are necessary, especially since many of these companies are included in the general government sector according to ESA95 methodology, and the accumulated arrears and losses might endanger the compliance with the deficit ceiling of 3% of GDP by end 2012.

To conclude, the Fiscal Council considers that the draft budget laws are consistent with the objective of fiscal consolidation to correct the excessive deficit by end 2012. The adjustment path of the budget deficit is ambitious and requires a firm commitment from the authorities. However, fiscal responsibility implies more than just reducing the budget deficit and should also cover issues of transparency and legal framework predictability. Moreover, anchoring the fiscal policy in a well-founded strategic vision is essential in order to get more credibility. The Fiscal Strategy is the central document that can lead to achieving these goals, and the Fiscal Council hopes that it will be given sufficient attention in 2011.

The above opinions and recommendations of the Fiscal Council were approved by the President of the Fiscal Council, according to Art. 43, paragraph (2), letter d) of FRL, based on the vote of the Fiscal Council members in the meeting on December 6th , 2010.