Fiscal Council of Romania

Fiscal Council's Opinion on the State Budget Law and the Social Security Budget Law for 2020

Summary

- FC notes the progress in terms of transparency of the budgetary construction operated on the occasion of the 2019 second budget revision – in the sense of updating the revenue projection and of including certain outstanding obligations in the budgetary expenditures;

- The latest available information regarding the 2019 budget execution suggests, in the FC's opinion, an even more unfavorable evolution in comparison to the estimates of MPF. Thus, FC estimates a reduction in budget revenues, without taking into account those from EU funds, of at least 0.25 pp of GDP, while the risk of exceeding the budgeted level for expenditures with goods and services probably materialized at a level of at least 0.2 pp of GDP. This data will have a corresponding impact on the subsequent budgetary constructions;

- Following the adoption of the draft budget for 2020, a series of changes in the level of taxes took place, mainly in the sense of reducing them. Cumulatively, these will lead to lower budget revenues by about 0.5 pp of GDP and, *ceteris paribus*, to a higher budget deficit for 2020 with the same amount;

- The aforementioned evolutions translate into an even greater strain of the public budget, a state underlined by FC's recent opinions which is characterized by low tax revenues and very high pressures on its resources;

- Considering the information available at this moment, FC estimates that the 2020 budget deficit will be in the 4.6 – 4.8% of GDP range, representing a deviation of 1 – 1.2 pp of GDP from the MPF target; this very complicated situation calls for further consolidation measures;

- The planned increase of the pension point by 40% from September 1st, 2020 would take place in the context of an already large budgetary slippage. Even without this measure, FC estimates that the 2020 budget deficit would be around 3.8 – 4.1% of GDP;

- The impact of the 40% increase of the pension point from September 1st, 2020, as well as of the other measures included in the new pension law, will be fully observable in 2021, the FC estimate regarding the budget deficit for that year being over 6% from GDP (in the absence of compensatory measures). The deterioration would continue in 2022, to over 7% of GDP. Under these conditions, a correction to levels close to the 3% of GDP threshold for the budget deficit, envisaged by authorities in the medium-term fiscal-budgetary framework, appears to be extremely ambitious, problematic and, at the same time, absolutely necessary; it is hard to imagine that the financial markets would tolerate budget deficits of such magnitude;
- In FC's opinion, the later the budgetary correction will start, given the increasing risks in the sense of poorer economic and fiscal performance, the stronger the necessary corrective measures and the higher their associated economic and social costs;
- The budgetary correction is demanded not only by the danger of entering the EDP, but also by the need to prove that we are able to regain control over the public finances; the corrections induced by financial markets are more painful than those made internally and on time;
- The budgetary consolidation is essential for the macroeconomic consolidation;
- The Government's intention to reform NAFA, also by computerizing the revenue collection activity which can significantly support the budgetary consolidation, is salutary;
- Fiscal activism which is advocated in other EU countries and in the USA is not feasible given the large internal and external deficits of Romania; we note here that the Romanian RON is not a reserve currency;
- The fiscal-budgetary policy maintains its expansionary character, even under the conditions of a budget deficit that has considerably exceeded the 3% of GDP threshold imposed by the corrective arm of the Stability and Growth Pact. This evolution is in contradiction with the national and European fiscal rules, as well as with the fiscal policy of all the other EU countries (except for Estonia).

Fiscal Council's Opinion on the State Budget Law and the Social Security Budget Law for 2020

Following the address no. 467417/16.12.2019, received from the Ministry of Public Finance (MPF), the Fiscal Council (FC) issued on December 18th, 2019 a preliminary opinion on the Report on the macroeconomic situation for 2020 and its projection for the 2021-2023 period, on the draft law of the state budget for 2020, on the draft law of the social security budget for 2020 and on the associated substantiation note, which formulated general considerations and evaluated the conformity of the budget proposal with the fiscal rules stipulated by the Fiscal Responsibility Law (FRL). The decision to issue a preliminary opinion took into account the insufficient time available to the FC for the analysis of the documents and the elaboration of the requested opinion, as a result of the Government's intention to approve the above mentioned documents during the meeting scheduled for December 18th, 2019. This text complements the preliminary opinion issued by the FC on December 18th, 2019. One week before, FC also issued an opinion on the Fiscal Strategy for the 2020-2022 periods, the analysis not being done *in extenso* for the same reasons. Given this motive, the present opinion also includes references to the medium-term fiscal-budgetary perspectives.

In the meantime, the projects of the State Budget Law and of the Social Security Budget Law for 2020 have continued their legislative course, being adopted on December 23rd, 2019 through assuming responsibility by the Government in the Parliament, and then promulgated on January 6th, 2020, so that at the time of elaboration of this opinion they are enacted as Law no. 5/2020, respectively as Law no. 6/2020. Also, the draft law of ceilings for some indicators specified in the fiscal-budgetary framework is enacted as Law no. 238/2019.

The fiscal-budgetary framework - context

<u>The second budget revision, implemented at the end of November 2019, marked a major amendment of the budget deficit from 2.76% to 4.43%[1] of GDP according to the cash methodology</u>, corresponding to an increase of the budget deficit according to the European methodology from 2.57% to 3.82% of GDP. The significant increase of the estimated budget deficit was due to the downward revision, of an unprecedented magnitude since the adoption of the FRL, of the general consolidated budget (GCB) revenues (-18.3 billion lei), while the total budgetary expenditures recorded a much smaller decrease (-2.1 billion lei).

[1] It is worth mentioning here the change made after the elaboration and publication of the FC's Opinion on the second budget revision, respectively the increase of the budget deficit from 4.3% to 4.43% of GDP.

The major fiscal slippage occurred as a result of the significant overestimation of revenues, even from the initial budgetary construction that was maintained during the first budget revision, other factors being the slowdown of the economy, the non-realization of temporary revenues, as well as the massive increase of social assistance and capital expenditures. <u>Thus, it is estimated that 2019 marked a considerable exceeding of the 3% threshold for the budget deficit, beyond which the European Commission (EC) can trigger the excessive deficit procedure (EDP)</u>.

FC notes the progress towards transparency of the budgetary construction operated on the occasion of the 2019 second budget revision - in the sense of updating the revenue projection and of including certain outstanding obligations in the budgetary expenditures. The precise identification of the budgetary revenues and expenditures from the previous year is relevant as it represents the starting point in the budgetary construction for 2020. In its opinion on the second budget revision, **FC has shown the need for credible budgetary consolidation measures**, considering the estimated level at that time of the budget deficit and its medium-term outlook.

FC welcomes the Government's intention to reform NAFA (National Agency of Fiscal Administration), also by computerizing the revenue collection activity. This reform can make a significant contribution to the budgetary consolidation (in the sense of reducing the deficits), but it would be unwise for the public budget to rely on uncertain revenues.

The latest information available on the 2019 budget execution suggests, in the FC's opinion, an even more unfavorable evolution compared to the estimates of MPF from the second budget revision, respectively lower revenues and higher expenditures. Thus, FC estimates a reduction in budget revenues, without taking into account those from EU funds, of at least 0.25 pp of GDP, while the risk of exceeding the budgeted level for expenditures with goods and services – previously highlighted by FC – probably materialized at a level of at least 0.2 pp of GDP. These developments also have an impact on the subsequent budgetary constructions, given their permanent character, a correction demanding new fiscal-budgetary policy measures. Even if, from the perspective of the 2019 budget deficit, a possible reduction of investment expenditures would be able to accommodate, at least in part, the influence of these factors, it would probably have only a temporary effect, respectively at the level of 2019. **In conclusion, these permanent factors lead to a more unfavorable starting point by about 0.45 pp of GDP for the budgetary construction, which is equivalent to a higher deficit at the level of 2020 by the same amount, other conditions being unchanged**.

Objectives and targets of fiscal-budgetary policy for the 2020 – 2023 period

The budget construction for 2020 envisages a deficit target of 3.59% according to the cash methodology, representing a decrease of 0.84 pp of GDP compared to the level estimated for 2019. The corresponding deficit target for 2020 according to ESA 2010 methodology is 3.58% of GDP, the reduction of the 2020 budget deficit compared to the level estimated for the previous year being of only 0.23 pp of GDP. This evolution is compatible, according to the MPF, with a reduction of the structural deficit by 0.32 pp of the potential GDP, respectively from 3.71% to 3.39%.

It is worth mentioning that the reduction of the cash deficit from 2020 compared to 2019 is supported by two one-off elements: the repayments of the car tax made in 2019 in the amount of 2.8 billion lei and the expected 2020 revenues of 2.5 billion lei from the rental of 5G frequency bands for the next 10 years by mobile operators. These elements justify a reduction of the cash deficit in 2020, compared to 2019, of about 0.47 pp of GDP, without implying any adjustment efforts. Moreover, this aspect is fully observable at the level of the budget balance according to ESA 2010, which does not improve as much as the one according to the cash methodology, the two elements described above affecting the budget execution according to ESA 2010 only to a very small extent.

Beyond the reduction of the planned cash deficit due to the one-off elements described above, the decrease of the budget deficit has as main sources the decrease (as share of GDP) of personnel expenditures (by 0.17 pp), of those with goods and services (by 0.21 pp) and of capital expenditures (by 0.45 pp) partially offset by the increase of social assistance expenditures by 0.61 pp of GDP, as a result of the pension point increase by 40% from 1 September 2020. In essence, the budget accommodates large pressures at the level of social assistance expenditures by a discretionary reduction of capital expenditures and by maintaining a growth rate lower than the one of nominal GDP for personnel and goods and services expenditures, while the structural adjustment of the budget deficit is minimal.

The fiscal-budgetary framework for the 2021-2023 period aims at an even more significant reduction of the budget imbalance, the GCB deficit being scheduled to improve at the end of this period compared to 2020 by 1.83 pp of GDP according to the cash methodology, leading to a level of 1.76% of GDP, and by 1.54 pp of GDP according to European methodology, leading to a level of 1.94% of GDP. In structural terms, according to the MPF, the deficit adjustment represents 1.54 pp of the potential GDP, a 0.85 pp deviation from the medium-term objective - represented by a structural deficit of 1% of the potential GDP – still persisting at the end of 2023.

The 2020 budget – problematic issues

Compared to the fiscal parameters that defined the basis of the budgetary construction already enacted, significant changes have occurred which are likely to affect the projection of budgetary revenues and, *ceteris paribus*, the budget balance. Thus, the reduction of excise duties on energy products and the elimination of over-taxation for part-time employees became a certainty, while the additional taxation of the energy sector and of the banking sector, established by GEO no. 114/2018, was repealed. The impact of these measures was not included in the estimation of revenues, a decision noted by the FC in its preliminary opinion on the draft budget, despite the fact that they were either in the final stage of the legislative process (in the case of excise duties on energy products and of the taxation of part-time contracts), or on the immediate agenda of the Government (in the case of GEO no. 114/2018).

According to FC's estimates, the reduction of excise duties on energy products has a budgetary impact, including VAT, of -3.6 billion lei or 0.32 pp of GDP; eliminating the over-taxation of part-time employees leads to a minus for the social security contributions revenue of 1.56 billion lei or 0.14 pp of GDP, while repealing some provisions of GEO no. 114/2018 (elimination of the tax on bank assets and of the additional taxation of the energy sector) has a negative impact estimated at 0.1 - 0.15 pp of GDP.

In the sense of increasing the budget revenues, it has acted an additional increase of the excise duty on cigarettes, which is expected to generate an additional revenue of about 0.7 billion lei. **Cumulatively, these measures lead to lower budget revenues by around 0.5 pp of GDP and, *ceteris paribus*, to a higher level of the 2020 budget deficit with the same amount**.

Taking into consideration the above mentioned elements, the budget deficit for 2020 (4.1%) according to ESA 2010 is higher by 0.3 pp of GDP compared to the estimated level for 2019 (3.8%), whereas its reduction according to the cash methodology is attributable only to the one-off factors previously described that **cannot account for a structural adjustment of the GCB balance.**

The fiscal-budgetary policy maintains its expansionary character, even in the context of a budget deficit that exceeded the threshold of 3% of GDP imposed by the corrective arm of the Stability and Growth Pact (SGP). This situation involves several challenging aspects:

i) The result of the 2019 budget execution 2019 will most likely indicate a budget deficit according to ESA 2010 around the level of 4% of GDP, which creates the prerequisites for triggering the EDP. Basically, the budget for 2020 does not respond to the need to correct this slippage if we consider the fiscal-budgetary measures included in the draft budget and the legislative measures adopted shortly after the budget law. **FC considers that there are not enough measures to offset the budget slippage and, moreover, it is deepening both in 2020 and in the medium term under the given conditions;**

ii) Such high levels of the budget deficit, even if admitting that they would be tolerated by the financial markets (which is a "heroic" hypothesis), lead to the accumulation of public debt and to the massive vulnerability of the public finances, the fiscal space being practically exhausted. This would lead to the impossibility of using the fiscal-budgetary policy in the recession phase of the business cycle and, very likely, it will impose fiscal corrections contributing to maintaining the pro-cyclical nature of the fiscal-budgetary policy. The benefits generated by the unnecessary application of fiscal incentives in the boom phase of the economy will be outweighed by the economic and social costs associated with their eventual withdrawal during the recession; <u>it is to be mentioned that, in countries that do</u>

not issue reserve currency, fiscal activism cannot be sustained for longer periods, or when internal and external deficits are large (as in the case of Romania);

iii) Moreover, having high levels of the budget deficit alongside with a public debt level that can no longer be considered as low, leads to an increase of the probability of a budget deadlock, with multiple ramifications on the macroeconomic situation and financing costs. This risky position is amplified by factors such as the level of the current account deficit (being singular in the region regarding its size and deteriorating financing structure) and the prospect of altering the sovereign rating in the absence of corrective measures considered as adequate and timely by the rating agencies;

iv) Such a situation is in contradiction with the fiscal rules laid down at European and national level, now the deviations being not only located at the level of the preventive arm of the SGP, but also at the level of its corrective one. **If, in the recent years, the only functional benchmark from the perspective of national and/or European fiscal rules has been represented by the 3% of GDP threshold for the budget deficit, now even this is exceeded and the path is towards deepening the deviation.** The previous recommendations of the EC, formulated in the context of the significant deviation procedure from the medium-term objective, as a result of the violation by Romania of the provisions of the preventive arm of the SGP, respectively the reduction of the structural deficit by 1 pp in 2019 and by 0.75 pp in 2020, have not been implemented by the Romanian authorities.

According to estimates, in 2019 Romania had the highest level for the budget deficit among the EU member states, both in terms of actual deficit and structural deficit, and the deterioration of the budget balance during the 2015-2019 period was by far the highest in the EU (see the graphs in *Annex no. 1*). During this period, all EU countries[2] have improved their budget balance, Romania being divergent in terms of fiscal-budgetary policies at European level; the high levels for the budget deficits will have, sooner or later, a correspondent increase in the public debt.

In the case of Romania, the slight reduction in the share of public debt in GDP during this period is explained by the high growth rates of nominal GDP and the low interest rates at international level, which generated a favorable differential between economic growth and the interest rate paid on public debt, concealing the accumulation of public debt generated by the high levels of the budget deficit. The return to lower growth rates of the nominal GDP - either due to the economic cycle[3] and/or the deterioration of the macroeconomic indicators due to fiscal and budgetary policy conduct - will most likely lead to an alert

[2] Except for Estonia.

[3] At the international level, the current economic cycle is characterized by an unusually long duration, taking into account historical developments, and the probability of its ending - by returning to the recession phase - increases over time.

increase in the share of public debt in GDP. This would be more visible if a market risk reassessment and a stronger differentiation between emerging economies would take place. Even if the gap up to the threshold of 60% of GDP provided by the European treaties is still high, there are serious arguments for which the tolerance of the Romanian economy to public indebtedness could be lower than this threshold; among these arguments are the level of development of the Romanian economy, the limited capacity of public debt absorption by the very narrow domestic financial market, the cost of financing the deficits that can grow very quickly, etc.

Regarding the macroeconomic framework underlying the budgetary construction for 2020, FC has already mentioned, in its preliminary opinion, problematic issues. Thus, FC estimates that the projected increase for the real GDP is overestimated by at least 0.5 pp compared to the forecasts of other financial institutions and taking into account the most recent developments; also the labor market indicators are optimistic, at least in terms of growth in the number of employees in the economy. Thus, the National Commission for Strategy and Prognosis (NCSP) forecasts an increase of 2% for this indicator, higher compared to 2018, although the statistical data indicates a slowdown compatible with the one of economic growth and with the high degree of labor market tightness. FC estimates that the wage envelope in the economy is more likely to be at least 1 pp lower which, in conjunction with a smaller increase of real GDP by 0.5 pp, has the potential to lead to lower budget revenues by at least 0.15 pp of GDP.

Also problematic from the perspective of the fiscal-budgetary policy conduct is the high level of the current account deficit; in 2019 the external imbalance was generated, probably, in proportion of over 80% by the saving-investment balance in the public sector. The slowdown in the economic activity of the main trading partners, against the background of the trade war, the uncertainties regarding Brexit and the deceleration of the main economies in Asia represent additional arguments in favor of correcting the external imbalance mainly through the budgetary consolidation, in order to protect the Romanian economy.

Another questionable element of the budgetary construction for 2020 is the projection of goods and services expenditures whose growth rate in 2020 is only 3.7%, close to the average inflation forecast for the current year of 3.1%. Moreover, this level is significantly lower than the nominal GDP growth of 8.5%, the evolution of this budgetary aggregate thus representing a source of fiscal consolidation in the amount of 0.21 pp of GDP. Such an evolution is uncertain given that, most likely, the budget execution for the year 2019 will mark a considerable deviation from the target proposed by the second budget revision and, in the absence of concrete measures such as deep reforms of the public procurement system, FC considers the growth rate projected for this category of expenditures is difficult to attain.

Investment spending is projected to increase slightly in the 2020 budget, respectively by 0.2 pp of GDP, compared to the level estimated by MPF for 2019 based on the growth of investment expenses financed through EU funds by 0.6 pp from GDP, partially offset by a decline in investments financed from domestic resources by 0.4 pp of GDP. This decline is mainly determined by the reduction of allocations to the National Program for Local Development (NPLD) by about 5 billion lei. The substitution of investments financed from domestic resources with investments financed through EU funds, thus freeing resources, represents, in the FC's opinion, a correct and welcome approach under the condition of materializing the absorption of European funds at the projected level. However, as FC pointed out in its preliminary opinion on the draft budget, the co-financing and ineligible expenditures included in the 2020 budget appear to be insufficient to support the absorption of EU funds at the level foreseen in the GCB, which represents an additional source of risk to the 2020 budget deficit.

<u>An element having a major impact on the budgetary construction for 2020, as well as for the following years, is the increase of expenditures related to the social security budget</u>, determined, on one hand, by the payment at the level of the whole year of the pension benefits increased by 15% on September 1st, 2019 (which generates additional budget expenditures of about 6.4 billion lei in comparison to 2019) and, on the other hand, by the expected increase of 40% scheduled for September 1st, 2020 (which generates additional budgetary expenditures of 10 billion lei, corresponding to 4 months of implementation in 2020). This situation involves several aspects that complicate the state of the public budget:

i) The additional increase of significant amplitude scheduled for September 1st, 2020 would take place in the context of a current substantial budget slippage (the budget deficit considerably exceeding the 3% of GDP threshold, beyond which the EDP can be triggered). Even without this measure, respectively under the conditions of maintaining the value of 1,265 lei for the pension point throughout the year 2020 (which is equivalent to an increase of the average annual pension of about 8% compared to 2019), the FC's estimate for the 2020 deficit is about 3.8 - 4.1% of GDP;

ii) The 40% increase of the pension point scheduled for September 1st, 2020, in the context of an inflation forecast below 4%, would represent by far the highest rate of real growth for the last 30 years. Over the last 2 and a half years, the rules-based approach for indexing the pension point has been abandoned, although it is still included in the legislation, in the favor of a discretionary approach, as the Government arbitrarily has established the value of the pension point. In the FC's opinion, the rules-based approach has many advantages, mainly ensuring the sustainability of the social security budget and of the GCB in general, while eliminating the risk of practicing inconsistent policies over time, with suboptimal results in the long run;

iii) **The implementation of this increase from September 1st, 2020, included in the draft budget, has major implications not only on the current year, but especially over the medium term**. Thus, for 2021 the implementation of this measure generates additional expenses compared to 2020 of more than 22 billion lei, while other provisions[4] included in the new pension law - which comes into force on September 1, 2021 – will generate additional expenses of about 11 billion lei.

[4] Scheduled increase of the minimum pension and modification of the pension calculation formula.

Together, all these measures generate additional spending by 33 billion lei compared to 2020. Considering the share of the social assistance aggregate in GDP, it will increase continuously, compared to the previous year, by: 0.6 pp of GDP in 2020, by 1.85 pp of GDP in 2021 and by 0.85 pp of GDP in 2022. Beyond the difficult situation of the GCB for the current year, the application of the new pension law according to the current calendar significantly and permanently deepens the existing slippage. It is difficult to imagine how such an evolution can be consistent with reducing the budget deficit and bringing it closer to the 3% threshold, as the authorities stated as their intention. And what matters even more, it would destabilize the domestic economy by forcing at some point very painful economic and social corrections.

Considering the above, FC estimates the level of the budget deficit for 2020 at around 4.6 - 4.8% of GDP, resulting a deviation from the MPF target of 1 - 1.2 pp of GDP, which calls for further fiscal consolidation measures.

The balance of risks, in the FC's opinion, seems tilted to the negative side, respectively towards a higher budget deficit, due to additional pressures that may arise from: more unfavorable economic developments at international level, the application of the decision to double the child allowances, delayed until August 1st, with an estimated impact of 2.9 billion lei in 2020, recording a more alert increase of the expenditures on goods and services. In the opposite direction, it could act the reduction of investment spending, but it is unlikely that it will be able to accommodate the possible materialization of the risks described above.

Fiscal and budgetary outlook on the medium term

Considering the medium-term fiscal-budgetary framework, the FC identifies the following problematic aspects:

i) Similar to the FC's objection on the draft budget for 2020, the tax changes adopted after the budget law was enacted (the reduction of excise duties on energy products, the elimination of over-taxation on part-time contracts, of the tax on bank assets and of the additional taxation of the energy sector and the increase of excise duties on cigarettes) also influences the projection of budgetary revenues in the medium term, leading to their reduction with about 0.5 pp of the GDP;

ii) According to the FC’s evaluation, the starting point of the budget projection, respectively the 2019 budget execution[5], is more unfavorable with at least about 0.2 pp at the level of budget revenues and with about 0.25 pp at the level of budget expenditures. Thus, in the absence of

[5] Estimated by FC based on the 11 months execution.

compensatory measures, in the medium-term the budget deficits will be higher by 0.45 pp of GDP;

iii) In the FC's opinion, the impact of the new pension law is only partially taken into account in the medium-term budgetary projection, **as the social assistance expenditures appear to be undervalued by about 1.3 pp of GDP in 2021, respectively by 2.4 pp of GDP in 2022;**

iv) In the FC's opinion other risk sources are: very optimistic macroeconomic forecast beyond the year 2020, which is well above than the one of international financial institutions, an ambitious adjustment, that is not accompanied by detailed measures to support it, of capital and goods and services expenditures, as well as additional expenditures caused by a possible substantial increase of allowances for children. To the contrary, it could act the manifestation of positive results generated by the measures already undertaken by NAFA, and those which will be adopted for increasing the collection rate, being sufficient space in this respect.

Assessing the fiscal prospects in the medium-term, the FC appreciates that there have not been adopted enough credible measures to reduce the budgetary slippage in line with the trajectory announced by authorities and moreover the slippage is deepening significantly. **Thus, considering unchanged policies, the FC estimates as being probable levels of the budget deficit higher than 6% of GDP in 2021, respectively higher than 7% of GDP in 2022. It has to be reiterated that such levels of the budget deficit are difficult to imagine as being tolerable by the financial markets and the economic reality in general, which is massively influenced by the increasingly uncertain and complicated international context; before reaching such thresholds, corrections of the deficit would be induced - which would be more painful as they would be delayed.**

Conclusions

The significant exceeding of the 3% of GDP threshold for budget deficit, estimated to have occurred in 2019, persists in 2020, and in the medium term under the given conditions. Although the draft budget for 2020 takes into account a reduction of the budgetary slippage, the tax decreases operated at a short time after the adoption of the budget law, as well as additional weaknesses of the budget execution for 2019, compared to the parameters approved by the second budget revision are leading to a probably deepening of the budgetary imbalance in 2020.

Considering the available information at this moment, **the FC estimates a likely level of budget deficit for 2020 between 4.6 – 4.8% of GDP**. The difference compared with the draft budget target of 3.6% comes from: i) 0.45 pp of GDP from the probable deterioration above the expectations of the budget execution for 2019, which represents the starting point for the subsequent budgetary constructions; ii) 0.5 pp of GDP from the modification of taxes after the adoption of the draft budget for 2020; iii) 0.15 pp under the assumption of a more plausible (prudent) macroeconomic forecast.

<u>The FC appreciates that are necessary additional measures concerning budgetary revenues and expenditures to ensure the convergence with the deficit target proposed for the current year.</u>

The planned increased of the pension point by 40% from September 1st, 2020 takes place in the context of an already existing significant budgetary slippage. Even without this measure, the FC's estimation regarding the budget deficit for the current year would be about 3.8 – 4.1 % of GDP, which translates into an even more severe budget strain, given the scarcity of available resources compared to the obligations currently undertaken, even without taking into account the future ones.

The impact of increasing the pension point by 40% from September 1st, 2020, as well as that of the other measures included in the new pensions law will be fully observable in 2021, implying an increase of social assistance expenditures share by another 1.85 pp of GDP compared with the current year and a level of the budget deficit around 6% of GDP. In 2020 the deficit would exceed 7% of GDP. Such levels of deficit are difficult to imagine as being accepted by the markets and indicate the need for timely correction. In these conditions, a correction towards levels close to the 3% of GDP threshold for the budget deficit, also considered by the authorities in the medium-term fiscal framework, appears to be extremely difficult to achieve. Therefore, the increase of the budget deficits should not be accepted, and the consolidation should start as early as 2020.

High and increasing levels of the budget deficit (admitting that the markets would tolerate them for a while) would determine public debt accumulation and major vulnerability of the public finances; the fiscal space would not exist which would lead to the impossibility of stimulating the economy in the recession stage of the economic cycle and more, it would inevitably impose fiscal corrections, contributing to maintaining the pro-cyclical nature of the fiscal-budgetary policy.

The need for budgetary consolidation should also be considered in correlation with the prospect of changing the sovereign rating, the correction being mentioned explicitly as a key element in the perspective of the future evaluations of the rating agencies. In this very difficult budgetary context, initiatives regarding tax cuts, as well as expenditures increases are not justified, being contrary to the logic of budgetary consolidation. Furthermore, the later the budgetary correction starts, the greater the extent of the necessary corrective measures will be and, implicitly the greater the economic and social costs.

The budgetary consolidation is essential for the macroeconomic consolidation.

The need for budgetary corrections, for consolidation of the public budget must be considered not only in conjunction with the danger of entering EDP, but also considering the need to demonstrate that we are able to regain the control over public finances; the corrections induced by the financial markets are more painful than those made internally and in time.

If, over the past years, the only functional benchmark from the perspective of national and/or European fiscal rules has been represented by the 3% of GDP threshold for the headline budget deficit, this is now exceeded, and the trend is to increase the deviation compared to it. The prospect of Romania's placement in the EDP appears difficult to be avoided, and this should urge prompt corrections.

The balance of risks related to the budget balance for 2020 is tilted, in the FC's opinion, on the negative side, respectively the registering of a higher budget deficit; additional pressures on the budget could arise from: more unfavorable economic evolutions at the international level, application of the decision to double the children allowance, extended after August, 1st, the registering of a more alert increase of the expenses with goods and services. In the opposite direction could act an investment expenditure decrease, but it is unlikely that this could compensate for a possible manifestation of the risks described above.

Regarding the fiscal prospects in the medium term, considering unchanged policies and tolerance (hard to believe) from the markets, the FC appreciates as being probable levels of the budget deficit higher than 6% of GDP in 2021, respectively higher than 7% of GDP in 2022. In these conditions and taking into account the complicated domestic and international economic context, including from the perspective of the costs and availability of financing, it is obvious the need to adopt large-scale corrective measures as quickly as possible, that are able to bring the fiscal situation back on a sustainable path, and in accordance with national and European fiscal rules.

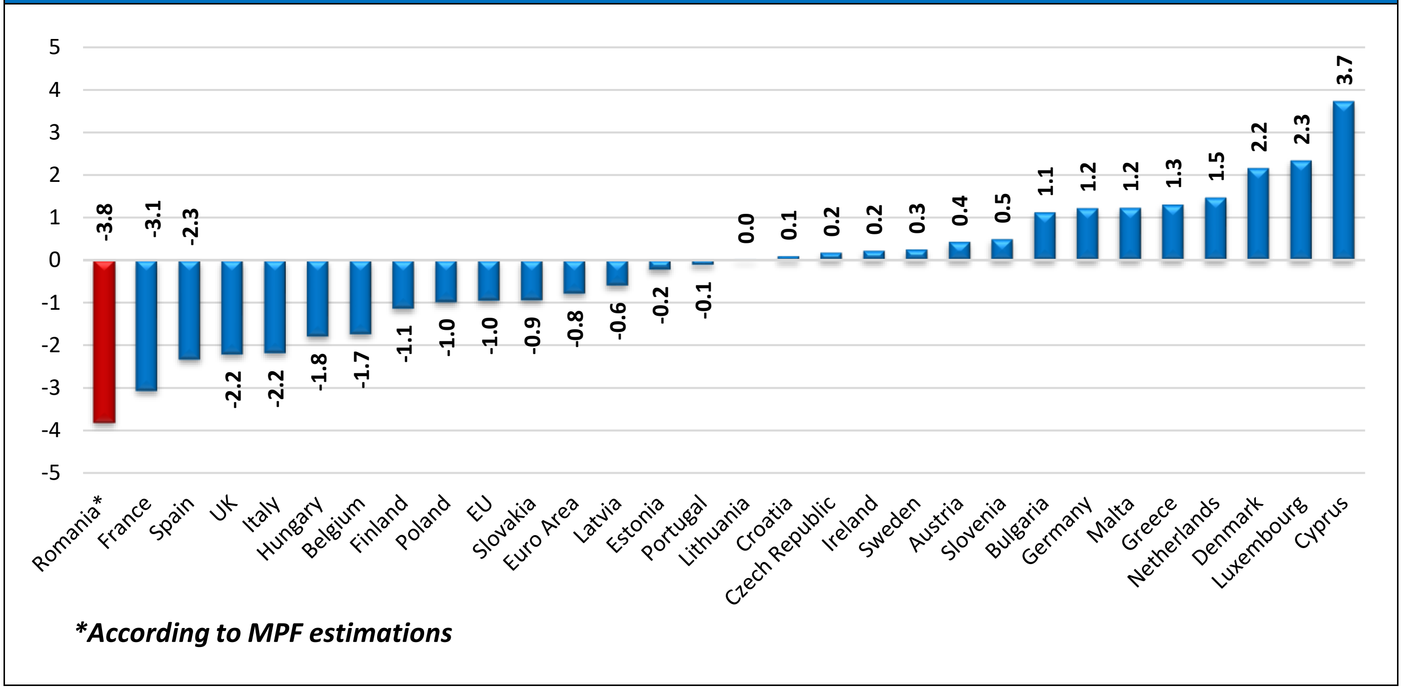
The opinions and the recommendations above mentioned by the Fiscal Council were approved by the Chairman of the Fiscal Council, according to Art. 56, para (2) letter d) of the Law no. 69/2010 republished, after being approved by the Council members, through vote, on 22th of January, 2020.

22th of January 2020 Chairman of the Fiscal Council

Professor Daniel DĂIANU

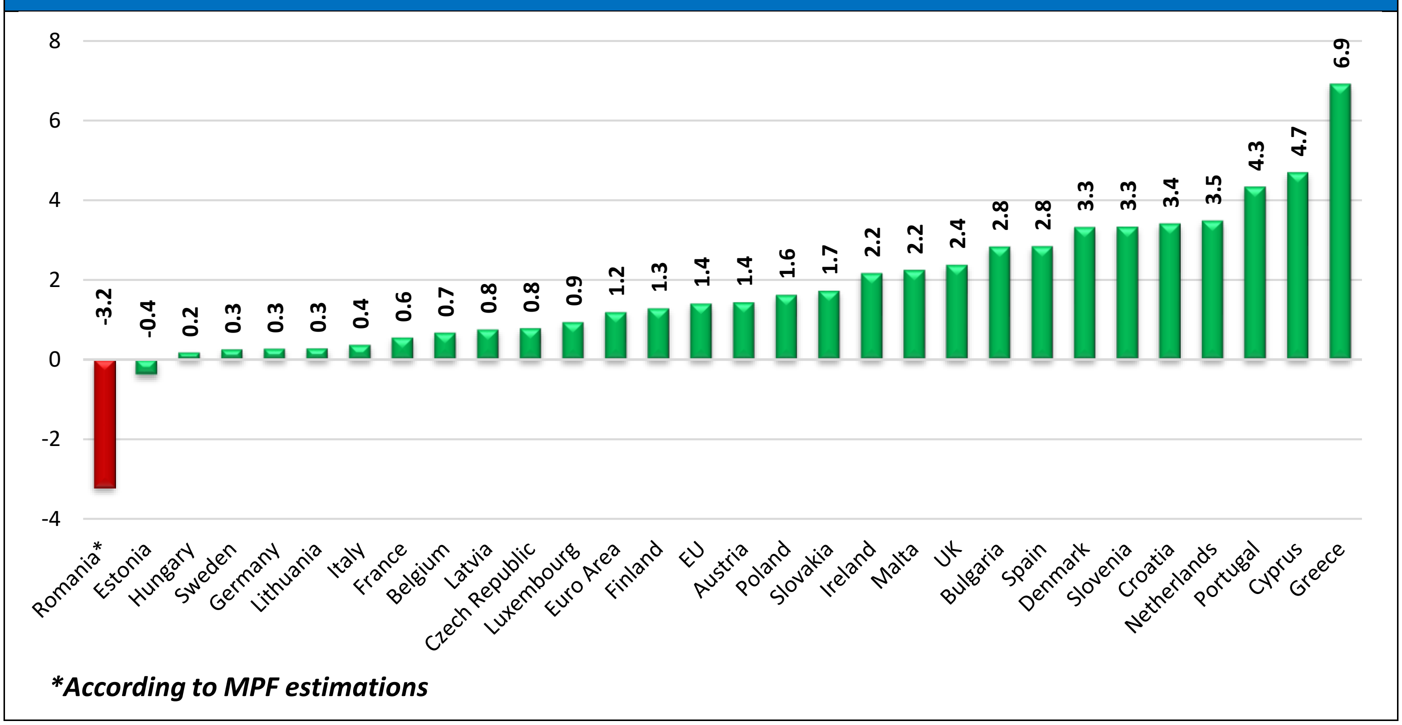
ANNEX 1

Figure 1: Budget balance in EU countries in 2019 (% of GDP, ESA 2010 standards)



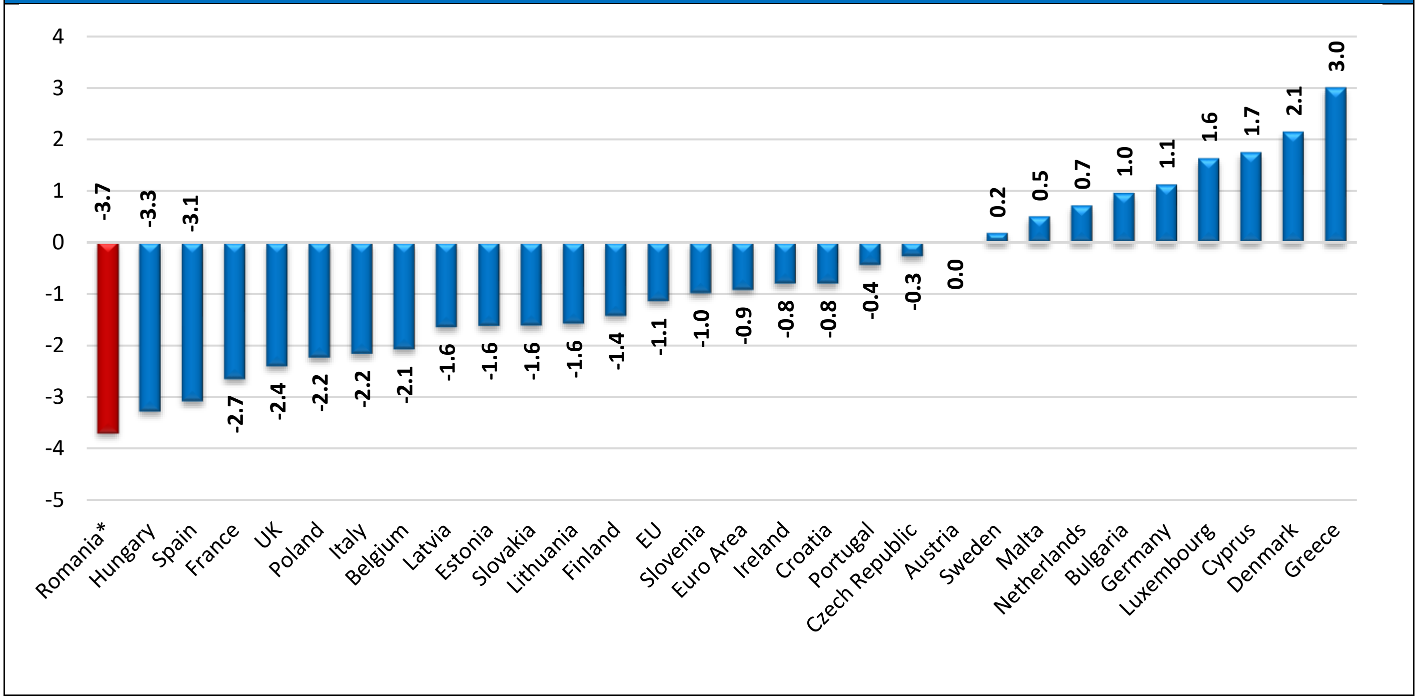
Source: Ameco, MPF

Figure 2: Budget balance difference 2019-2015 in EU countries (pp of GDP, ESA 2010 standards)



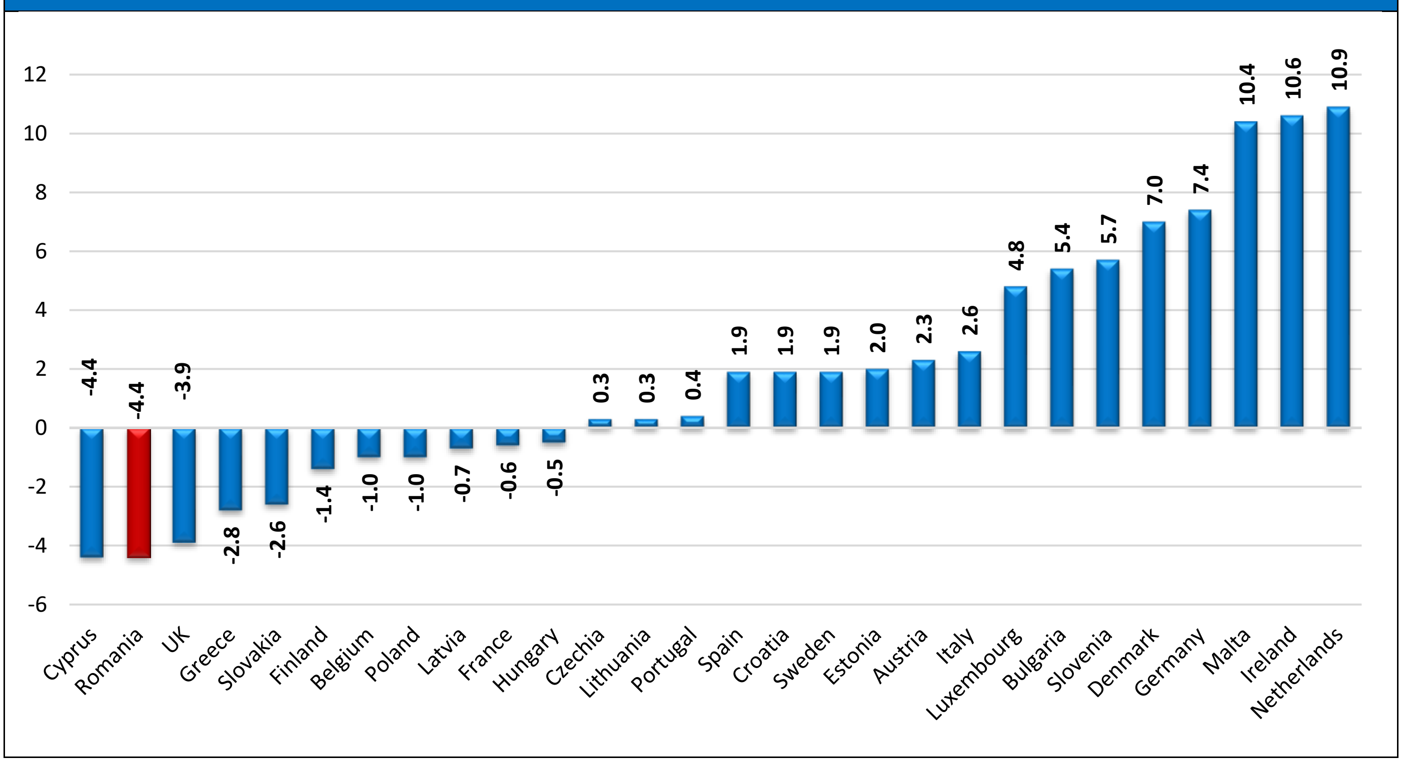
Source: Ameco, MPF, FC's calculations

Figure 3: Structural budget balance in EU countries in 2019 (% of potential GDP)



Source: Ameco, MPF

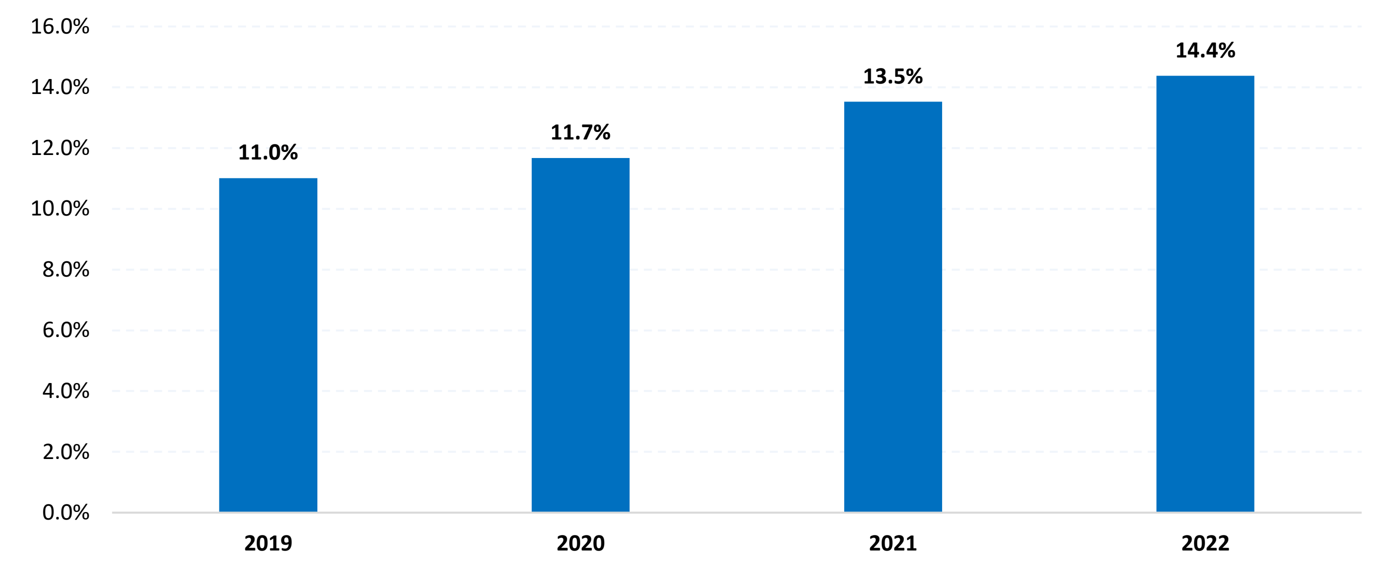
Figure 4: Current account balance in EU countries in 2018 (% of GDP)



Source: Eurostat

ANNEX 2

Figure 5: Social assistance expenditures in the period 2019 - 2022 (% of GDP, cash standards, FC's estimation and projections)



Source: FC's calculations based on the impact assessed by MPF in the explanatory note accompanying the law, NCSP

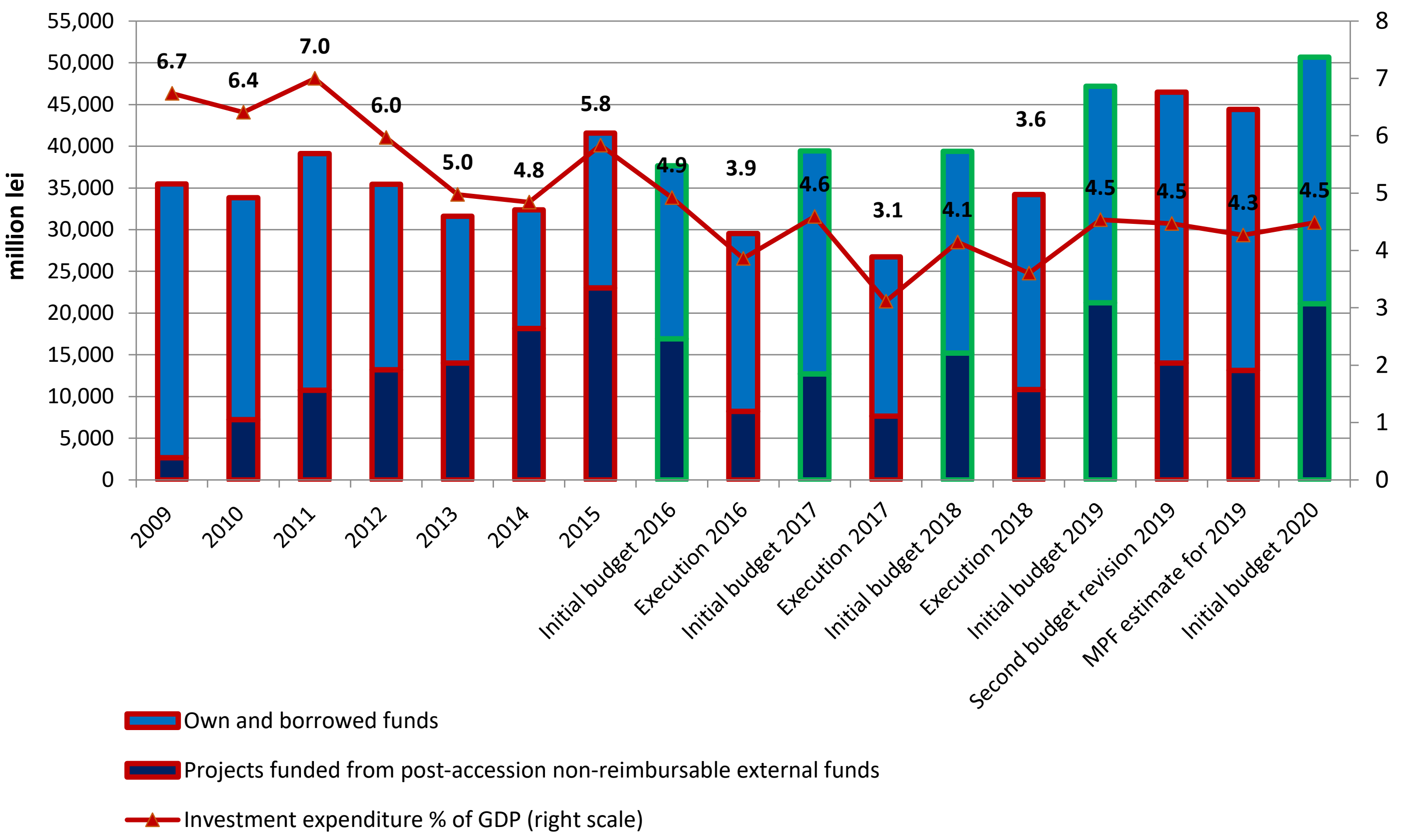
Table 1: The budgetary impact of the provisions of the pension law on the social assistance expenditure of the state budget and the state social security budget (billion lei, cash standards)

		2020	2021	2022
The impact of the increase of the social allowance for pensioner and of the newly established rights on the social assistance expenditure of the SB	Difference from 2019	0.35	5.37	12.30
	Difference from the previous year	0.35	5.02	6.93
The impact of the increase of the pension point on the SSB social assistance expenditure	Difference from 2019	16.88	39.39	43.78
	Difference from the previous year	16.88	22.51	4.39
The impact of changing the pension calculation formula on the SSB social assistance expenditure	Difference from 2019	-	5.29	17.22
	Difference from the previous year	-	5.29	11.93
Total impact	Difference from 2019	**17.23**	**50.06**	**73.30**
	Difference from the previous year	**17.23**	**32.83**	**23.24**

Source: MPF, FC's calculations

ANNEX 3

Figure 6: The evolution of the public investment expenditure in the period 2009-2020 (planned vs. execution, million lei)



Source: MPF, FC's calculations