Fiscal Council's Opinion on the Draft Second Supplementary Budget for 2014

On September 26th, 2014, at 6:57 PM, the Ministry of Finance sent by letter no. 19836/26.09.2014 to the Fiscal Council, the second supplementary budget draft for 2014, the explanatory note and the Government Ordinance project regarding the draft of the budget revision for 2014, as well as the explanatory note and the Government Ordinance project regarding the draft of revised social security budget for 2014, requesting the Fiscal Council's opinion under the article 40, paragraph (2) of Law no. 69/2010. Given the Government's intention to approve the above documents on the meeting of September 30th, 2014, the Fiscal Council is seen again in the position of having available only one working day to draft and approve its opinion. In addition, it is difficult to imagine how the Government can accomplish the legal requirement derived from article 40, paragraph (4) of the Fiscal Responsibility Law and subsequent amendments (FRL), to analyze during the budget revision process approval the Fiscal Council 's opinion other than in a purely formal manner. The Fiscal Council is thus obliged to reiterate the previous recommendations addressed to the Government to prepare the draft laws and provide the necessary documents to the Fiscal Council at least one week before the adoption of the relevant legislation during the Government meeting, allowing both the Fiscal Council and the Government, a reasonable time for drafting opinions, respectively for analyzing and eventually adopting the Fiscal Council's recommendations in the Government meeting dedicated to the approval of these legislative acts. Moreover, the article 4, paragraph (1), point 1 of Law no. 69/2010 indicates that „the Government and the local authorities have the obligation to make public and maintain in public debate, for a reasonable period of time, all the information necessary to allow the assessment of the implementation of fiscal and budgetary policies, the respective outcomes and the stance of central and local public finances".

The coordinates of the Draft of the Second Supplementary Budget – the compliance with the fiscal rules

Compared with the budget approved on the occasion of the first budget amendment, the general consolidated budget (GCB) revenue decrease by 1.32 billion lei, the expenditure by 1.37 billion lei, so that the budget deficit is projected to slightly diminish (by 48 million lei); considering the reduction in interest spending by 572 million lei, the primary deficit is projected to increase by 524 million lei. Personnel spending decrease marginally compared to the level projected in the first budget amendment, respectively by 22 million lei. Article 6 letters b) and c), article 16 and article 18 paragraph (4) of the FRL state as mandatory the ceilings established by the Fiscal Strategy and by the accompanying law regarding the thresholds for the nominal levels of the GCB deficit, the GCB primary deficit, the total spending excluding the financial assistance from the EU and other donors and also for the personnel spending, limiting the possibility of increasing total expenditure of the GCB during revisions exclusively for paying the debt service and Romania's contribution to the EU budget. The first budget amendment already projected minor breaches of the above mentioned mandatory ceilings for the GCB budget deficit (by 50 million lei), the GCB primary budget deficit (by 166 million lei) and personnel spending (by 85 million lei), but a larger increase (by 1.59 billion lei) compared to the ceiling corresponded to the total spending excluding the financial assistance from the EU and other donors, solely due to the introduction of a new swap scheme in order to clear the outstanding obligations and a change in the accounting treatment of the sale transactions from the state reserves, both measures having a neutral impact on the budget deficit. The changes introduced by the project of the second budget amendment significantly reduce the size of these thresholds overruns in the case of GCB deficit (the breach is only 2 million lei), in the case of total expenses excluding financial assistance from the EU and other donors (the related overrun is reduced at only 523 million lei) and in the case of personnel expenses (the breach is reduced at 62 million lei), but generate a large increase in the size of these thresholds overruns in the case of the primary deficit (up to 689 million lei), given the fact that the savings recorded at the level of interest expenses are not used for reducing the budget deficit, as the rule concerning the primary balance, stated in the Law no. 69/2010 would have required. Moreover, the draft law provides again the already usual exemption from the above described fiscal rules, diminishing their credibility.

The Coordinates of the second budget revision - budgetary revenues

GCB revenues are downwardly revised by 1.32 billion lei compared to the programmed level from the first budget revision. A small part of this review is due to the reevaluation of the swap compensation scheme already approved, whose amount decrease by 250 million lei (from 1,598 million lei to 1,348 million lei), plus a newly approved scheme of 59 million lei, so that the aggregate impact is of -191 million lei, both at the level of budgetary revenues and expenditures. The most part of the revenues revision comes from incorporating in the budgetary projection the impact of reducing from October the 1st, 2014 the employer's social security contribution (by 5 pp), that generates a gross impact at the level of revenues from social security contributions evaluated at -1 billion lei, given its incidence only on two months of the cash-based execution for this year. A significant large downward revisions is made at the level of revenues (without the aforementioned swaps) regarding "nontax revenues" (-451 million lei), "amounts received from the EU in the account of payments made and prefinancing" (-300 million lei) and "taxes on using goods, authorizing the use of goods or on carrying activities" (-101.6 million lei). These negative revisions at the level of certain categories other than social contributions are, however, almost entirely compensated by the ascending changes (without swaps) operated in the revenue estimations regarding "VAT" (+544.8 million lei) and "corporate income tax" (+ 190.5 million lei).

The Fiscal Council has serious reservations regarding the proposed upward revision for the projection of VAT receipts, given that the income flows for the two months of the budget execution available after the first budget revision – namely July and August – are not at all likely to generate optimism regarding the future receipts from this tax which, consequently, makes the proposed ascending revision at the level of budgetary revenues estimate for this category to appear as implausible. Specifically, the aggregated VAT receipts at the level of the aforementioned months are lower than those from the previous year by 1.3% (-114 million lei), a phenomenon partly explained by the base effect related to the VAT reduction on flour and bakery products implemented starting with September 1st, 2013 that, according to NAFA data, generated monthly reduced revenues on average by 32.1 million lei during September 2013-July 2014 compared to the same period of the previous year. Moreover, according to NAFA data obtained by the Fiscal Council, the annualized impact on budget revenues from VAT of the aforementioned measure, evaluated according to the available reports at the end of July 2014 (10 months of implementation), was of -386.7 million lei decrease compared to the same period of the previous year (-55.1% during September 2013-July 2014 compared to the same period of the previous year), a level that not seems to indicate a materialization of the expectations of an increase in the payment voluntary compliance[1].

Moreover, the projected evolution of VAT receipts appears as inconsistent with the proposals to revise the budgetary spending, their level, itself generator of VAT revenues, being lower than the one projected in the context of the first budget revision. A simple calculation shows that the monthly average revenue over the last four months should be increased by about 20% compared to that corresponding to the last 8 months from the preceding budget execution, after both the compared levels have been adjusted for the way in which the compensation schemes are distributed at an intra-annual level. The Fiscal Council admits that the uneven investment expenditure execution, the budgeted annual amounts being scheduled to be spent in a proportion of 62,4% over the last four months of the year (i.e. 23.4 billion lei from 37.5 billion lei) is likely to lead to symmetric distortions at the level of the monthly VAT returns. However, its assessments indicate that, even taking into account the massive acceleration of the investment spending in the last four months of the year according to the proposed schedule, it appears as prudent to revise downward the annual VAT returns estimates by at least 800 million lei, depending on the assumptions about the size of the intermediate consumption related to investment projects.

Also, the Fiscal Council reiterates its reservations already mentioned on the occasion of the first budget revision regarding the estimated inflows from the post-accession EU funds of which the ultimate beneficiary is the public sector. The reductions of the revenue estimates at this chapter by only 300 million lei appears as inadequate in terms of ensuring the verisimilitude of the annual projected level, given that in order to converge to it, the average monthly inflows in

[1] A *caeteris paribus* evaluation would most likely indicate revenue losses higher than the above, given that realised revenues after the VAT reduction also include the favorable effect that occurs during years with rich crops. In these years, the reduction of prices regarding the agricultural raw materials is not accompanied, according to historical data, by decreases of the final price net of taxes, which tend to remain relatively fixed, a phenomenon likely to generate more added value and therefore VAT receipts. Moreover, NAFA data also shows a decrease in the number of average monthly VAT documents filed by companies with activities related to NACE codes 1061 and 1071 targeted by the VAT reduction, from 2481 during September 2012-July 2013 to 2382 during September 2013-July 2014 (-4.0%), which also seems to indicate the absence of a voluntary compliance increase in the payment behavior.

the last four months of this year should be about 2.46 billion lei, a level which is almost double to the best performance from this year, respectively that from August; moreover, achieving the estimated annual level would be a first in terms of historical estimates on this chapter of income in Romania and is less credible as the gap between the achievements from the 8 months execution and the annual estimates is higher than the ones from the previous years. The Fiscal Council will return to the EU funds topic during the current opinion in the context of the budget expenditure.

The coordinates of the second budgetary revision – budget expenditure

Compared to the programmed public spending in accordance with the first budget amendment, the current review indicates a reduction of around 1.36 billion lei, of which 191 million lei are due to the impact of the revaluation of the swaps described above. The spending reduction is mainly located on three categories, namely, projects funded by external post-accession grants (-2,455 million lei), interest expenses (-572 million lei) and expenditure funded from reimbursable funds (-451 million lei). The allocations within the following categories increase significantly: expenditures on goods and services (+933 million lei, excluding the impact of the swap scheme), capital expenses (+370 million lei, excluding the impact of the swap scheme) and the contingency reserve fund (+377 million lei). In essence, compared to the programmed levels in the first budget revision, the allocations for investment expenditure are revised negatively (-2,381 million lei), the amounts being partially used to supplement some categories of current expenses, mainly those on goods and services of the local budgets; while the difference, to which are added the savings on interest expenses, is used to offset the impact of the social security contribution reduction on budgetary revenue, in order to ensure the convergence to the deficit target.

The Fiscal Council appreciates as inconsistent the assumptions regarding the estimates on revenues from post-accession funds and the expected significant reduction on the expenses related to projects funded from non-reimbursable funds. Assuming a bottom up elaborated budget, starting from concrete projects, as it should be the case especially with regard to investment objectives with European funding, it should be impossible to attract such a volume of European funds without adequate co-financing costs, including here both the standard co-financing required by the European Commission and the ineligible outlays whose amount varies on the nature of each investment objective. In the case of the current proposal to revise the GCB, the estimated European inflows are expected to record a relatively small reduction (-300 million lei), while the aggregate expenditure counterpart undergoes a downward revision of an entirely different order of magnitude (-2.455 billion lei), which is likely to lead to a significant contribution to a downward revision of the budget deficit. From the Fiscal Council's perspective, there are two possible explanations for this. The first explanation is that the reduction in revenues recorded in the case of the post-accession funds corresponds to the abandonment of investment projects for which the amount of ineligible expenditure represents approximately 87% of the project, which, although theoretically possible, it seems unlikely. A second possible explanation would be that the reduction in expenditure is the result of using an expenditure buffer included in the initial budget construction in order to comply with the deficit target in the event of unforeseen events which, although it is a proof of caution, it appears as undesirable from the perspective of building a transparent budget. Given the above mentioned, the Fiscal Council considers appropriate a clarification from the Ministry of Public Finances.

The Fiscal Council also considers that the reallocations made within the investment spending category – in the sense of abandoning the investment projects funded by external post-accession grants or funded from reimbursable funds, as well as reducing the spending on road infrastructure works of CNADR simultaneously with the supplementation of capital expenditure allocations to local budgets – are not in accordance with the principle of resources allocation to priority projects, characterized by a favorable cost-benefit ratio and with a high economic impact, especially considering the results of the evaluation exercise of the investment works portfolio in terms of these criteria achieved in the previous years.

In addition, it would have been expected that the reduction of social security contribution to generate, in return to the negative impact on the revenues related to this categories, also a reduction in the aggregate expenditure plan, which includes the contribution owed by the employer (the amount would be of about 270 million lei). The figures from the rectification proposal indicate though a marginal reduction in the wage bill of only 22 million lei, which means that the expected reduction was accompanied by additional spending allocations within the same category.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of the Fiscal Council, according to article 43, paragraph (2), letter d) of Law no. 69/2010, as amended and supplemented, after being approved by the Council members through vote, on 30 September, 2014.

30th September, 2014 **Chairman of the Fiscal Council**

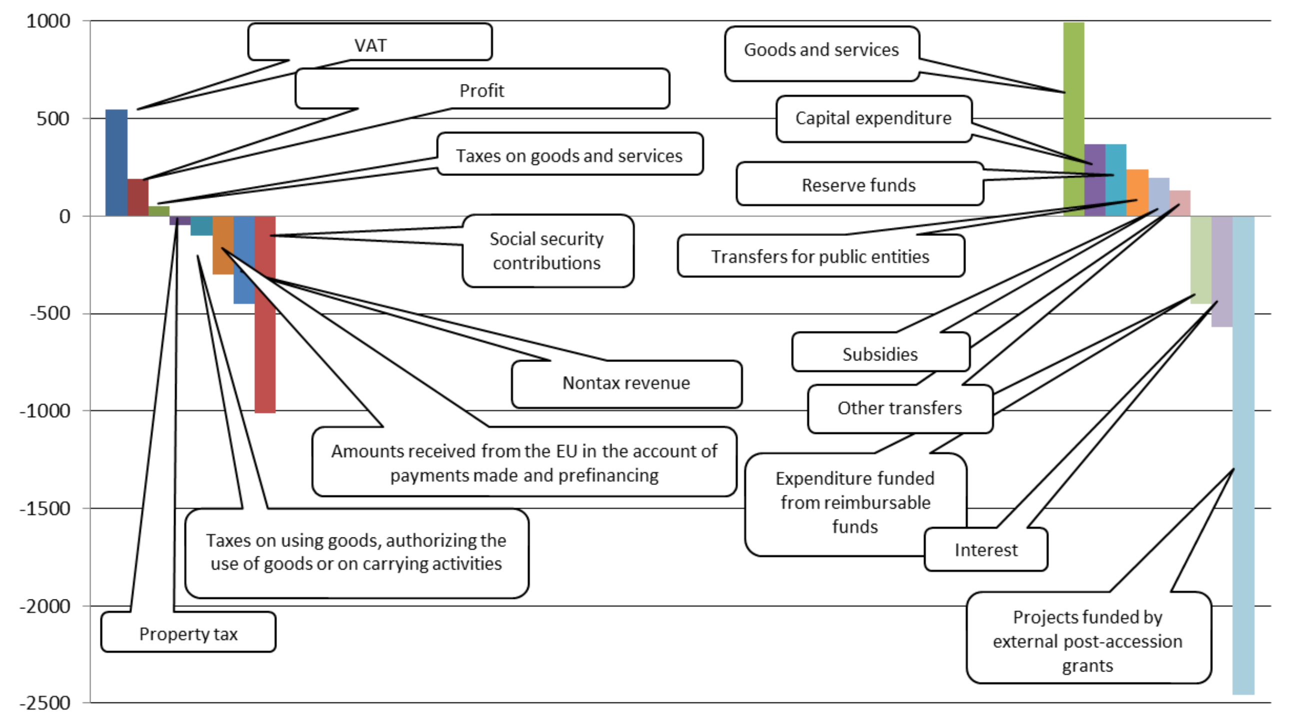
IONUȚ DUMITRU

ANNEX I	Initial budget 2014	Swap program 2014	Initial budget 2014 without *swap*	First budget revision (R1) 2014	Swap	R1 without swap	R2	Swap	R2 without swap	R1 - Initial budget	R2 - Initial budget	R2 - R1
										Adjusted values for swap impact		
	1	2	3=1-2	4	5	6=4-5	7	8	9=7-8	10=6-3	11=9-3	12=9-6
TOTAL REVENUE	216,808.3	850	215,958.3	218,346.0	1598.0	216,748.0	217,029.5	1407.0	215,622.5	789.6	-335.8	-1,125.5
Current revenue	201,331.2	850	200,481.2	201,788.8	1598.0	200,190.8	200,772.2	1407.0	199,365.3	-290.5	-1,116.0	-825.5
Tax revenue	126,162.2	850	125,312.2	126,359.5	1598.0	124,761.5	126,804.4	1407.0	125,397.4	-550.7	85.2	635.9
Taxes on profit, wages, income and capital gains	36,724.9		36,724.9	35,873.5	0.0	35,873.5	36,063.9	0.0	36,063.9	-851.5	-661.0	190.5
Profit	11,378.0		11,378.0	11,800.5	0.0	11,800.5	11,991.0	0.0	11,991.0	422.5	613.0	190.5
Personal income tax	24,000.9		24,000.9	22,726.9	0.0	22,726.9	22,726.9	0.0	22,726.9	-1,274.0	-1,274.0	0.0
Other taxes on income, profit and capital gains	1,346.0		1,346.0	1,346.0	0.0	1,346.0	1,346.0	0.0	1,346.0	0.0	0.0	0.0
Property tax	5,040.7		5,040.7	6,299.9	0.0	6,299.9	6,251.0	0.0	6,251.0	1,259.2	1,210.3	-48.9
Taxes on goods and services	83,362.6	850	82,512.6	83,178.1	1542.0	81,636.1	83,480.5	1351.2	82,129.3	-876.5	-383.3	493.1
VAT	54,621.6	850	53,771.6	53,563.0	1542.0	52,021.0	53,917.0	1351.2	52,565.8	-1,750.6	-1,205.8	544.8
Excises	24,102.0		24,102.0	24,114.1	0.0	24,114.1	24,114.0	0.0	24,114.0	12.1	12.0	-0.1
Other taxes on goods and services	1,807.1		1,807.1	2,615.0	0.0	2,615.0	2,665.0	0.0	2,665.0	808.0	858.0	50.0
Taxes on using goods, authorizing the use of goods or on carrying activities	2,831.9		2,831.9	2,886.1	0.0	2,886.1	2,784.5	0.0	2,784.5	54.1	-47.5	-101.6
Tax on foreign trade and international transactions (customs	623.0		623.0	626.0	0.0	626.0	626.0	0.0	626.0	3.0	3.0	0.0
Other tax revenue	411.0		411.0	382.0	0.0	382.0	383.0	0.0	383.0	-29.0	-28.0	1.0
Social security contributions	57,779.0		57,779.0	57,331.4	56.0	57,275.4	56,321.6	55.8	56,265.9	-503.6	-1,513.2	-1,009.5
Nontax revenue	17,390.0		17,390.0	18,097.8	0.0	18,097.8	17,646.2	0.0	17,646.2	707.8	256.2	-451.6
Capital revenues	621.0		621.0	1,701.2	0.0	1,701.2	1,701.2	0.0	1,701.2	1,080.2	1,080.2	0.0
Grants	14.6		14.6	24.6	0.0	24.6	24.6	0.0	24.6	10.0	10.0	0.0
Amounts received from the EU in the account of payments made and prefinancing	14,841.5		14,841.5	14,831.4	0.0	14,831.4	14,531.5	0.0	14,531.5	-10.1	-310.0	-300.0
Financial operations	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amounts collected in the single account (State budget)	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

ANNEX I	Initial budget 2014	Swap program 2014	Initial budget 2014 without *swap*	First budget revision (R1) 2014	Swap	R1 without swap	R2	Swap	R2 without swap	R1 - Initial budget	R2 - Initial budget	R2 - R1
										Adjusted values for swap impact		
	1	2	3=1-2	4	5	6=4-5	7	8	9=7-8	10=6-3	11=9-3	12=9-6
TOTAL EXPENDITURE	231,298.4	850	230,448.4	233,105.9	1598.0	231,507.9	231,741.5	1407.0	230,334.5	1,059.5	-113.9	-1,173.5
Current expenditure	213,514.3	850	212,664.3	215,150.4	1198.0	213,952.4	213,416.0	1007.0	212,409.0	1,288.1	-255.3	-1,543.4
Personnel	47,786.2		47,786.2	48,090.7	15.0	48,075.7	48,068.2	14.8	48,053.4	289.5	267.2	-22.3
Goods and services	39,363.7		39,363.7	40,417.3	224.0	40,193.3	41,468.7	282.8	41,185.9	829.6	1,822.2	992.6
Interest	11,223.5		11,223.5	11,107.9	0.0	11,107.9	10,535.6	0.0	10,535.6	-115.6	-687.9	-572.3
Subsidies	5,732.7		5,732.7	5,483.2	0.0	5,483.2	5,678.4	0.0	5,678.4	-249.5	-54.3	195.2
Total Transfers	108,139.7	850	107,289.7	108,540.3	959.0	107,581.3	106,238.2	709.4	105,528.8	291.6	-1,760.9	-2,052.5
Transfers for public entities	1,399.9	850	549.9	1,650.9	850.0	800.9	1,642.0	600.0	1,042.0	251.0	492.1	241.1
Other transfers	11,816.7		11,816.7	11,934.7	68.0	11,866.7	12,067.6	68.4	11,999.2	50.0	182.5	132.5
Projects funded by external post-accession grants	20,250.9		20,250.9	20,251.0	0.0	20,251.0	17,795.5	0.0	17,795.5	0.0	-2,455.5	-2,455.5
Social assistance	71,512.7		71,512.7	71,553.5	41.0	71,512.5	71,494.2	41.0	71,453.2	-0.2	-59.5	-59.3
Other expenditure	3,159.5		3,159.5	3,150.3	0.0	3,150.3	3,238.9	0.0	3,238.9	-9.2	79.4	88.6
Reserve funds	168.3		168.3	467.3	0.0	467.3	834.3	0.0	834.3	299.0	666.0	367.1
Expenditure funded from reimbursable funds	1,100.2		1,100.2	1,043.7	0.0	1,043.7	592.5	0.0	592.5	-56.5	-507.7	-451.2
Capital expenditure	17,784.1		17,784.1	17,955.6	400.0	17,555.6	18,325.5	400.0	17,925.5	-228.5	141.4	369.9
Financial operations	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Payments made in previous years	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EXCEDENT(+) / DEFICIT(-)	-14,490.0		-14,490.0	-14,760.0	0.0	-14,760.0	-14,712.0	0.0	-14,712.0	-269.9	-222.0	47.9

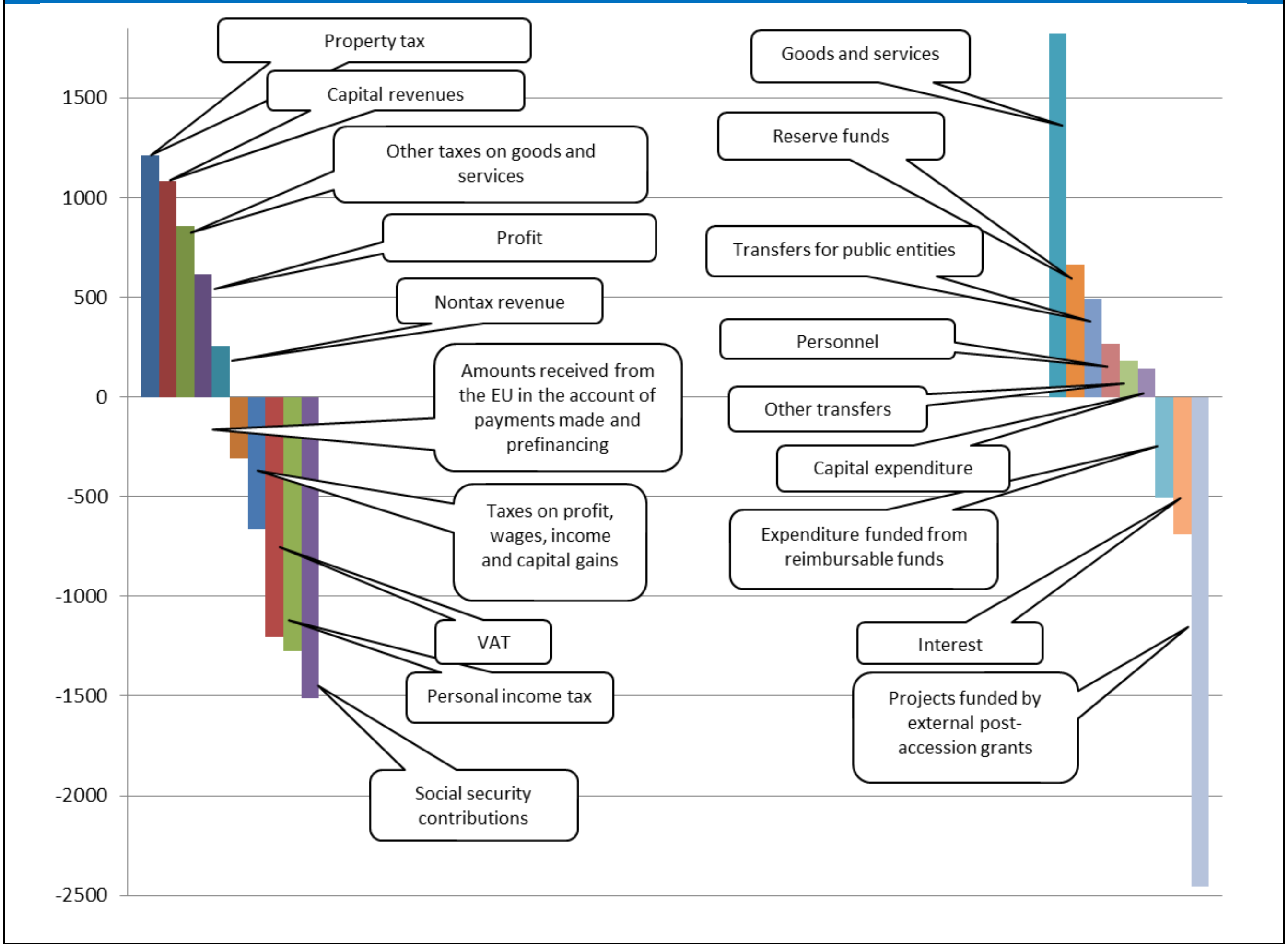
Source: Ministry of Public Finance, Fiscal Council's calculations

Figure 1: The main changes in expenditures and revenues compared to first budget revision (without the impact of swap schemes), million lei



Source: Ministry of Public Finance, Fiscal Council's calculations

Figure 2: The main changes in expenditures and revenues compared to the initial budget (without the impact of swap schemes), million lei



Source: Ministry of Public Finance, Fiscal Council's calculations