Fiscal Council of Romania

Position Note regarding the Restriction of Public Expenditures

The Fiscal Council (FC) issues this Note based on the way in which the Government has decided to act in order to reduce public expenditures. It is understandable the desire to restrict expenditures, to use public money better, considering the size of the budget deficit that is projected for 2023. According to the FC's evaluations, this deficit, which amounted to 3.55% in the first 9 months of the year, will reach about 6.5% of GDP (in cash terms), in 2023, in the absence of corrective actions; we consider additional expenditures regarding salaries, social assistance, interest, etc., compared to the projected ones, and revenues lower than those in the budget programming[1]. Since fiscal measures cannot have a significant effect in the remaining period until the end of 2023, only the limitation of expenditures could further reduce the deficit, bringing it below 6% of GDP in cash terms.

The FC has been waiting for the budget revision and requested, in September of this year[2], data from the Ministry of Finance to issue its own opinion. We are now witnessing the adoption of a new ordinance – concerning the 2023 budget – which is, in fact, a budget revision. Government Emergency Ordinance (GEO) no. 90/2023, regarding the restriction of public expenditures in the last 2 months of the year, expresses concern over the prospect of exceeding last year's deficit (which was 5.7% in cash terms, respectively 6.3% in ESA terms), given the Government commitments and targets related to the excessive deficit procedure (EDP). But this expenditure limitation is done through extreme measures and a *sui generis* instrument, the contingency reserve fund (CRF) at the Government's disposal.

The public motivation of GEO no. 90/2023 is surprising: to stop the excessive, uncontrollable expenditures. We make this statement because the expenditures of the budgetary credit officers are constrained by the existing allocations provided by the budget law, including through budget revisions. Therefore, an actual budget revision could have been done.

Regarding the set of fiscal measures, recently promulgated in the form of Law no. 296/2023, however controversial it may be, it is a step in the right direction, towards the achievement of a fair tax regime by

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[1] Additional expenditures of approx. 18 billion lei, respectively, revenues lower than those programmed by approx. 20 billion lei.

[2] Through address no. 31/25.09.2023, sent to the Ministry of Finance, requesting 8 sets of relevant data for the 2023 budget reconfiguration process ((i) military expenditures, (ii) amounts related to support to Ukraine, (iii) other relevant measures for the deviation from the target, (iv) the impact of the adopted measures on the revenues and expenditures projected for the 2023-2026 period, (v) the estimated impact of the pension and salary reform, (vi) the execution of European funds and co-financing, (vii) the execution of investment expenditures, as well as (viii) the forecast of the deficit at the end of 2023 (provided no corrective measures are taken)). Up to the moment of elaborating this Position Note on the restriction of public expenditures, the data requested from the Ministry of Finance has not been received by the FC.

eliminating exemptions and loopholes, combating tax evasion; it could bring in additional tax revenues of around 0.9-1.4% of GDP in 2024. But there is still a long way to a budget deficit below 3% of GDP in a sustainable manner.

The FC does not underestimate the challenges of the budget execution, under very difficult domestic and international conditions, but advocates for measures that respect the fiscal rules, take into account the transparency criteria and good practices. The FC pleads for realism and prudence in budget constructions.

1. The economic context

It is well-known that Romania's budget is very fragile, and this situation is not recent, as repeatedly pointed out by FC's documents. Thus, the large structural budget deficit, around 5% of GDP in 2019, persisted over time and reached 5.8% of GDP in 2022, according to data from the European Commission[3]. The level of the budget imbalance caused Romania to enter the excessive deficit procedure in April 2020.

The years of the pandemic and the energy crisis led to the temporary suspension of fiscal rules in the EU until the end of 2023 and obscured our deficits in relation to those of other EU member states (see Annex 1). The invasion of Ukraine further complicated the international situation and forced some additional expenditures.

The budget fragility is also seen in the very low level of revenues, the lowest in the EU (except for Ireland – see Annex 2); tax revenues (including social security contributions) are approx. 27% of GDP, while the EU27 average is 40-41%. We have large, institutionalized tax evasion, as the European Commission notes – including through the tax regime that allows all kinds of loopholes, ways to evade the payment of taxes[4] (see Annex 3).

The public budget problems did not ease in 2023. In 2022, the ESA deficit was approx. 6.3% of GDP[5], and the cash one was 5.7%. But the faulty construction of the 2023 budget (on both sides: revenues and expenditures) made the deficit target of 4.4% unrealistic. The FC stated in its analysis of the budget draft, in December 2022, that the probable level of the 2023 deficit was around 5.7-5.8%. Additional expenditures compared to the budget draft and lower revenues (the September budget execution shows a deficit of 3.55% of GDP) determine the FC to evaluate that, in the absence of corrective actions, the cash deficit would reach about 6.5-6.6% of GDP in 2023. Moreover, the Minister of Finance also spoke of a deficit above 6.5% of GDP in the absence of corrective measures.

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[3] European Commission, *European Economic Forecast Spring 2023* - Statistical Annex, Table 40, European Union, May, 2023.

[4] Although the effective VAT rate places us on the ninth position in the EU27 (with 12.3%), collection efficiency places Romania on the last place, with a VAT gap of 36.7% in 2021, far from the next ranked, Malta, with 25.7%, the average in the EU being approx. 5%.

[5] See the last EDP notification regarding Romania, from October 2023: https://ec.europa.eu/eurostat/documents/1015035/16570584/RO-2023-10.pdf/62486ce6-0b64-7aed-8520-c1391453d383?t=1697803732165.

2. *The ordinance is, in fact, a budget revision which leads to the restructuring of public expenditures*

Between September and October 2023, the Government adopted a series of normative acts that introduced budgetary measures, as follows: GEO no. 73/September 14, 2023 *regarding some budgetary measures*; GEO no. 74/September 20, 2023 *for the amendment of paragraph (4) of Article 4 from Law no. 227/2015 regarding the Fiscal Code*; GEO no. 78/September 28, 2023 *to supplement the GEO no. 73/2023 regarding some budgetary measures, as well as some measures to improve the absorption of European funds* and GEO no. 90/October 27, 2023 *for the approval of some measures to reduce the 2023 budget expenditures in order to comply with the budget deficit target assumed in the Convergence Programme, as well as for the modification and completion of some normative acts*.

- GEO no. 74/2023 derogated from the rule regarding the amendment to the Fiscal Code, which provided a minimum period of 6 months between the moment of its publication in the Romania's Official Gazette and the moment it starts to produce effects, under certain circumstances now more broadly defined (excessive budget deficit procedure) and aimed at budget revenues (introduction of new taxes, fees or social contributions, increase of existing ones, elimination or reduction of existing facilities).
- GEO no. 73/2023 modified the CRF operating framework, by way of derogation from Law no. 500/2002 and from art. 12 (1) a) and c) and art. 26 (4) and (5) of Law no. 69/2010 (*with regard to the ceiling for the general consolidated budget balance, the ceiling for personnel expenditures and the ceiling for total expenditures of the general consolidated budget, respectively, the limits for the total balance and personnel expenditures of the general consolidated budget*), transforming it from an instrument dedicated to exceptional situations into a budget revision tool for funding the current and capital expenditures of the main budgetary credit officers[6].
- GEO no. 90/2023 generalized the mechanism introduced by GEO no. 73 and supplemented by GEO no. 78/2023, the CRF thus becoming an instrument through which the Government can reduce expenditures and redirect, at its discretion, resources to other areas. Consequently, the normative act presents major risks from a legislative point of view and has undesirable macroeconomic and budgetary effects.

From a legislative perspective, GEO no. 90/2023 derogates from art. 12 (1) e) and art. 23 (1) of Law no. 69/2010 with subsequent amendments and additions, allowing the transfer of budget credits from investments to current expenditures, and cancels the rules concerning budget revisions, according to which "*Any revision of the state budget, social security budget and special funds budgets, as well as the utilization of the amounts withheld in accordance with art. 21 para. (5) of Law no. 500/2002, with subsequent amendments and additions, shall take into consideration the conclusions of the half-year report on the economic and budgetary situation, along with the Fiscal Council's opinion regarding it*", emphasizing the arbitrariness in the use of public resources and their discretionary allocation.

[6] For the priority funding of personnel expenditures, social assistance expenditures, the national public contribution related to projects financed from non-reimbursable external funds, medicine expenditures, health programs and actions of the main budgetary credit officers.

In addition, the principle of transparency[7], which must govern the implementation of budgetary policies, is evaded, effectively going against the spirit and the letter of both the European legislation on fiscal rules, and the one proposed to enter into force in the EU in the near future, which emphasize the compliance of the authorities with the national fiscal rules and their strict enforcement. Ignoring these principles also contradicts the OECD requirements concerning the accession process.

From a macroeconomic perspective, the accumulation of arrears at the level of the cash budget execution is very likely, which may further reduce economic growth. Not receiving the invoices for investment expenditures already made, the non-payment of already received invoices and the re-routing of these amounts to current expenditures will affect Romania's economic growth in the following period, making the fiscal adjustment more difficult in 2024. It must be said that using the January-September average as a reason for limiting expenditures in November and December has very little relevance, since the payment of many invoices regarding the realization of projects throughout the year is made in the last months.

From the point of view of the budget, the provisions of GEO no. 90/2023 can reduce the cash budget deficit, especially by generating arrears (postponing the settlement of some invoices, of payment titles issued by the National Authority for Property Restitution, of payments related to executory court decisions or administrative acts etc.), but not enough to significantly reduce the deficit towards the 2023 target; indeed, the deficit target is unrealistic considering the construction of the public budget – as the FC signalled in its opinion on the 2023 budget draft (from December 2022). Considering the ESA 2010 methodology (according to which the targets are set in the excessive deficit procedure), the possible reduction of the deficit through the effect of the aforementioned legislation is considerably more limited and any such effect is compensated by a symmetrical impact, respectively an increase in the 2024 deficit. This makes it more difficult to reach the budget deficit target next year, even in the presence of measures to increase tax revenues. The reform of pensions and wages will also complicate the budget consolidation process in the coming years and make the need for additional tax revenues more acute.

Under the above circumstances, the FC estimates that it is possible that the cash deficit this year will be around 6% of GDP, and the ESA deficit will be higher – but both will deviate far from the target of 4.4% of GDP, although it must be reiterated that this target was not realistic. Not carrying out some military expenditures can help limit the deficit in cash terms, but without effect in the European methodology.

The CRF can reach a very high level in terms of the volume of resources that passed through it this year, given the increasing derogation from the fiscal rules. From the beginning of the year until October 27, 2023, the Government adopted 42 Government Decisions allocating amounts from the CRF. Until September 14, when the legislative framework regarding the operation of the CRF was changed, 12 Government Decisions were adopted, worth only 0.60 billion lei. Afterwards, based on the new legislative framework for the operation of the CRF, from September 14 to October 27, 30 Government Decisions were adopted, amounting to 6.15 billion lei. In the 2007-2022 period, according to the data from the last Annual Report of the FC, allocations from the CRF varied between a minimum of 0.53 billion lei, in 2015,

[7] According to art. 4 (1) 1 of Law no. 69/2010: *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 necessary information to allow the assessment of the implementation of fiscal and budgetary policies, of their outcomes and of the state of central and local public finances*.

and a maximum of 7.96 billion lei, in 2020 (see Annex 4). Furthermore, the unspent sums of the budgetary credit officers are transferred to the CRF to be redistributed. These premises create the conditions for the CRF allocations to reach a record value by the end of the year.

Given the major risks stemming from the legislative precedent and the derogation from the most important fiscal-budgetary normative acts, and starting from analyses and data regarding the questionable effectiveness of this approach to reduce deficits, by means of restricting expenditures, questions arise regarding the legitimacy of resorting to this budgetary procedure.

The use of the CRF, *de facto* replacing budget revisions, sets a precedent that involves major risks, ranging from a lack of transparency in budget execution to discretionary use and an increased tendency to resort to derogations from the fiscal rules. Implementing actual budget revisions was feasible, even though the situation is very difficult and requires urgent measures to restrict spending.

Moreover, considering the institutional-legislative framework and the fact that Government Ordinances must be approved by the Parliament, the FC considers that it is not unlikely that an actual budget revision may need to be adopted before the end of 2023.

The fiscal rules in the EU and the practices promoted by the OECD demand that this procedure (Emergency Ordinance for amending the budget without an actual revision) must not be repeated, as transparency is one of the essential requirements for the implementation of public policies, especially the fiscal-budgetary one.

3. Denial of the budgetary reality

In Romania, there is a “denial of reality”; it is not understood that a significant correction, even if gradual (over a few years), from above 6.5% to 3% of GDP, means, *ceteris paribus*, a reduction in revenues – it implies a decrease in domestic consumption of goods and services. And the correction cannot be made only on the expenditure side, given the very low level of tax and non-tax revenues; believing that the adjustment can be achieved through the *inflation tax*, under the given circumstances, is a fantasy. The FC has repeatedly emphasized this aspect.

If tax revenues were collected much better, it would be an extraordinary gain for budget consolidation, but progress in this direction has been insignificant so far. The elimination of exemptions and rethinking the tax regime (regarding micro-enterprises and self-employed individuals, etc.) are part of the fight against tax evasion and tax optimization. There has been only a slight, timid advancement in this regard – probably also due to the resistance of interest groups.

We are now paying for the recklessness in both the distant and recent past, the lack of adequate, intelligent budget planning. Just as mistakes were made through pro-cyclicality during years of economic boom, now we must be pro-cyclical during a period of slow economic growth (in 2023, GDP growth will likely be around 2%).

Unfortunately, the conditions in Europe and globally are not favourable. The only economy performing well is that of the United States; within the EU, there are multiple problems, with numerous struggling economies.

European funds are a significant opportunity that must not be missed. It is essential for the Government to ensure co-financing and a high absorption of European resources. European funds can alleviate the contractionary impact of the budget correction, assist in financing external deficits (it is promising that the current account deficit will likely decrease below 7% of GDP in 2023), stimulate reforms, greatly aid infrastructure modernization, digitalization and the transition to a green economy.

The FC reiterates the importance of efficiency analyses of public expenditures, the so-called spending reviews, which support the overall budget consolidation. This year, such analyses must be conducted on health and education (they are also included in the National Recovery and Resilience Plan). The FC believes that an efficiency analysis should be carried out on the functioning of the state, both at the central and local levels of public administration. Spending reviews are among the best practices promoted by the OECD.

4. We need realistic budget constructions

We need realistic budget constructions, the creation of fiscal space because future shocks (related to climate change, energy transition, the need for defense in an increasingly complicated, often hostile international environment) will exert significant pressure on the budget. It needs to be reiterated that the reform of pensions and wages puts additional pressure on the public budget and, implicitly, on the budget consolidation.

The budget correction towards a deficit of 3% of GDP cannot be achieved until 2025, in the opinion of the FC; it is more likely that the budget correction will be completed by 2026. The FC assesses that the measures taken so far are not sufficient to achieve the correction within this time frame, unless there is a significant improvement in the collection of tax revenues.

The FC considers that reforming the tax regime remains an absolute necessity for sustainable budget consolidation.

The Position Note regarding the restriction of budget expenditures was approved by the Chairman of the Fiscal Council, in accordance with the provisions of art. 56, para. (2), letter d) of Law no. 69/2010 republished, following its endorsement by the members of the Council, through vote, during the meeting held on October 31, 2023.

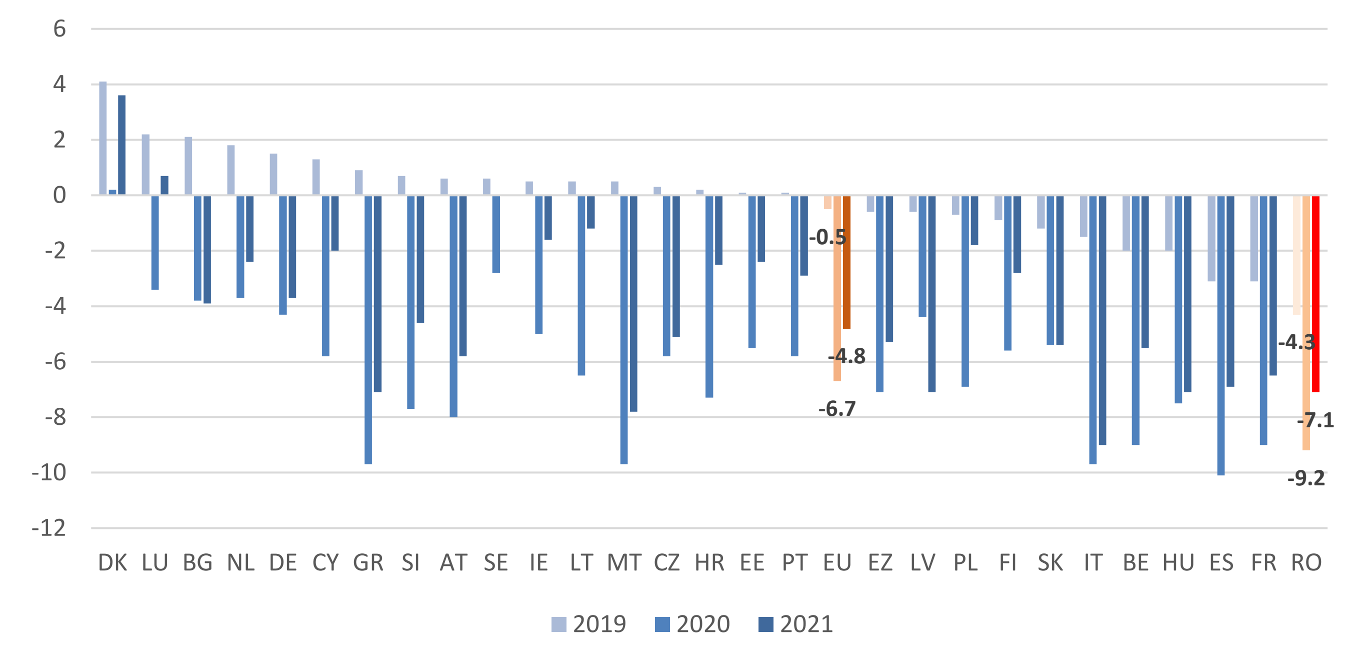
October 31, 2023

Chairman of the Fiscal Council

Professor DANIEL DĂIANU

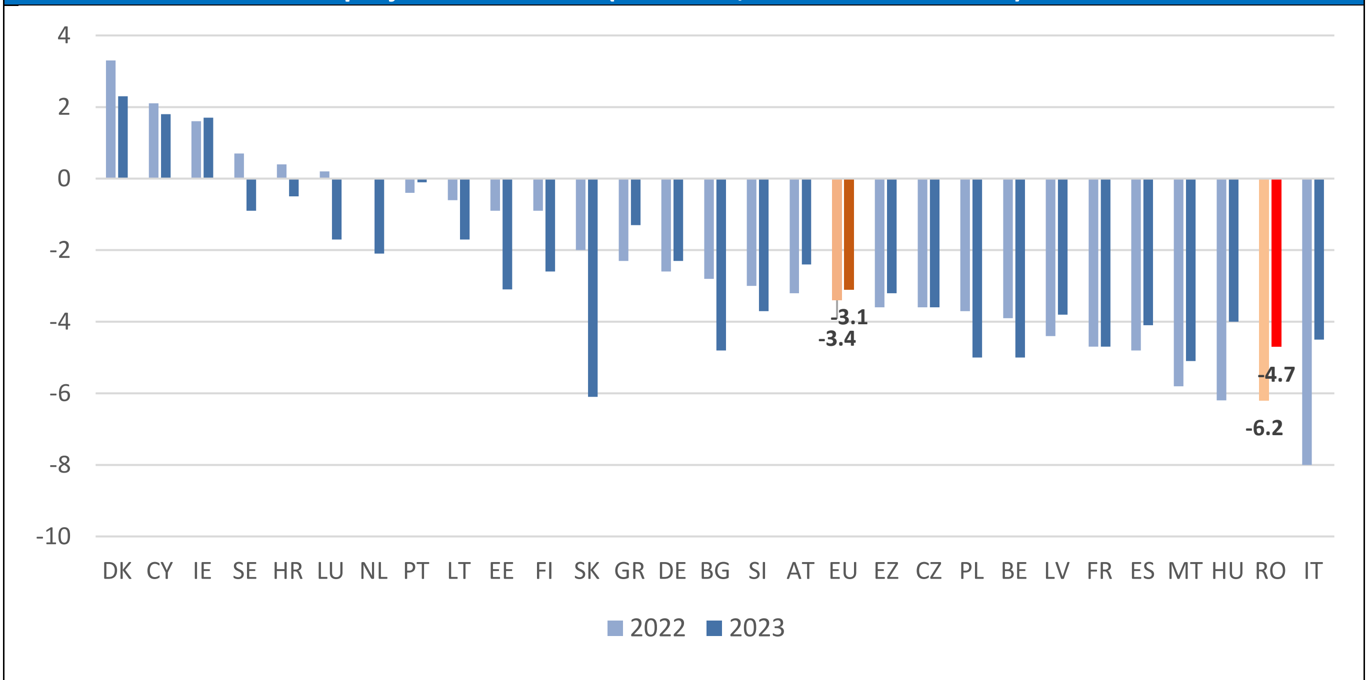
Annex 1

Figure 1. Budget balance in Romania and EU member states during the period 2019-2021 (% of GDP, ESA 2010 standards)



Source: AMECO

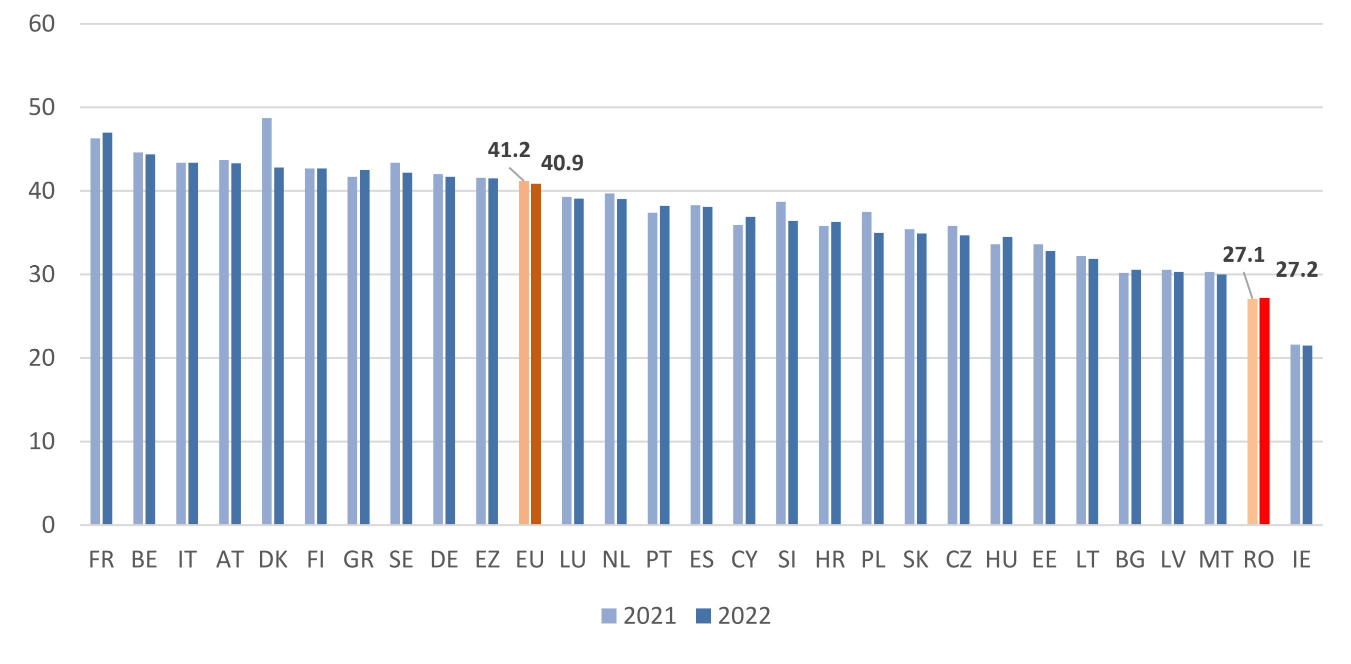
Figure 2. Budget balance in Romania and EU member states in 2022 and the European Commission's projection for 2023 (% of GDP, ESA 2010 standards)



Source: AMECO

Annex 2

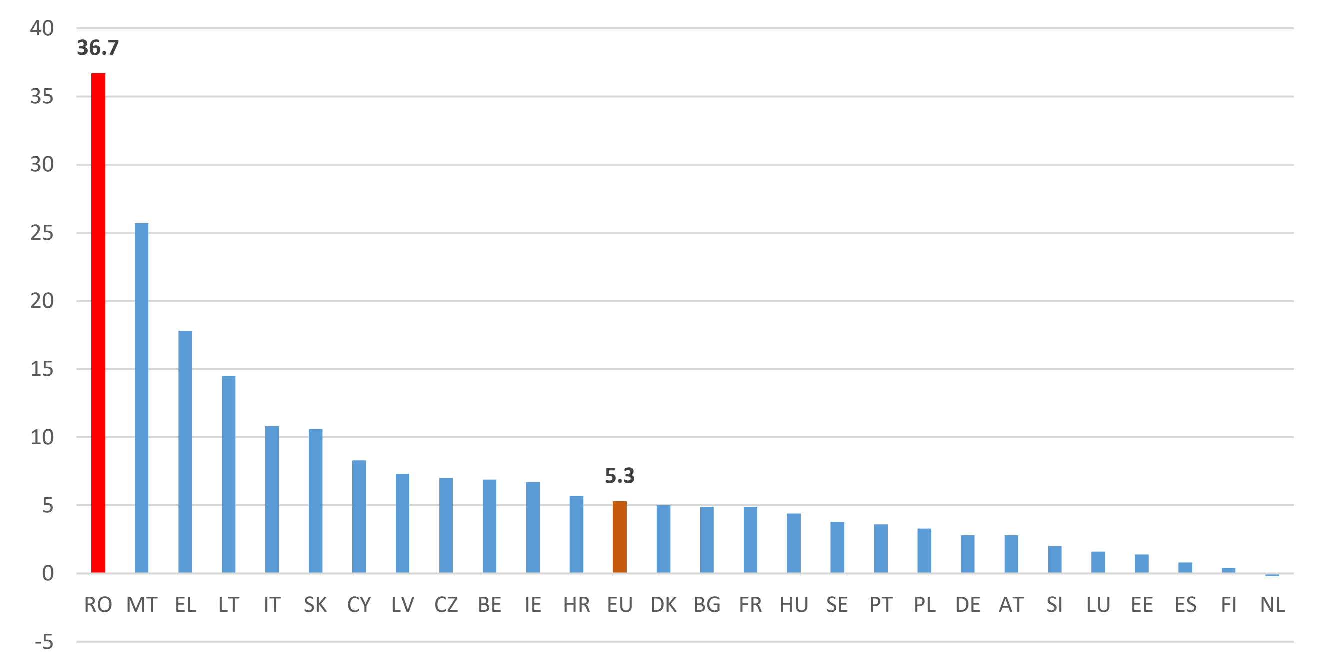
Figure 3. Tax revenues in Romania and EU member states during the period 2021-2022 (% of GDP, ESA 2010 standards)



Source: AMECO, FC's calculations

Annex 3

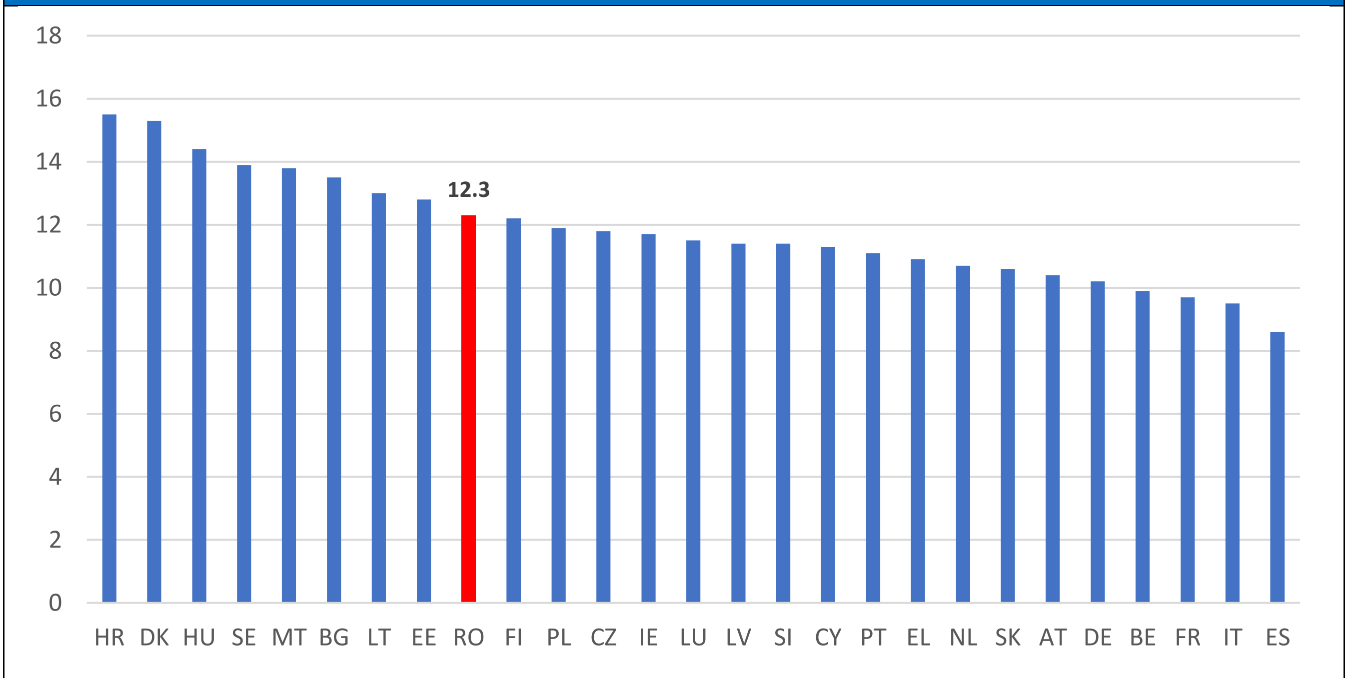
Figure 4. Value-Added Tax (VAT) gap in 2021 (% of VTTL*)



Source: European Commission, CASE, Poniatowski, G., Bonch-Osmolovskiy, M., Śmietanka, A., Sojka, A., VAT gap in the EU – Report 2023, Publications Office of the European Union, Luxembourg, 2023

** VAT Total Tax Liability, denoting VAT revenues theoretically estimated to be collected*

Figure 5. Effective VAT rate* in 2021 (%)

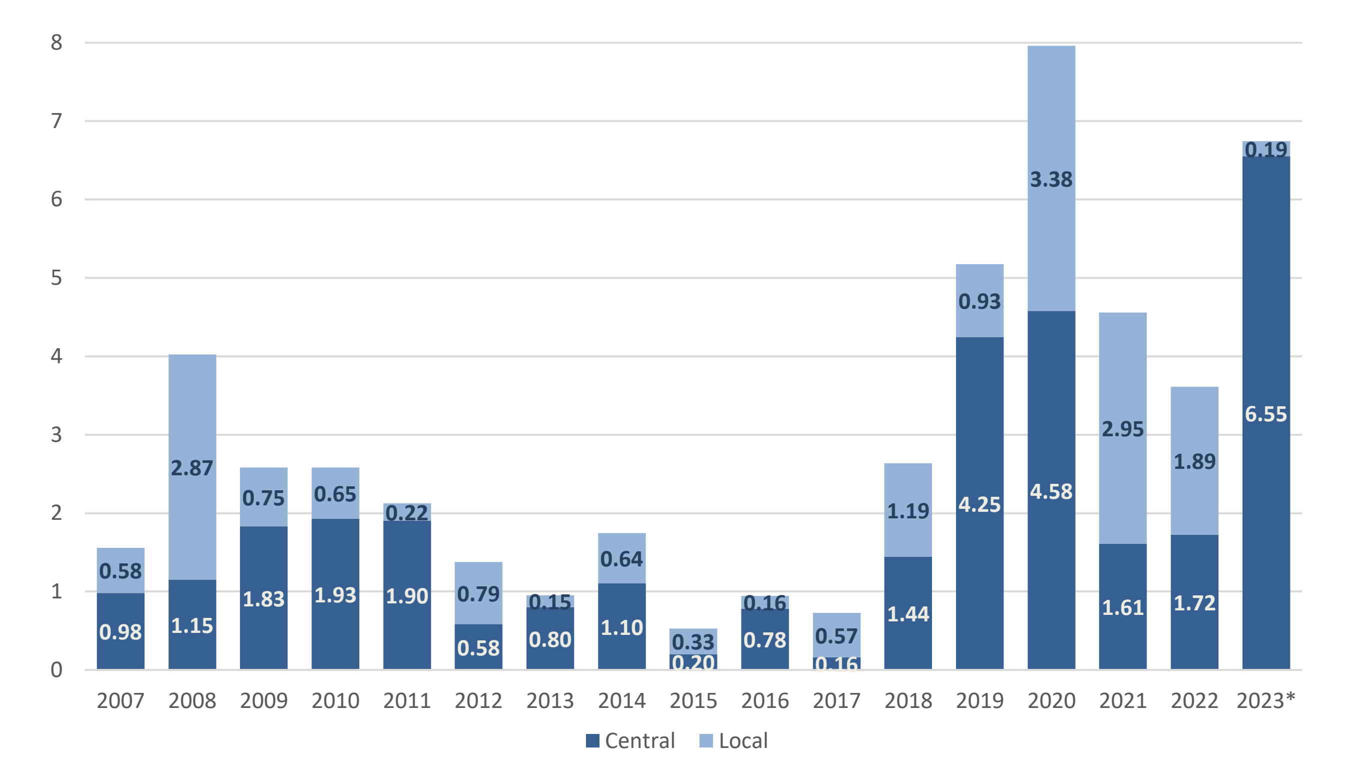


Source: European Commission, CASE, Poniatowski, G., Bonch-Osmolovskiy, M., Śmietanka, A., Sojka, A., VAT gap in the EU – Report 2023, Publications Office of the European Union, Luxembourg, 2023

** The effective VAT rate is calculated as the ratio between the VAT Total Tax Liability (VTTL) and the macroeconomic tax base (final consumption of households and NPISH)*

Annex 4

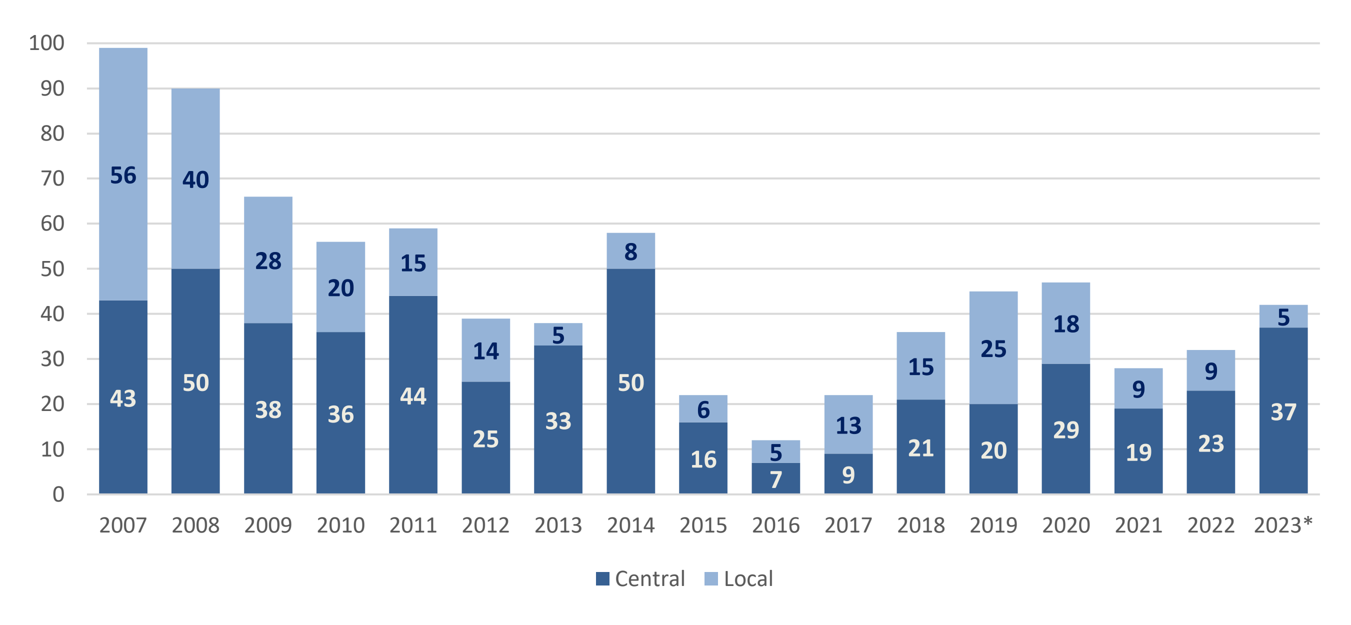
Figure 6. Total allocations from the Government's contingency reserve fund (billion lei)



Source: FC's calculations based on the data from Government Decisions regarding the allocation of funds from the CRF

** Government Decisions from the beginning of the year until 27.10.2023*

Figure 7. Number of Government Decisions regarding allocations from the contingency reserve fund



Source: FC's calculations based on the data from Government Decisions regarding the allocation of funds from the CRF

** Government Decisions from the beginning of the year until 27.10.2023*