

Fiscal Council's Opinion on the Second Budget Revision for 2016

On November 16th 2016, the Fiscal Council received from the Ministry of Public Finance by letter no. 55263/14.11.2016, the draft of the second budget revision for 2016, the explanatory note and the draft Government Ordinance project regarding the second budget revision for 2016, as well as the explanatory note and the Government Ordinance project regarding the second revised social security budget for 2016, requesting the Fiscal Council's opinion under article 53, paragraph (2) of the Fiscal Responsibility Law no. 69/2010 republished (FRL).

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

Compared with the budget approved on the occasion of the first budget amendment, the general consolidated budget (GCB) revenues increase by 813.1 million lei and the GCB expenditures increase by 766.1 million lei, so that the GCB budget deficit is projected to a level of 20,858.4 million lei, standing by about 47 million lei below the ceiling for the budget deficit defined by Law no. 338/2015 (the law for approving ceilings for certain indicators specified in the budgetary framework).

The project regarding the second budget revision for 2016 records a number of exemptions from the provisions stipulated by article 12 letters b) and c), article 17 paragraph (2), article 24 and article 26 paragraph (4) and (5) of the Fiscal Responsibility Law republished and also from the provisions stipulated by article 3 letter (5) and (7) of the Law no. 338/2015, stating thus the failure to comply with practically all the fiscal rules excepting the GCB balance rule. Article 12 letters a), b) and c), article 24 and article 26 paragraph (4) and (5) of the FRL state as mandatory the ceilings established by the Fiscal Strategy and by the accompanying law regarding the ceilings for the nominal level 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, allowing the possibility of increasing total expenditure of the GCB on the occasion of the budgetary revisions exclusively for servicing public debt and, respectively, for paying the contribution to the EU budget.

- The first budget revision already recorded significant deviations from the mandatory ceilings stipulated in the Law no. 338/2015 for the personnel expenditure (by 1368.1 million lei in nominal terms, or by about 0.1 pp as a percentage of GDP) and for the total spending excluding the financial assistance from the EU and other donors (by 3,344.6 million lei, only partially justified under the fiscal rule established by art. 24 of FRL for the amount of 319.1 million lei corresponding to the supplementation of the interest spending occurred on this occasion). The absence of compliance with the fiscal rules intervened also at those stated by art. 12 letter a) (regarding the level expressed as a percentage of GDP for personnel spending) and letter c) (for the nominal level of the total expenditure and personnel spending) and with the rules established by art. 17 paragraph (2) (which prohibits increasing personnel spending during the budget revisions) and of art. 24 (which allows the increase in the context of budgetary amendments of the total GCB expenditure net of financial

assistance from the EU and other donors, exclusively for paying the debt service¹, or for the Romania's contribution to the EU budget).

- The changes introduced by the Second Supplementary Budget Draft increases the size of the non-compliance with the ceiling for personnel expenditures by 132.4 million lei (i.e. the ceiling on personnel expenditure of GCB is exceeded in nominal terms with 1,500.5 million lei and as a percentage of GDP by 0.1 pp, given the increase in the forecast for GDP with 11,600 million lei compared to the one available when the Law no. 338/2015 was drafted), the increase by another 755.6 million lei compared to the First Supplementary Budget Draft regarding the ceiling for total expenditure excluding financial assistance from the EU and other donors, the ceiling ruled by the Law no. 338/2015 being exceeded with 4,100.2 million lei. Furthermore, the compliance with the limits stipulated by the Law no. 338/2015 for the ceiling on primary balance of GCB (the primary deficit exceeds the ceiling with 375.6 million lei) was not met, given that the downward revision of interest expenditure (-742 million lei compared to the First Supplementary Budget Draft and -422.7 million lei compared to the initial budget) is accompanied by an increase of other expenses, not entailing an equivalent reduction in the GCB deficit. Therefore, the Second Supplementary Budget Draft violates the provisions of art. 12, letter a), b) (except the ceiling on GCB balance in nominal terms and as a percentage of GDP) and c), art. 17, para. (2), art. 24 and art. 26, para. (4) and (5).

The government ordinance draft concerning the Second Supplementary Budget Draft for 2016 provides the corresponding derogations from the fiscal rules mentioned above and redefines the ceilings of the Law. 338/2015 according to the levels of the budget aggregates in the Second Supplementary Budget Draft. In the Opinion on the First Supplementary Budget Draft for 2016, the Fiscal Council noted, as well as in the Opinion on the Second Supplementary Budget Draft for 2015, that, in the light of experience of systematic recourse to derogations from the provisions of the FRL and redefining the parameters stipulated in the ceilings Law during each budget amendment, there is *de facto* existence of two classes of fiscal rules, one of "strong" rules (those relating to the GCB balance) - which usually operates successfully, and one of "weak" rules (the rules concerning mandatory ceilings for all the other elements relevant from the perspective of the law - primary balance, personnel expenditure, total expenditure excluding financial assistance from the EU and other donors, strengthened by the FRL through the interdiction of increasing the total expenditure and personnel expenditure during the budget amendments), for which the lack of *ex ante* compliance is the rule rather than the exception, the derogation being involved in almost all budget amendments that occurred following the entry into force of the FRL in April 2010. The execution below the program for expenditures, especially for investment, sometimes has led to *ex post* compliance with the fiscal rules. Such a scenario appears to be very likely for the current year given the coordinates of the budget execution, there being the premises of a major under the program execution for investment expenditure, in the conditions of a much lower absorption of European funds than that foreseen in the draft budget. A lower than expected absorption usually entails lower co-financing

¹ Under the circumstances that less than one-tenth of the increase in expenses was related to the debt service payment

expenses, which should lead to a budget deficit lower than the target. In these circumstances, it is likely to exist an *ex post* compliance with the ceilings on total expenditure and primary deficit, in contrast to the situation regarding the rules on personnel expenditure, where non-compliance with the fiscal rules appears as being certain.

The Fiscal Council ascertains once again the violation of most fiscal rules, except the GCB deficit rule, noticing the *de facto* inoperability of a large subgroup of fiscal rules and reiterates its recommendations regarding the compliance with those rules². The perpetuation of the *de facto* inoperability of the fiscal rules associated to the budget deficit requires a serious discussion.

The coordinates of the second budget revision - budgetary revenues

GCB revenues are revised upwards by 813.1 million lei compared to the level programmed in the first budget revision. This value includes the effect of the swap reduction, which has a symmetric effect on the revenues and expenditures, by 147 million lei, thus the budgetary revenues, adjusted with swap, are forecasted to increase by 960.5 million lei. The important sources for revisions compared to the estimated values in the first budget revision, taking into account swap adjusted values are:

- *Personal income tax*: +567.3 million lei. Updating the programmed level for the whole year appears to be justified from the perspective of the up to date budget execution and updated forecasts regarding the dynamic of salaries. Moreover, in its opinion on the first amendment, the Fiscal Council appreciated that a wage dynamics higher than the projection from the spring forecast of the National Commission of Prognosis (NCP) was possible given the evolution of earnings and the autumn projection of NCP records an upward review of the gross wages dynamics from 8.3% to 10.2%.
- *VAT*: +526.4 million lei. The revision program takes over the exceeding of the receipts at the level of the third quarter of revenue program, excluding the swap scheme (+336 million lei), corresponding to a degree of achievement of 102.7%. The up to date execution data indicates that the proposed value is feasible.
- *Non-tax revenues*: +182.5 million lei. The Fiscal Council reiterates its concerns expressed during the first budget revision regarding the proposed level for this revenue aggregate, given the evolution of revenues at the end of September 2016. If an acceleration during the last quarter of the year is possible, given the registration of some extraordinary revenues of about 847 million from the recovery of some amounts from previous years of budgetary funding already provided during the first budget revision, it isn't enough for generating the convergence with the annual target, given the historical evolution of monthly flows of non-tax revenues.
- *Taxes on using goods, authorizing the use of goods or on carrying activities*: -121,9 million lei due to the under-program receipts at 9 months from taxes on gambling.

The budget revision leaves virtually unchanged the estimated amounts to be attracted from the European Union for the year 2016: 13,55 billion lei. Given that the revenues at the end of September

² See "The Fiscal Council's Opinion on the Second Supplementary Budget Draft for 2015", http://www.fiscalcouncil.ro/Opinion-R2_FC_2015.pdf

(2.9 billion lei) represented only 22% of the amount proposed for the entire year, achieving the programmed levels appears highly unlikely. Even taking into account an accelerated of the entries of the last quarter of the 2015 proportions (most likely exceptional given that 2015 was the final year of financial framework), it appears unlikely even achieving revenues which would be half of the amount advanced for the whole year. *Ceteris paribus*, such a development, accompanied by a symmetrical reduction in financing costs, should lead to budget deficits considerable lower than programmed.

The budget expenditures are revised upward by 766.1 million lei or by 913.6 million lei if we eliminate the influence of the updated swap scheme. In essence, the fiscal space relative to the annual deficit target created by the increases of the budget revenues described above along with the significant reduction of the estimated annual interest and goods and services expenditures, is used to significantly increase allocations for social assistance and capital expenditure. Specifically, the relevant changes in the level of expenditures programmed occurs in the following categories (the numbers are net of the impact of swap, and the comparison base is the first budget revision as notified by the Fiscal Council at the end of July 2016):

- *Interest expenses*: -741.8 million lei.
- *Goods and services*: -456.2 million lei.
- *Social assistance*: +1,132.9 million lei. The upward revision of the consolidated budget expenditures has as sources: the increase of the allocation for this chapter in the state budget with 426.3 million lei, as well as the increased social spending planned for local budgets by 674.6 million lei. Additional expenses have not occurred as a result of new legislative measures, but as a result of the under-budgeting in the state budget, of the military pension expenditures, and in the local budgets, of the expenses occasioned by the payment of allowances for persons with disabilities who gives up the accompanying person.
- *Personnel expenses*: +132.4 million lei.
- *Investment expenses*: +710 million lei. The projected level of capital expenditure is revised upward by 1.1 billion lei, while reducing the allocations for other investment transfers (-138.8 millions lei), EU projects (-125.3 million lei) and for expenses related to the reimbursable financing programs (-119.6 million lei). Data on execution at the end of three quarters of 2016 indicate the 45% spending of the annual allocation of the investment expenditure, with relatively similar levels of achievement of the subcomponents. Basically, the convergence with the annual target regarding investment expenses would require spending 21.4 billion lei in the fourth quarter, more than double the amount spent in the first three quarters of the year. The Fiscal Council is skeptical that an acceleration of this magnitude is possible, especially given that the absorption of European funds in the new financial year appears to be delayed (the expenditure related to EU funded projects from the 2014-2020 framework at the end of September was only 18.5 % of the annual programming).

In conclusion, the Fiscal Council considers that the budget deficit will rather stand at the end of the year under the proposed level of 2.75% in GDP, as investment spending is likely to have an execution under the program. We appreciate that the size of this under the program execution is likely to considerably exceed the probable non-realization of the forecasted level of non-tax revenues. The

existence of a fiscal space relative to the fiscal deficit target for 2016 must, however, be seen as a temporary situation, given that the delays in implementing investment projects with european financing of the new financial year are likely to be recovered in the coming years.

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 November 2016.

22th November 2016

Chairman of the Fiscal Council,

IONUȚ DUMITRU

ANNEX 1 The main sources for increasing the budgetary expenditure on the occasion of the second budget revision in 2016

	Budgetary impact – million lei	Expenditure item
Special pension recalculation and refunding the differences between the pensions due for December 2010 and those established according to the Law no. 119/2010 (the budgets of the Ministry of Internal Affairs, the Ministry of National Defense and the Romanian Intelligence Service)	336.70	Social assistance
Provide the funding needed to finance the rights for people with disabilities within the budget of the Ministry of Labor, Family, Social Protection and Elderly Persons	110.00	Social assistance
Ensuring the funding of benefits for the people with disabilities who renounce to their attendant	562.30	Social assistance
Increase allocations for the National Program for Local Development and ensure funding of the Loan Agreement "Integrated systems for rehabilitation of the water supply and sewage, of drinking water treatment plants and of wastewater treatment plants in towns with a population of up to 50,000 residents "(budget of the Ministry of Regional Development and Public Administration)	1,255.00	Capital spending
Ensuring the funding for the remuneration of clerical and cult places personnel (budget of the Government's General Secretariat)	92.70	Personnel spending

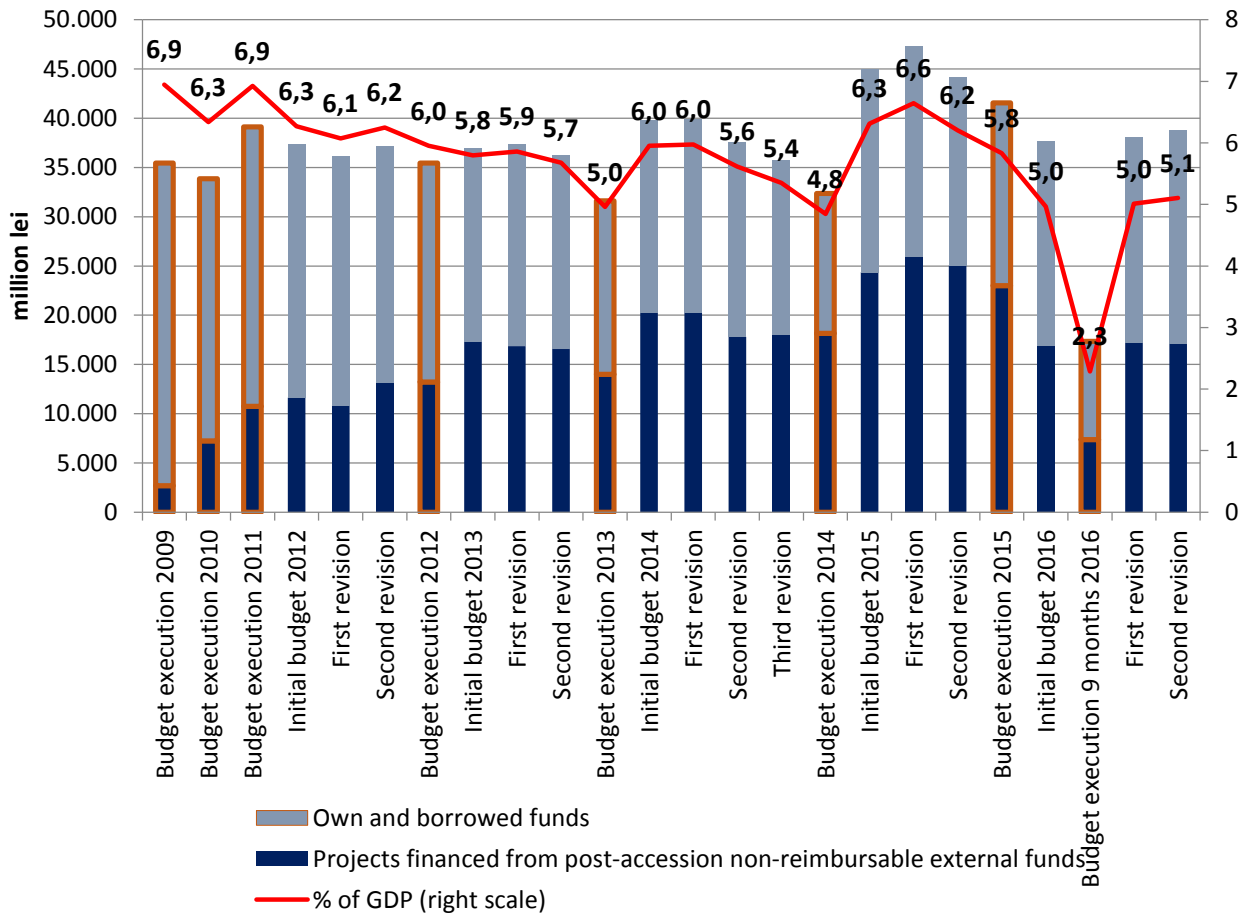
Source: Ministry of Public Finance

ANNEX II	Initial budget 2016	Swap program 2016	Initial budget 2016 without swap	First budget revision (R1)	Additional swap	R1 without swap	Second budget revision (R2)	Additional swap	R2 without swap	R1 - Initial budget	R2 - Initial budget	R2-R1
	1	2	3=1-2	4	5	6=4-5	7	8	9=7-8	10=6-3	11=9-3	12=9-6
	without swap											
TOTAL REVENUE	231125.5	1070.0	230055.5	234882.4	1070.0	233812.4	235695.5	922.6	234773.0	3757.0	4717.5	960.5
Current revenue	217018.2	1070.0	215948.2	220412.9	1070.0	219342.9	221242.9	922.6	220320.3	3394.7	4372.1	977.4
Tax revenue	136123.0	1070.0	135053.0	139015.5	1070.0	137945.5	139618.4	922.6	138695.9	2892.5	3642.9	750.3
Taxes on profit, wages, income and capital gains	41759.6		41759.6	44179.3		44179.3	44711.0		44711.0	2419.6	2951.3	531.7
Corporate income tax	14384.9		14384.9	15437.5		15437.5	15361.4		15361.4	1052.7	976.5	-76.1
Personal income tax	26206.9		26206.9	27103.8		27103.8	27671.1		27671.1	896.9	1464.2	567.3
Other taxes on income, profit and capital gains	1167.8		1167.8	1637.9		1637.9	1678.4		1678.4	470.0	510.6	40.5
Property tax	5980.1		5980.1	5982.7		5982.7	5883.5		5883.5	2.6	-96.6	-99.2
Taxes on goods and services	87137.6	1070.0	86067.6	87438.2	1070.0	86368.2	87660.9	922.6	86738.3	300.5	670.7	370.1
VAT	52342.3	1070.0	51272.3	52748.6	1070.0	51678.6	53127.6	922.6	52205.0	406.3	932.7	526.4
Excises	27382.3		27382.3	27562.3		27562.3	27562.3		27562.3	180.0	180.0	0.0
Other taxes on goods and services	3958.6		3958.6	3757.1		3757.1	3722.7		3722.7	-201.5	-235.8	-34.3
Taxes on using goods, authorizing the use of goods or on carrying activities	3454.5		3454.5	3370.2		3370.2	3248.3		3248.3	-84.3	-206.2	-121.9
Tax on foreign trade and international transactions (customs duty)	836.7		836.7	1015.6		1015.6	950.2		950.2	178.9	113.5	-65.4
Other tax revenue	409.0		409.0	399.9		399.9	412.9		412.9	-9.1	3.9	13.0
Social security contributions	61748.8		61748.8	60766.8		60766.8	60811.3		60811.3	-982.0	-937.5	44.6
Nontax revenue	19146.4		19146.4	20630.6		20630.6	20813.1		20813.1	1484.2	1666.7	182.5
Capital revenues	951.7		951.7	901.8		901.8	874.5		874.5	-50.0	-77.2	-27.2
Grants	20.6		20.6	22.5		22.5	22.6		22.6	1.9	2.1	0.1
Amounts received from the EU in the account of payments made and prefinancing	336.9		336.9	744.0		744.0	756.1		756.1	407.1	419.2	12.1
Financial operations	0.0		0.0	0.0		0.0			0.0	0.0	0.0	0.0
Amounts collected in the single account	0.0		0.0	0.0		0.0			0.0	0.0	0.0	0.0
Other amounts received from the EU for operational Programmes funded under the convergence objective	0.0		0.0	0.0		0.0			0.0	0.0	0.0	0.0

Amounts received from the EU/other donors in the account of payments made and pre-financing for financial framework 2014-2020	12798.1	12798.1	12801.3	12801.3	12799.5	12799.5	3.2	1.4	-1.8			
TOTAL EXPENDITURE	252031.0	1070.0	250961.0	255787.8	1070.0	254717.8	256554.0	922.6	255631.4	3756.8	4670.4	913.6
Current expenditure	232848.4	1070.0	231778.4	236725.5	1070.0	235655.5	236397.4	922.6	235474.8	3877.1	3696.4	-180.6
Personnel	57335.0		57335.0	58703.0		58703.0	58835.4		58835.4	1367.9	1500.4	132.4
Goods and services	43111.4		43111.4	43500.2		43500.2	43116.6	72.6	43044.1	388.8	-67.4	-456.2
Interest	11069.0		11069.0	11388.1		11388.1	10646.3		10646.3	319.1	-422.7	-741.8
Subsidies	6464.3		6464.3	6721.3		6721.3	6933.5		6933.5	257.0	469.1	212.2
Total Transfers	114235.8	1070.0	113165.8	115631.8	1070.0	114561.8	116304.9	850.0	115454.9	1396.0	2289.1	893.2
Transfers for public entities	1966.8	1070.0	896.8	1720.8	1070.0	650.8	1680.1	850.0	830.1	-246.0	-66.7	179.2
Other transfers	12311.1		12311.1	12163.2		12163.2	11800.5		11800.5	-147.9	-510.6	-362.7
Projects funded by external post-accession grants	4600.7		4600.7	6864.9		6864.9	6682.1		6682.1	2264.2	2081.4	-182.8
Social assistance	79373.4		79373.4	80749.4		80749.4	81882.2		81882.2	1375.9	2508.8	1132.9
Projects funded by external post-accession grants 2014-2020	12449.2		12449.2	10464.0		10464.0	10521.5		10521.5	-1985.2	-1927.7	57.5
Other expenditure	3534.5		3534.5	3669.5		3669.5	3738.5		3738.5	135.0	204.0	69.0
Reserve funds	100.0		100.0	202.5		202.5	101.8		101.8	102.5	1.8	-100.7
Expenditure funded from reimbursable funds	532.8		532.8	578.5		578.5	458.9		458.9	45.8	-73.9	-119.7
Capital expenditure	19182.6		19182.6	19062.4		19062.4	20156.6		20156.6	-120.3	973.9	1094.2
Financial operations	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
Payments made in previous years and recovered in the current year	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
EXCEDENT(+)/DEFICIT(-)	-20905,5		-20905,5	-20905,5		-20905,5	-20858,4		-20858,4	0,0	47,1	47,1

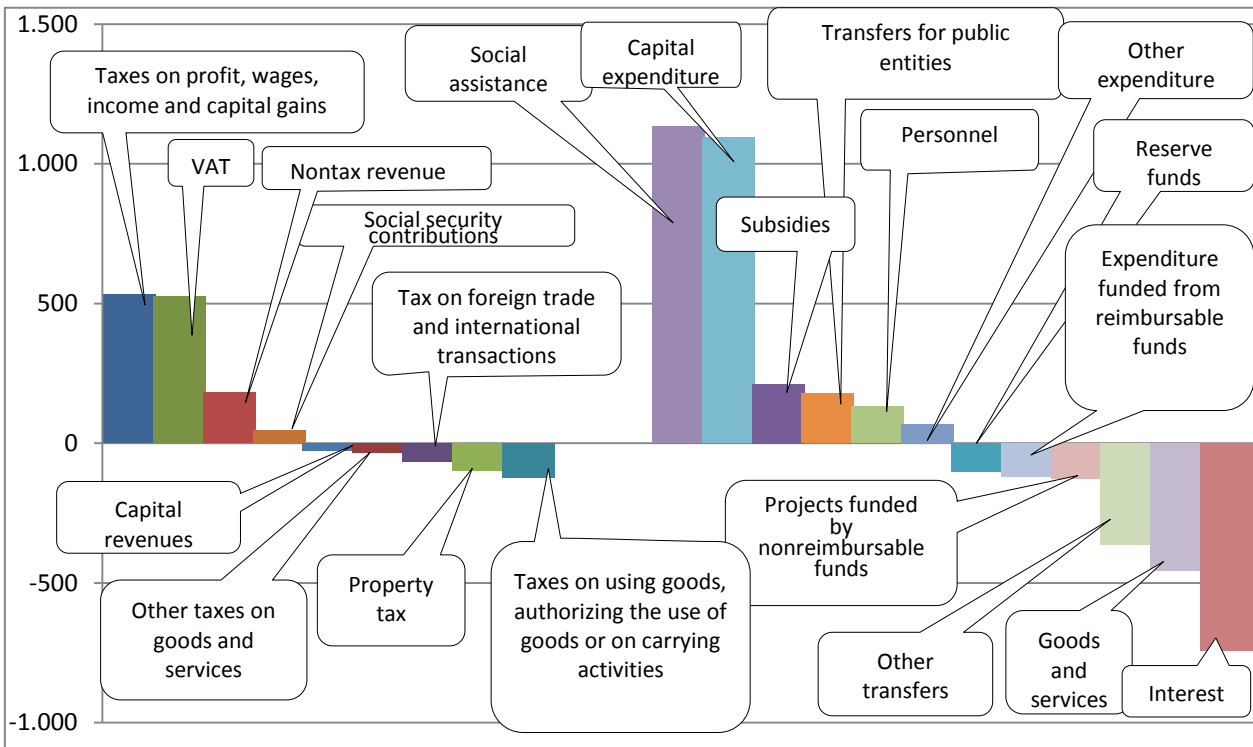
Source: Ministry of Public Finance, Fiscal Council's calculations

Figure 1: The evolution of investment expenses between 2009-2016 – planned level vs. execution (million lei)



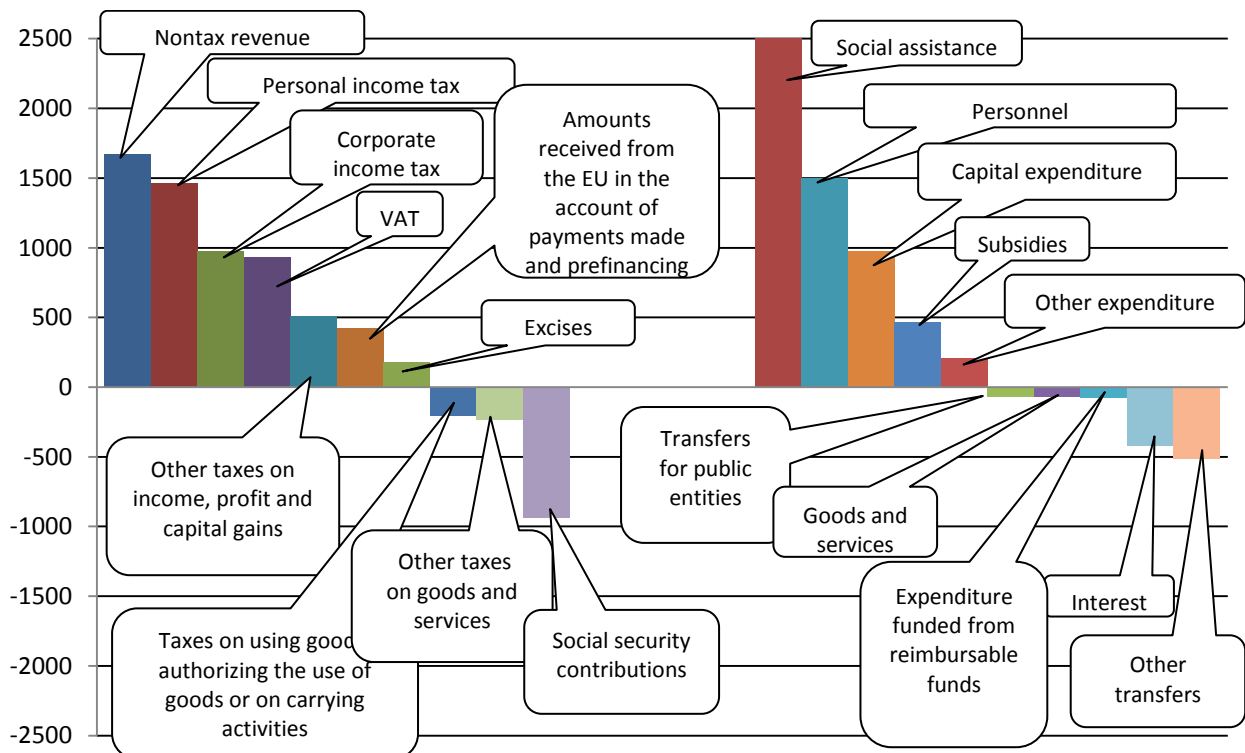
Source: Ministry of Public Finance, Fiscal Council's calculations

Figure 2: 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 3: The main changes in revenues and expenditures compared to initial budget (without the impact of swap schemes), million lei



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