Fiscal Council's opinion on the Fiscal Strategy for 2013-2015

On May 30th 2012, the Fiscal Council received from the Ministry of Finance a letter requesting, based on Art. 40, paragraph (2) of Law no. 69/2010, an opinion regarding the *Fiscal Strategy for 2013-2015.*

Based on Art. 23 letter c) of the Fiscal Responsibility Law (FRL) no.69/2010, the fiscal framework of the fiscal strategy (FS) may be reviewed if a change of Government occurs, a case in which at the beginning of the mandate, the new Government will make public, whether its program complies with the latest fiscal strategy approved by the Parliament; otherwise the Ministry of Public Finance will prepare a new fiscal strategy. In the new context created by the change of government and recent adjustments in the parliamentary majority's configuration, the Fiscal Council considers that the new Executive has the right, according to the FRL, to formulate its own medium-term fiscal policy coordinates, without being constrained by the parameters of previously approved FS, but complying with the principles and the rules from the law no. 69/2010. Updating the fiscal strategy was necessary as the previous version was elaborated based on a macroeconomic framework already outdated even at the time of approval by the Parliament; in fact, the assumptions and corresponding targets were significantly different from those embodied in the budget law for 2012, approved in December 2011. Based on article 40, paragraph (2), letter b) of the Fiscal Responsibility Law, the Fiscal Council has the legal attribution to "*analyze and issue opinions and recommendations on the Fiscal Strategy and assess its compliance with the principles and rules specified in this law*". Moreover, according to article 40, paragraph (2), letter a), the Fiscal Council has the legal attribution to "*analyze and issue opinions and recommendations on official macroeconomic and budgetary forecasts*".

Thus, given its mandate in accordance with law no.69/2010, **the Fiscal Council issues the following opinions and recommendations on the Fiscal Strategy for 2013-2015 (FS 2013-2015)**:

Compliance with the rules from the Fiscal Responsibility Law (FRL)

Given the above arguments, the only rule that can be evaluated is the one defined in Art. 6, letter d), which states that "*until the consolidated general budget balance is in surplus in the previous year, the annual rate of growth in the forecasted consolidated general budget expenditures will be maintained below the annual rate of growth of the forecasted nominal GDP for the three-year period of the fiscal strategy*".

The FS for 2013-2015 partially complies with this rule, as public spending expressed as a percent of GDP is forecasted to decline from 34.68 percent of GDP in 2012 to 34.48 percent of

GDP in 2013. However, the general Government expenditures are projected to increase slightly faster than the nominal GDP in 2014, to a level of 34.63 percent of GDP, while in 2015 their share falls to 34.53 percent of GDP. Eliminating the impact of the projected absorption of EU funds, budget expenditures expressed as a percentage of GDP would fall steadily (32.5 percent in 2012, 32.3 percent in 2013, 31.9 percent in 2014 and 31.8 percent in 2015). The Fiscal Council considers that an amendment of Article 6, letter d) of the Law no.69/2010 referring to "total budgetary expenditure eliminating financial assistance from the European Union and other donors", similar to Article 6, letter c) would be appropriate. Thus, consistency between the articles of the law would be ensured, while better performance in terms of EU funds absorption, which is undoubtedly desirable, would not be penalized through reducing other government spending.

Assessment of the macroeconomic framework of the FS for 2013-2015

In accordance to the macroeconomic baseline scenario underlying the fiscal strategy, real GDP, after a 2.5 percent growth recorded in 2011, is forecasted to advance by 1.7 percent in 2012 and 3.1 percent in 2013, the acceleration of the positive dynamics being projected to continue in the coming years, reaching a level of 3.9 percent in 2015.

The macroeconomic assumptions underlying the 2013-2015 FS are compatible with the latest projection of the European Commission, which estimated a GDP growth of 1.4 percent and 2.9 percent in 2012 and 2013. However, given the annual GDP growth rate of only 0.3 percent recorded in the first quarter of 2012 and the recent resurgence of tensions in international financial markets related to developments in the sovereign debt crisis in Europe, the Fiscal Council considers the GDP growth projections as rather optimistic and points to the unusually large size of the adverse risks to the macroeconomic parameters, and thus to the fiscal targets.

Regarding the projections of labor market indicators, although the Fiscal Council considers plausible the assumptions related to the number of employees in the economy, it assesses as optimistic the projection on short-term dynamics of the average wage. Taking into account salary increases announced in the budgetary sector (8 percent from June 1st and 7.4 percent from December 1st), the dynamic of wages in the private sector should be more than 7 percent in 2012 so that the advance for the overall economy to be consistent with the projection of 6.7 percent from 2013-2015 FS, which seems unlikely given the average annual growth of about 4 percent recorded in the first four months of 2012.

Assessment of the fiscal framework in the 2013-2015 period

The Fiscal Strategy draft reaffirms the commitment regarding fiscal consolidation over the next three years, the budget deficit (cash methodology) being projected to fall from 2.25% of GDP in 2012 to 1.43% of GDP in 2015. According to the fiscal strategy, when adjusting with the projected impact of UE funds absorbtion on the budget, the 0.8 percentage points of GDP reduction of the budget deficit in the period 2012-2015 is based largely on a decrease in budgetary expenditures which are projected to fall by 0.63 percentage points of GDP in 2015 compared to 2012; the increase in revenues has a significant contribution on budget deficit adjustment only in 2013 (an increase of 0,26 pp. of GDP in budget revenues compared with 2012).

According to the latest Convergence Program version notified to the European Commission, the new deficit targets (ESA95) are 2.8 percent of GDP for 2012, 2.19 percent for 2013, 1.2 percent in 2014 and 0.94 percent in 2015. These targets are consistent with the medium term objective of a 0.7 percent structural deficit in 2014 and 2015, according to the commitments assumed under the Treaty on stability, coordination and governance in the economic and monetary union (also known as the fiscal compact).

The differences between the cash budget balance and that according to ESA 95, for the period covered by the FS, can be explained mainly by three factors. First, the amount of state obligations to pay to certain categories of employees in the public sector as a result of final court rulings was registered in the balance of 2011 according to ESA95 (6.4 billion RON, respectively 1.1% of GDP), while according to cash methodology these will be reflected gradually, during the period 2012-2016, following the decision of the Parliament, with an acceleration of payments in the period 2014-2015 (5 percent of the amount of state obligations would be paid in 2012, 10 percent in 2013, 25 percent in 2014 and 2015, 35 percent in 2016). Secondly, the Government aims to reduce the settlement period for bills paid from the state budget and social security budget to 60 days (especially in the health sector)[1]. This is expected to be achieved especially in the period 2014-2015, which will determine an increase in the cash deficit without affecting the budget balance according to ESA95, the payment obligations being already reflected in the previous years' levels of the latter. Thirdly, the projects in progress related to the National Infrastructure Development Program (PNDI), recently stopped through the Government's Ordinance no. 14/2012 (published in the Official Gazette of April 26th, 2012), will continue to be reflected in the ESA95 execution, upon completion, until 2014, but the effective payment will be made and therefore reflected in the cash execution especially starting with 2015.

Given the projected dynamic of the main budgetary items and the information provided by the 2013-2015 FS, the Fiscal Council considers that the FS was elaborated mainly based on the implicit assumption of maintaining the current coordinates of the fiscal policy ("no policy change"). Also, the Fiscal Council has to mention again the lack of transparency in explaining

[1] According with EU directive 2011/7/EU on combating late payment in commercial transactions.

the forecast of the main budgetary aggregates for the reference period, as the 2013-2015 FS only contains a list of already adopted measures, while not including the impact assessment of the discretionary measures envisaged for the 2013-2015 period.

Budgetary revenues and expenditures

The budgetary revenues as a percentage of GDP are projected to advance in the FS reference period from 32.4 percent of GDP in 2012 to 33.1 percent of GDP in 2015, due to a significant improvement of EU post-accession funds' absorption. Thus, while the share of GDP of tax revenues (excluding social contributions) remains relatively constant at 18.7-18.8 percent over the considered period, the projected level of revenue from structural funds increases from 2.1 percent of GDP in 2012 to 2.7 percent of GDP in 2015.

The Fiscal Council considers as optimistic the projected medium-term evolution of fiscal revenues (including social contributions) from social contributions, especially those for the year 2013, given that for most categories of tax revenues, the forecasted changes are higher than those of the relevant macroeconomic base. Even if such dynamics could be explained by increased efficiency in the efforts to combat tax evasion, the Fiscal Council considers as relatively risky to account for their impact *ex ante*, and recommends rather an *ex post* assessment, when efforts to improve tax collection will be efectively materialized.

Particularly, the projected dynamic of revenues from social contributions appears to be inconsistent with the scenario envisaged for wages and the number of employees in the overall economy (which would justify an increase of about 7 percent of revenues from social contributions *caeteris paribus*). Also, it should be taken into account that revenues from social contributions are unfavorably affected by the impact of the recent Constitutional Court decision on the calculation of health insurance contributions on pensions (about 1.1 billion RON in one year, all of which three quarters in 2012 and the rest in 2013), plus the recent decision of the refund in 16 installments of the difference between contributions collected during January 2011 - April 2012 on the basis of the methodology that was declared unconstitutional and those calculated under the new methodology (which amounted to about 1.5 billion RON, of which seven installments in 2012 and 9 installments in 2013), reflected as negative revenues. Despite this, revenues from social contributions in the FS are projected to increase in 2013 by 9.7 percent, respectively by 0.2 percentage points of GDP, mainly due to the 12.1 percent nominal growth rate of the item directly affected by the negative impact of discretionary measures decided in 2012 - contributions for health insurance. In the opinion of the Fiscal Council, such dynamics cannot be explained in the absence of discretionary measures which, unfortunately, are not specified in the text of the fiscal strategy.

In this context, the Fiscal Council reiterates its previous recommendations on compliance with the transparency principle stated in Art. 4 of Law no. 69/2010, thus requiring a more detailed presentation of the macroeconomic bases, of the considered elasticities for each revenue category, and also of the impact of discretionary measures affecting the projections.

Regarding the legislative measures intended to be adopted in the strategy's horizon of applicability, the FS text includes "the analysis of personal income tax and of the opportunity to amend it to ensure that the fairness principle is met, the tax burden of each taxpayer being determined by its ability to pay tax" and also "a careful consideration of whether to establish new VAT rates in order to reduce tax evasion and to maintain the purchasing power of low-income population". In both cases, the FS text does not specify concrete measures envisaged in this respect nor quantifies their impact.

Given that the fiscal strategy should be an essential tool to ensure medium-term fiscal policy consistency and predictability, the Fiscal Council believes that a rigorous definition of the parameters that will affect revenues in the next years would be necessary despite the current government's limited mandate and the uncertainties regarding the political configuration that will result after the parliamentary elections scheduled for the end of the year.

As regards government expenditure, its level, expressed as percentage of GDP (excluding the impact of scheduled post-accession European funds' absorption), is decreasing; this is explained mainly by the dynamics of social assistance, as a result of the new indexing pensions' scheme, which will be applied in the following years (the previous year's average inflation plus half of the real wage growth in the same period), and by the scheduled replacement of financing capital expenditure from own resources with European funds financing.

More transparency is desirable also in forecasting personnel expenditure dynamics, taking into account that, except for references to wage increases this year and to maintaining the rule of partial replacement of employees leaving the system, the strategy does not specify the medium-term assumptions considered for the average wage and the average number of employees in the public sector.

Conclusions

According to the Fiscal Council, further fiscal consolidation efforts and structural reforms are necessary in the next years not only because of the commitments assumed by Romania at an European level and because of the agreements with the IMF / EC / World Bank, but also in order to ensure public finances' sustainability over the medium and long term, so that the fiscal policy can manage risks without making significant adjustments to expenditure and revenue, which would have economic and social destabilizing effects; in addition, the principle of intergenerational fairness must be respected.

The Fiscal Council considers that the balance of risks in terms of fiscal policy in the coming years is rather tilted on the negative side (a budget deficit higher than projected). In this context, according to the Fiscal Council, the 2013-2015 FS should contain a separate chapter that evaluates risks to macroeconomic and budget indicators' forecast and also any measures envisaged in the event that these risks materialize, especially given the recent developments in international financial markets.

In line with previous recommendations, the Fiscal Council insists that the assumptions underlying the budget and fiscal aggregates' trajectory must be clearly presented, especially in terms of explicit quantification of the impact of discretionary measures affecting it.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of Fiscal Council, according to Article 43, paragraph (2), letter d) of Law no. 69/2010, after being approved by the Council members through vote, on June 12, 2012.

June 12, 2012 **Chairman of the Fiscal Council**

IONUȚ DUMITRU