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

Under article 23, letters b) and c) of the Fiscal Responsibility Law (FRL) no. 69/2010, the fiscal framework of the fiscal strategy (FS) may be reviewed when there is a significant worsening of the macroeconomic indicators that were used in the fiscal strategy elaboration or when 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 or not. In the latter case, the Ministry of Public Finance will prepare a new fiscal strategy. The Fiscal Council considers that the present case is consistent with both situations stated in the above mentioned law articles and the Government's initiative to update the previous version of the strategy is justified. Moreover, the first form of the strategy and the associated law approving ceilings for certain indicators specified in the budgetary framework had not undergone a complete legislative process and were not approved by the Parliament.

Under 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 revised 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 article 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 Fiscal Council recalls that, in its opinion regarding the original form of FS 2013-2015, it warned about the existence of an inconsistency between the provisions of the above mentioned article and article 6 letter c), which refers to "total budgetary expenditure eliminating financial assistance from the European Union and other donors". This inconsistency has the potential to penalize the Government for better performance in terms of EU funds absorption by imposing a constraint to operate cuts in other chapters of expenditure and the Fiscal Council considers that an amendment of this article is adequate in order to use the same definition of total expenditure, respectively the definition stated at article 6, letter c). Considering an *ad litteram* interpretation of the budgetary rule mentioned above, the trajectory for total expenditure would only partially comply with the fiscal rules, given that the marginal reduction of total expenditure as a share of GDP would be recorded only in the years 2014 and 2015 (from 35.73% of GDP in 2013 to 35.72% of GDP in 2014 and 35.7% in 2015), while in 2013 an increase of total expenditure as a share of GDP would be recorded (from 35.53% in 2012 to 35.73% in 2013). However, adjusting total expenditure with the projections of revenues regarding the financial assistance from the EU and other donors, its growth rate is maintained below the one of nominal GDP and its trajectory expressed as a percentage of GDP registeres a continuous decreasing (from 34.09% of GDP in 2012 to 33.82% in 2013, respectively 33.49% and 33.23% of GDP in 2014 and 2015), which would respect the spirit of the fiscal rule mentioned above.

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

The economic growth assumption underlying the updated FS 2013-2015 is significantly more unfavorable than the one used in the previous version of the strategy, noting a downward revision compared to the latest projections of the European Commission (November 2012). Thus, the current projection is based on an increase of real GDP of 1.6% in 2013 (3.1% in the previous version of FS and 2.2% in the projection of the European Commission), 2.2% in 2014 (3.6% in the previous version of FS and 2.7% in the projection of the European Commission), respectively an increase of 2.8% in 2015 (3.9% in the previous version SFB). For the year 2013 the downward revision is explained by the inertial effect of GDP dynamics, which was far below expectations during the year 2012 (the economic growth is estimated to register a value of only 0.2% compared with a growth assumption of 1.7% in the previous form of FS 2013-2014), but the trajectory for the coming years reflects mainly, according to the updated FS, a weaker than expected performance of the European economy.

The Fiscal Council considers as relatively realistic the macroeconomic scenario taken into account in the elaboration of the revised FS 2013-2015, assessing the risks as relatively balanced. However, in the Fiscal Council's opinion, the upward trend considered for the economic growth is conditioned over the medium and long term by the recovery of the structural reforms implementation delays and by a substantial improvement of EU funds absorption (which would have positive effects in the short term). Also, the magnitude of the structural fiscal consolidation effort necessary to achieve the medium-term objective (respectively a structural deficit of 1% of GDP) is substantially lower than in previous years, thus supporting an acceleration of economic growth.

Regarding the projections of labor market indicators, the average growth rate of employment in the period 2013-2015 (1.3%) remains unchanged compared to the previous strategy, despite the significant downward revision of the economic growth path during this interval. Although such a development appears to be validated by the unexpected increase in the number of employees in 2012, recorded in the conditions of an economic growth far below initial forecasts, this can be interpreted as a frontloading in the number of jobs created by the private sector in anticipation of favorable developments in the aggregate demand, which materialized in a lesser extent (as indicated by the recent macroeconomic projections in Europe) would have the potential to trigger future corrective actions in order to recover the 2012 losses of competitiveness. Given the statistical inertial effect associated with the new jobs created in 2012, the projection for the current year seems to be plausible, but for the period 2014-2015 the Fiscal Council considers as more prudent a lower employment growth than the one from the current projection.

The Fiscal Council appreciates that the assumptions for the number of employees and average wage in the public sector for the year 2013 are explicitly presented in the strategy. Nevertheless, the Fiscal Council notes that despite its previous recommendations, an explicit presentation of these assumptions for the entire period covered by the strategy is still missing, although these hypotheses are underlying both the economic aggregates trajectories and the level of personnel spending of the general consolidated budget.

Assessment of the fiscal framework in the 2013-2015 period

The updated Fiscal Strategy reaffirms the commitment regarding fiscal consolidation over the next three years, the budget deficit (cash methodology) being projected to fall from 2.5% of GDP in 2012 to 1.8% of GDP in 2014, while in 2015 it is forecasted to remain at the same level as in 2014. According to the strategy, the deficit reduction of about 0.7 percentage points of GDP in the period 2012-2015 is projected to be realized by increasing revenues (with 0.9 percentage points of GDP, from 33.0% of GDP in 2012 to 33.9% of GDP in 2014), while budget expenditures are forecasted to increase in 2013 by 0.2 percentage points of GDP, to 35.7% of GDP, after that being projected to remain at this level. The above figures incorporate the expected substantial growth of inflows from EU funds and adjusting for that, the reduction in the deficit for the years 2013 and 2014 is the result of maintaining the growth rate of total expenditures below the dynamics of nominal GDP (0.6 pp. of GDP cumulative adjustment) and a slight increase in the share of revenues in GDP (0.1 pp. of GDP, cumulatively between 2012 and 2014).

The Fiscal Council considers that the proposed targets are consistent with achieving in 2014 of the medium term objective of 1% structural deficit (which would ensure compliance with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union – the Fiscal Compact, ratified by Romania in June 2012). It should be noted that the objective of medium-term structural deficit that Romania needs to align to as a result of its status as an EU member state, determined from the deficit that stabilizes the share of GDP of the public debt stock plus an adjustment due to the incorporation of a portion of the long-term costs of aging, was revised upwards by the European Commission to 1.25% of GDP as a result of the favorable impact of structural reforms on pensions in the latter, assessed in the context of the *Ageing Report 2012*. However, given the maximum limit set by the Fiscal Compact, which was signed by Romania, the operational level of the medium-term objective is 1% structural deficit. The necessary structural adjustment effort in the years 2013 and 2014 appears to be significantly lower the one from 2010 to 2012, its cumulative two-year level (about 0.8 to 1 pp. of GDP) accounting for about half of that already implemented deficit reduction during 2012. In addition, the economic growth in 2012 and its revised projection for 2013 is translated into a widening negative output gap in these two years, and therefore a greater negative cyclical component of the budget balance, which make the structural deficit objective for 2014 consistent with a higher headline deficit (ESA95) - 2% of GDP in 2014 (corresponding to a structural deficit of 1% of GDP), compared with 1.3% in the previous version of the FS 2013-2015 (corresponding to a structural deficit of 0.7%).

The FS 2013-2015 anticipates a reduction of the gap between the deficit calculated using the national methodology (cash) and the ESA 95 (accrual), given that the first will incorporate expenditures that have already been recorded in the previous years under ESA95; in particular, they relate to the amount of state obligations to certain categories of employees in the public sector that occurred after final court rulings (about RON 6.4 billion recorded in accrual system in 2011, but began to be paid in 2012 and thus continuing to burden the cash budget system in increasing proportions until 2016), and the allocation of funds necessary to reduce the invoice payment period to 60 days, in accordance with EU Directive 2011/7.

Budgetary revenues and expenditures

The level of revenues as a percentage of GDP is projected to increase in the FS from the a level of 33% of GDP in 2012 to 33.9% of GDP in 2015, due to improved post-accession EU funds absorption, which is expected to add revenues of 1.2% of GDP at the end of 2015 compared to 2012. The main categories of taxes are expected to grow in line with nominal GDP, fluctuations occurring at the level of "other general taxes on goods and services" (fall in 2013), as a result of non-including revenues from the clawback tax and "tax on the use of goods, authorizing the use of goods or conducting activities" (fall in 2014), given the exceptional income in 2013 from renting frequency bands by mobile operators (+2.1 billion). Non-tax revenues are expected to register a slight increase as a share of GDP since 2014, following the intentions stated by the Government to reassess the level of royalties for natural resources since 2014 (non-tax revenues are projected to increase in 2014 by 0.2 pp. of GDP, the main factor driving the reduction in the projected budget deficit from 2.1% of GDP in 2013 to 1.8% of GDP in 2014).

In the Fiscal Council's opinion, the projected trajectory of the main categories of budget revenues appears consistent with a no policy change scenario. Although the FS 2013-2015 states that the authorities intend to operate over the period covered by the strategy's substantial changes in the tax code with a major impact on budgetary revenues (the return to a 19% VAT, VAT reduction to agricultural producers from 24% to 9%, reduction in employers' social contributions by 5 pp., introducing a differentiated income tax revenue, with rates lower than 16% for certain portions of income), it does not contain any details of the moment when the measures will be implemented or any assessment of their impact. Thus, the Fiscal Council finds serious deficiencies of transparency in underlying the medium-term trajectory of budgetary revenues, given that a detailed assessment of the impact of discretionary measures is provided only to those adopted in the context of the 2013 budget.

While in the conditions of accepting the hypothesis of not changing the current tax system, the revenue projections generally appear as realistic, in the Fiscal Council's opinion, a slight overestimation of the receipts from VAT and excise duties can be identified in 2014 and 2015. Even if a better dynamic compared to the one of the relevant macroeconomic bases can be justified by a potential increase in the efficiency of the collection process, the Fiscal Council reiterates its call for caution, considering as risky an *ex-ante* inclusion of the result of the measures against tax evasion and recommending the *ex-post* inclusion, after the efforts to improve the collection are materialized.

While noting a significant improvement of transparency regarding the projections of the budgetary aggregates for the first year covered by the FS 2013-2015, the Fiscal Council considers as necessary a more detailed overview of the macroeconomic bases and elasticities considered for each category of revenue and the impact of discretionary measures affecting the projections for the rest of the period covered by the strategy in accordance with the transparency principle stated in article 4 of Law no. 69/2010.

Under article 20, paragraph (2) of Law no. 69/2010, the Fiscal Strategy should include a sensitivity analysis of the fiscal targets to changes in the macroeconomic indicators. However, the Fiscal Council notes the absence of this analysis that we consider mandatory, especially in the current economic environment which is still difficult to predict, for both the European economy and, implicitly, the Romanian economy.

Regarding the expenditures, their projected trajectory shows an increase from 35.4% of GDP in 2012 to 35.7% of GDP in 2013 and maintaining this level until 2015. The above figures incorporate the expected substantial growth of inflows from EU funds while adjusting for that, the budget expenditures are projected to have a growth rate below the dynamics of nominal GDP (cumulative adjustment of 0.6 pp. of GDP in 2013-2014 of total expenditure minus EU funds absorption). This trend is driven mainly by the social assistance category dynamics as a result of the application of the new pension indexation scheme in the coming years (average inflation plus half of the previous year's real wage growth), plus the scheduled replacement of capital expenditure from own resources with EU funds and spending cuts to subsidies.

Regarding the spending on goods and services, the revised FS projects a slight increase as a share of GDP in 2013 to 5.98% from 5.89% in the previous year, followed by a reduction to a level of 5.54% of GDP in 2015. Increased spending on goods and services in 2013 is explained mainly by the application of the European Commission Directive 7/2011 on combating late payment in commercial transactions. The Government will have to reduce the invoice payment period to 60 days and the financial effort is of approximately RON 3.5 billion (0.54% of GDP). In the Fiscal Council's opinion, reducing spending on goods and services to around 5.5% of GDP will be a major challenge given their evolution in the previous years characterized by frequent overruns compared to the allocations from the initial budget and the intention to reduce the arrears of the general consolidated budget. In this context, the expenditures with goods and services seem under-estimated and there are significant risks of exceeding the amounts provided in the FS. In the Fiscal Council's opinion, such a reduction is not possible without very deep structural reforms, particularly in the health system, and without a more efficient public procurement system in general.

The projected dynamic of personnel costs shows an advance as a percentage of GDP in 2013 to 7.4% from 6.97% in 2012 while afterwards entering on a downward trend, the 2015 forecasted level being 6.94% of GDP. The level of personnel expenses in the FS accommodate increases in salaries due to return to June 2010 wages and the amounts resulting from obligations of the state towards certain categories of employees in the public sector following final court rulings. Excluding the impact of the latter, personnel costs are expected to be increased in nominal terms by only 2.56% in 2014 and 2.75% in 2015. In the context of the declared intention of maintaining the number of employees in 2013 at the level recorded in November 2012 and in the absence of projections regarding the number of employees in the public sector for the period 2014-2015, the Fiscal Council considers as under-estimated the staff costs, as their growth rate is lower than the expected average inflation. Also, according to article 6, letter a) of the Fiscal Responsibility Law "personal expenses of the general government as a percentage of GDP cannot exceed the annual ceilings set under the fiscal strategy for the first two years covered by it". Therefore, a nominal wage increase in 2014 over the level provided in the FS 2013-2015 can be legally sustained only by a higher than expected advance of nominal GDP.

The expenditures on projects financed through post-accession EU funds are expected to significantly accelerate from 2.26% of GDP in 2012 to 4.68% of GDP in 2015 while reducing capital expenditures from own resources from 3.3 % in 2012 to 2.97% of GDP in 2015; thus the investment financing will be done mainly from EU funds. In the context of the so far very poor performance regarding EU funds absorption, the Fiscal Council draws attention to the significant risks to the fiscal targets generated by the failure to attract EU funds while using own resources to ensure the continuity of the projects, the experience of 2012 being eloquent in this respect.

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 February 5th, 2013.

February 5th, 2013

Chairman of the Fiscal Council

IONUȚ DUMITRU