Romania

Fiscal Council

Annual Report

2014

Note:

The Annual report for 2014 was approved by the Chairman of the Fiscal Council, according to article 56, paragraph (2), letter d) of Law no. 69/2010, after being adopted by the members of the Council through vote, on November 16, 2015.

The publication of the Annual Report was delayed due to data availability for the chapters relating to the state owned entreprises and tax evasion assessment for Romania. In the case of state companies, the financial reports for the year 2014 of the state companies in Romania have been received by the Fiscal Council from the Ministry of Public Finance in the latter part of July 2015 and required laborious processing of the raw data for the analysis developed by the Fiscal Council. In the case of the necessary data to estimate tax evasion, the availability of detailed statistical data needed for the calculations was delayed (the required data were partially available and were sent to the Fiscal Council in late September 2015 for estimating VAT tax evasion) and at the time of publishing this report, the Fiscal Council is still having clarifying discussions with the National Institute of Statistics. Therefore, the Fiscal Council decided to publish the Annual Report without VAT evasion estimate, which will be updated and published in a note at the moment of clarifying all the necessary aspects with the National Institute of Statistics.

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List of abbreviations

CEE	Central and Eastern Europe
CF	Cohesion Fund
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EC	European Commission
EMFF	European Maritime and Fisheries Fund
EMU	Economic and Monetary Union
ERDF	European Regional Development Fund
ESA 2010	European System of National and Regional Accounts 2010
ESA 95	European System of Accounts 1995
ESF	European Social Fund
EU	European Union
FC	Fiscal Council
FRL	Fiscal Responsibility Law No 69/2010
FS	Fiscal Strategy
FSu	Updated Fiscal Strategy
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
IBL	International Bureau of Labor
IMF	International Monetary Fund
ITC	Information Technology and Communications
MEF	Ministry of European Funds
MPF	Ministry of Public Finance
MTO	Medium-term objective
NAE	National Agency for Employment
NAFA	National Agency for Fiscal Administration
NBR	National Bank of Romania
NCEF	National Commission for Economic Forecasting
NIS	National Institute of Statistics
NMS 10	New Member States from Central and Eastern Europe
NPISH	Non-profit institutions serving households
NREF	Non-reimbursable external funds
NRP	National Reform Programme
NTRO	National Trade Register Office
OPFMA	Operational Programme for Fisheries and Maritime Affairs
pp	Percentage points

PPP	Public Private Partnerships
SGP	Stability and Growth Pact
SME	Small and Medium Enterprises
SOEs	State Owned Enterprises
SSC	Social Security Contribution
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact)
VAT	Value added tax
WB	World Bank

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I. Summary

The Fiscal Council (FC) is an independent authority established by the Fiscal Responsibility Law No. 69/2010 (FRL), which aims to support the Government and the Parliament in designing and implementing the fiscal policy and to promote the transparency and sustainability of public finances.

According to the Fiscal Responsibility Law, the Fiscal Council has among its prerogatives to issue an Annual Report to analyze the conduct of the fiscal policy during the previous year against the framework set out in the Fiscal Strategy and the Annual Budget, to assess the macroeconomic and fiscal developments as well as the objectives, targets and indicators included in the Fiscal Strategy and the Annual Budget.

Economic growth above expectations in 2014, but lower than in the previous year.

The economy advance in 2014 reached a level of 2.8%, a superior dynamic compared with the 2.2% anticipated in the draft budget, but lower than the level of 3.5% recorded in the previous year. Thus, the real GDP in 2014 is very close to that from 2008 (lower by 0.2%), year which marked the debut of the financial and economic crisis in Romania. The most important contribution to the real GDP growth was generated in 2014 by the households final consumption expenditure (+3.8 pp), the final consumption expenditure of general government also having a positive influence (+0.7 pp), while gross fixed capital formation determined a negative contribution of 1.8 pp. Thus, if in the previous year the external demand was the main driver of economic growth, in 2014 it was represented by the domestic demand, the investments have continued their negative trend.

The fiscal consolidation was higher than the initial targets due to a massive underperformance of the investment expenditures. Although in the period 2013 - March 2014 it was initiated a reform process in the domain of the public investment management,

The budget for 2014 was based on a cash deficit target of 1.8% of GDP and 2.2% of GDP according to ESA 2010, corresponding to a structural deficit of 1.7% of GDP, but the final execution recorded significantly lower levels, respectively 1.87% for cash deficit and 1.48% according to the European methodology, the medium term objective being reached at the end of the last year, although this was scheduled for 2015. The main reason of this development is given by the substantial underperformance of the public investment expenditures; according to national methodology these are with 1.11% of GDP lower than the

the new regulatory framework is not fully operational and the project prioritization has not been accomplished yet.

amounts envisaged in the initial budget. Also, the gross capital formation of the State according to ESA 2010 reached in 2014 the minimum of the past nine years as a percentage of GDP. Practically, Romania did not use the fiscal space that was available in 2014, the portfolio management of the public investment projects reflecting an administrative inability to achieve the planned investment projects, particularly for those funded by external grants, this evolution being likely to unjustifiably induce a negative fiscal impulse in the economy. Although the Government has initiated during 2013 - March 2014 a reform process in the domanin of the public investment management, the Fiscal Council considers that the new legal framework is not fully operational and the prioritization of the projects envisaged by it is not yet achieved, the reform of the public investment management being still in an early stage.

The fiscal rules established by the FRL were frequently violated in 2014, these exerting a weaker constraint on the fiscal policy.

Even if the important fiscal targets were fulfilled, the way how the budgetary process was conducted in 2014 calls into question the relevance of the fiscal rules and the commitment towards the compliance with the fiscal discipline, the Government using derogations from almost all the legal provisions which establish rules. The efficiency of a fiscal rule is determined by the level of constraint that it exercises over the conduct of the fiscal policy. The ease with which the fiscal rules could have been circumvented repeatedly this year, along with the recorded violations in the years that have passed since the adoption of the FRL in 2010, highlights the weakness of the constraints exercised by the fiscal rules and raises serious questions on the commitment to meet in the future fiscal rules established by taking into the national law the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact).

The efficiency of tax collection is still at a low level. A reform of the tax collection system was initiated, but perhaps it requires some time for the

Romania has the lowest share in GDP of total budgetary revenues to GDP (fiscal and non-fiscal revenues), of only 33.4% of GDP in 2014, by 11.8 pp below the European average, while the ratio of the fiscal revenue in GDP (taxes and social contributions) was 27.6%, significantly lower than in similar economies such Hungary (38.5%), Slovenia (36.7%), the Czech Republic (34.0%) and Poland *results to appear.*

(32.9%). The fiscal revenues collected in 2014 were close to those envisaged in the draft budget, under the circumstances of a nominal GDP advance close to that anticipated. The level of the efficienty of taxation for VAT significantly decreased, but instead it increased for social security contributions, corporate tax and income tax.

In 2013 it was initiated a comprehensive reform process for NAFA in cooperation with the World Bank. The Fiscal Council considers that the reform process, that is absolutely necessary in the context of a tax system characterized by a low efficiency, is still in an early stage, and if the process is successful, it has the potential to generate a significant fiscal space over the medium-term. However, the adoption of decisions related to any tax cuts or increase of the expenditures based on the potential gains of efficiencies must occur only ex post, after the reform process proves to be irreversible and capable of generating long-term results.

The financial postion of the public pensions system has deteriorated in 2014, and the trend will continue in the coming years following the decision to reduce the social security contributions owed by employers by 5 pp, that representing the main funding source for the pension system. The return to the special pensions system eliminated in 2010, in conjunction with the inequities created, jeopardize the durability of the reforms previously initiated and it could generate new pressures on

If in the period 2000 – 2007, social security budgets were characterized by a relatively equilibrated or even positive balance, after 2008 the deficits have represented an important component of the general consolidated budget deficit, respectively between 67.5% and 218.7% in the period 2010 – 2014. In 2014, the social security budget deficit reached 1.94% of GDP, higher than the deficit of the general consolidated budget and the expected trend for the coming years is represented by a significant growth of it to 2.69% of GDP in 2015 and 2.80 % of GDP in 2016. Practically, compared to the previous version of the Annual Report of the Fiscal Council, the forecasted deficit for the period 2015-2018 deepened by 6-7 billion lei, representing the budgetary impact of the measure regarding the reduction of the social security contributions by 5 pp from October 1st, 2014. In addition, the Fiscal Council notes the manifestation of some reversing pressures of the pension system reforms aiming at ensuring the financial sustainability in the long term and firmly appeals in the favor of maintaining the progresses made in recent years, both in terms of principles introduced (the exclusive use of the principle of the contribution in determining the pension *the social security budget deficit.*

benefit) and in terms of the strict compliance with the indexation mechanism introduced by the new pension law.

In 2014 it can be seen a deterioration at the level of utilization of the contigency reserve fund, suggesting the change of the Government's behavior compared to 2009-2013. In this context, urgent actions regarding legislative amendment are needed, setting out the manner of the utilisation of the contigency reserve fund.

This deterioration occurs both in terms of the total expenditure allocated and the adopted number of the Government decisions to allocate certain amounts from the contigency reserve fund. Thus, during 2014, 1.75 billion lei (0.7% of total expenditure) have been allocated from the contingency reserve fund, of which 1.1 billion lei were allocated to the central administration and 0.65 billion for local authorities. Compared to the previous year, the contingency reserve fund allocations increased by 795 million lei, respectively by 83.68%, in the context of increased amounts transferred to local authorities by 494 million lei and increased transfers to central administration by 300 million lei.

The Fiscal Council considers as absolutely necessary the implementation of urgent measures to amend the legislation which sets out the use of the contigency reserve fund, reiterating the recommendation on explicit identification of expenditures that can be allocated from the contigency reserve fund with a higher transparency, including through regular reporting to the Parliament of the manner and of the level of the utilisation of the fund.

The level of public debt has continued to increase in 2014, being forecasted a significant increased for the period 2016-2018 compared with the previous projections in the context of implementation of the new Fiscal Code.

The public debt continued to increase in 2014, even at a higher rate than that from 2013, its share in GDP advancing, according to the European methodology ESA 2010, to 39.8%, from 38% recorded at the end of 2013, despite of a lower budget deficit in 2014 compared to 2013, i.e. 1.5% of GDP and of a lower interest paid for loans. This trend is explained by the additional increase in the Treasury reserves, in order to finance in advance the budget deficit and by increase of the buffer used to protect against manifestation of adverse conditions in financial markets. Given the implementation of the new Fiscal Code, the public debt will be stabilized in the period 2016-2018 around the level reached in 2014 compared to a downward trajectory in the absence of the fiscal loosening package. Thus the public debt is projected, according to the calculations of the Fiscal Council, at a value of 40.8% of GDP in 2018, respectively by 4.6 pp more than the projected level in the absence of the new Fiscal Code, i.e. 36.2% of GDP in 2018.

The extremely poor performance in absorbing the European funds, together with the risk of automatic disengagement reflects a failure of the public administration in this area.

Romania has the lowest performance in the EU in terms of absorption of EU funds, with a rate of only 56.3% in 2014 after about eight years from accession. Even though in 2014 compared with the previous year we have made progress in attracting European funds (i.e. an increase of the absorption rate with 18.5 pp), having in view the deadline for attracting the European funds allocated for the programming period 2007-2013, respectively 31 December 2015, the risk of losing a large part of the allocated funds is very high. Thus, even under the materialisation of the ambitious target for 2015, namely an absorption rate of 80% (equivalent to an increase of 23.7 pp compared to 2014), the loss of the amount allocated to Romania for the period 2007-2013 would comprise 3.84 billion euro, which evidently shows a failure of the public administration and the performance until this moment indicates that the potential losses are even greater.

In this report, the Fiscal Council has made a first assessment of the transparency of the fiscal policy in Romania, and its results show an increase in recent years, but still there is room for improvement.

Analyzing the fiscal transparency from the perspective of the Code of Good Practices on Fiscal Transparency developed by the International Monetary Fund (IMF) and through the FRL, the Fiscal Council considers that Romania made important steps in order to improve it, but further efforts are needed.

Thus, the transparency regarding the tax reporting should be optimized so as to reduce the fragmentation of the tax reporting for the entire public sector, the transparency of the forecasts of the macroeconomic variables could be improved by publishing explanations on the assumptions on which these forecasts are based.

In addition, the transparency of the budget documentation should be improved by the existence of regular presentations on the value of total liabilities for multi-annual investment projects and publications of the cost-benefit analyzes before approval and by the existence of a report published regularly regarding the achievements towards the stated objectives. In addition, the reports regarding the fiscal risks are currently in an early stage and could be significantly improved.

The balance of risks as regards the fiscal policy coordinates in the opinion of the Fiscal Council is tilted to recording a lower than expected budget deficit for 2015, and respectively on the negative side starting next year, considering the implementation of the new Fiscal Code and the already decided increases for budgetary spending by the Government. Such developments are in flagrant contradiction with the principles and rules established by the FRL and with the fiscal governance treaties at the European level at which Romania adhered.

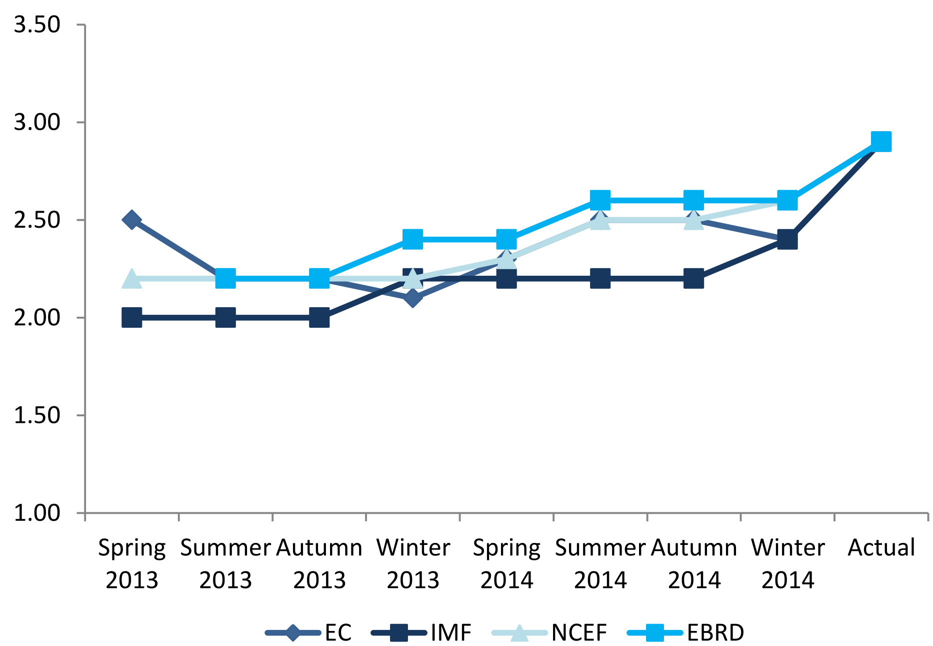
In the Fiscal Council's opinion, the balance of risks related to the conduct of the fiscal policy is tilted to recording a lower than expected budget deficit, given that the discretionary measures that were newly introduced (extending the application scope of the reduced VAT rate of 9% for food products and restaurant services starting 1st June, 2015 and doubling the child benefits) will most likely be funded by the fiscal revenues collected in addition to the program in the first half of 2015 and by a new reduction of the public investments than those from the program assumed in the draft budget which appears probable, given their under execution in first 6 months, but also the experience of past years.

Regarding the Fiscal Code, entered into force on 10th September 2015, the Fiscal Council remarks an extreme risk of a permanent and major deterioration of Romania's public finances position starting in 2016. The Fiscal Council estimates indicate headline deficits right next to the reference value of 3% of GDP for 2016, (without taking into account the recent decision to raise salaries across all categories of state employees by 10% from December 1 which will likely lead to the exceeding of the threshold) and significantly over 3% in 2007, the estimated developments in the structural budget balance suggesting the reversal of the progresses made so far in terms of fiscal consolidation. Such developments are in flagrant contradiction with the principles and rules established by the FRL and with the fiscal governance treaties at the European level at which Romania adhered and would imply de facto the failure of a fiscal framework based on rules which was not able to exercise strong constraints on the fiscal policy makers.

II. Macroeconomic framework in 2014

In 2014, Romania recorded the fourth consecutive year of economic growth as the GDP advanced by 2.8% in real terms, a lower dynamic compared to 3.5% reached in 2013, given that the investments have decreased by 7.2%. Despite the positive developments in the last 4 years (a cumulative growth of about 8.2%), the real GDP in 2014 is lower than in 2008, the gap being a marginal one, respectively of 0.2%. Compared to the initial forecasts considered in preparing the draft budget for 2014, and also to the forecasts of the European Commission (EC) and National Commission for Economic Forecasting (NCEF), the economic growth was higher by approximately 0.6 pp, the developments above expectations being attributable to the recovery of domestic demand.

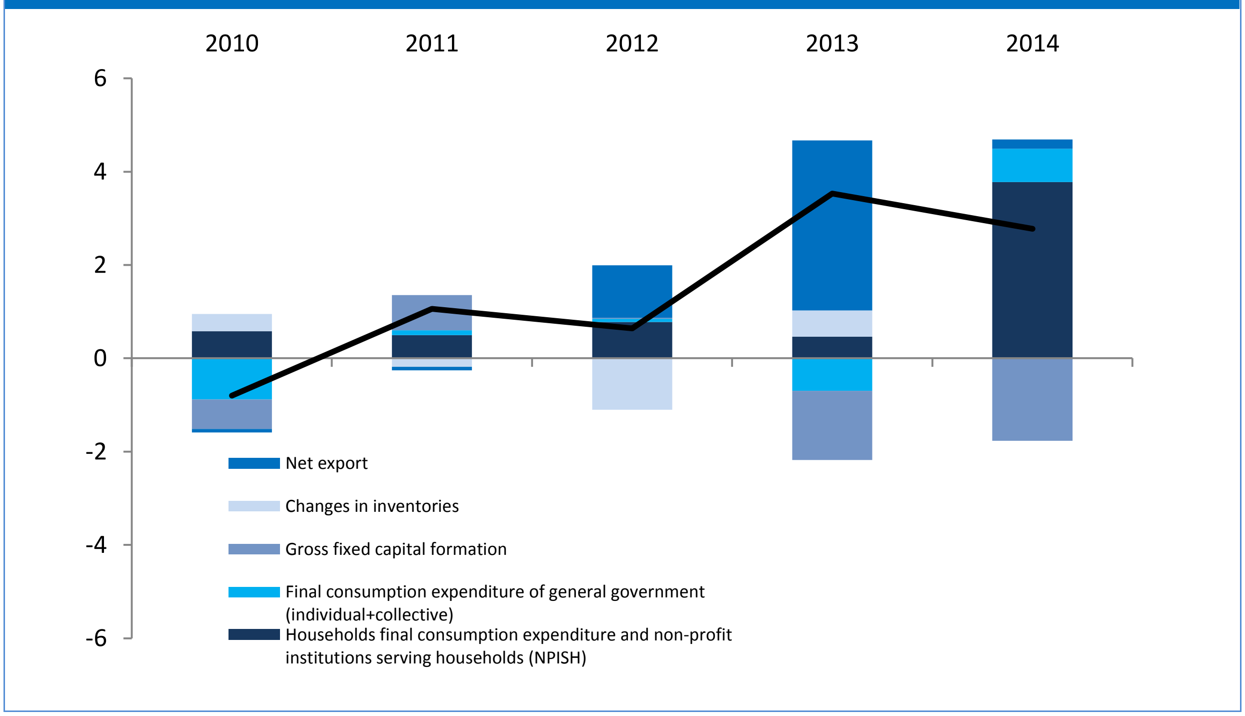
Figure 1: The evolution of economic growth forecasts for 2014



Source: EC, IMF, NCEF, EBRD

The main contribution to the economic growth registered in 2014 came from households final consumption expenditure (+3.8 pp), its increase in real terms being 6.2%, owing to the real wage growth, a low inflation rate and an increased consumer confidence in the future economic perspectives. Moreover, the general government final consumption expenditure had a positive contribution (+0.7 pp), while the gross fixed capital formation had a negative contribution of 1.8 pp, corresponding to a decrease of 7.2% in real terms, in the context of lower gross fixed capital formation of the state by 2.9%. In 2014, the net exports contribution to GDP growth was slightly positive (+0.2%), as a result of very close developments in exports and imports, these components registering an advance in real terms of 8.1% and respectively 7.4%. On the supply side, increases in the economic activity's volume were recorded in the majority of sectors, the most significant being recorded in information and communication (+8.2%), followed by professional, scientific and technical activities; administrative and support services (+4.1%), industry (+3.6%) and real estate (+3.5%), shows, culture and recreation activities; repair of household goods and other services (+2.5%), wholesale and retail trade, repair of motor vehicles and motorcycles, transport and storage, hotels and restaurants (+2%), agriculture, forestry and fishing (+1.5%) and constructions (+0.3%), while negative developments were recorded in financial intermediation and insurance sectors (-2.7%) and public administration and defense, education, health and social assistance (-0.1%).

Figure 2: Contributions to economic growth



Source: Eurostat, Fiscal Council's calculations

The inflation rate at the end of the year was outside the target range (1.5% - 3.5%), recording a level of 0.83%, significantly below the level projected in the Fiscal Strategy 2014-2016, respectively 3%. This varied during the year in the range 0.66% - 1.54%, the average increase of prices in 2014 being of 1.1%, below the level projected in the Fiscal Strategy (2.4%). The first half of the period was characterized by a disinflationary process, the annual inflation rate being of 1.05% in the first quarter, mainly due to the favorable base effect generated by the dissipation of the impact of the energy prices hike operated in early 2013, respectively 0.66% in the second quarter especially due to the favorable shocks on the supply side. In the third quarter, the inflation was back within the target variation band, reaching a level of 1.54%, due almost entirely to canceling the statistical effect of the VAT decrease for some bakery products starting with September 2013, while during the last quarter the inflation rate evolution has returned to the downward trend due to the action of some exogenous factors: the substantial decline in crude oil quotations in the international markets and also in the context of a very good agricultural production at a regional level. Due to the substantial reduction in the price growth rate and to the existing macroeconomic perspectives and associated risks, the central bank continued the monetary policy easing in 2014 by gradually reducing the monetary policy rate, from 3.75% to 2.75%, and the minimum reserve requirement ratio (for the domestic currency denominated liabilities from 15% to 10% and for those denominated in foreign currencies from 20% to 14%).

The prices' increase at the level of the whole economy, measured by the GDP deflator, was 1.8% in 2014, considerable inferior to that considered in the revised Fiscal Strategy for 2014-2016, respectively 3%, mainly due to the significant slowdown of the price increase associated to the effective final consumption expenditure, sustained on the supply side by the good agricultural year.

As regards the external position, Romania streghtened its significant progress from 2013, as the current account deficit declined to 0.43% of GDP in 2014, from 0.81% of GDP at the end of the previous year, given the 44.4% decrease of the current account balance in nominal terms and an increase of GDP with around 4%, considering values expressed in euro. The decrease of the current account deficit from 1,168 million euro in 2013 to 649 million euro in 2014 was mainly determined by an improvement in the trade balance, from a deficit of 742 million euro in 2013 to a surplus of 467 million euro in 2014, exclusively on the account of services balance (+1,157 million euro). A positive contribution to changing the current account balance was given by the decrease of the primary incomes deficit by 183 million euro, while the reduction of secondary incomes balance surplus (-877 million euro) had a negative impact on the variation of current account balance[1]. The exports of goods continued to grow in 2014 at a rate of approximately 6.6% (+2,908 million euro) in the context of improving the EU economic outlook, the main trading partner of Romania, the dynamic being similar to the one of imports that recorded an increase of about 5.8% (+2,852 million euro) in the context of a domestic demand increase.

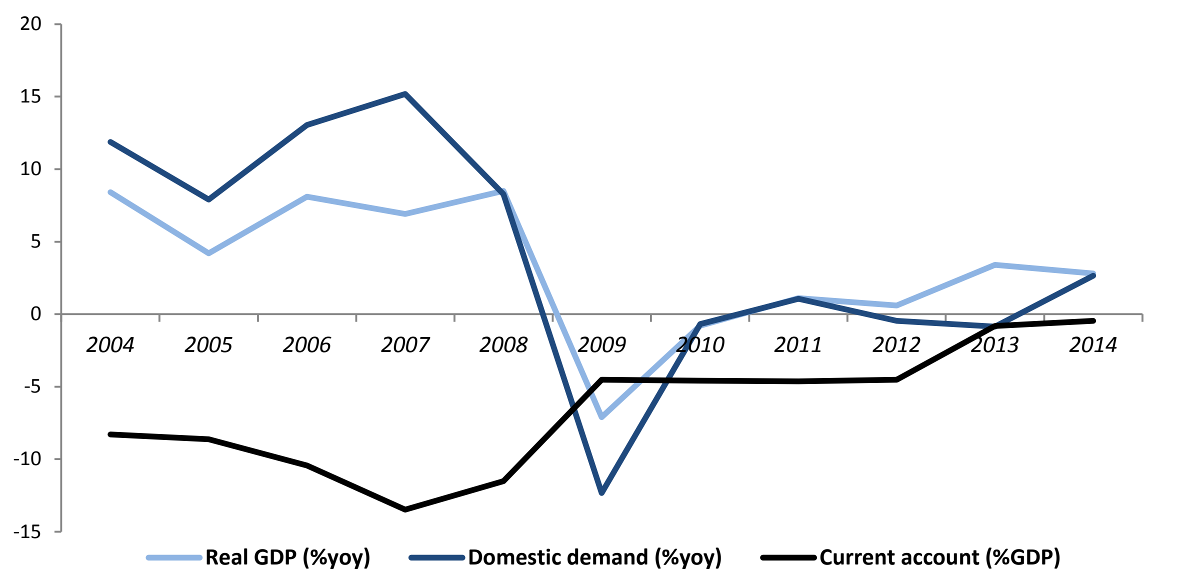
Analyzing the changes in the current account balance in terms of difference between the rate of saving and the rate of investment, it can be seen that both of them registered a negative

[1] According to BPM6 standards (The balance of payments manual developed by IMF), the terminology of current account components changed. Thus, the primary income balance and the secondary income balance replace the income and transfers balance.

dynamic, the latter decreasing by 1.49 pp of GDP, a higher adjustment than the one of saving rate, respectively 1.11 pp of GDP. Moreover, the adjustment of the current account deficit with 11.1 pp of GDP in 2008-2014 was achieved by reducing investment by 10.41 pp of GDP, while the national savings rose in the same period only by 0.68 pp of GDP.

The foreign direct investment registered a negative trend; they decreased with 14.6% compared to 2013, their values amounting to 2,495 million euro, close to the average level of the last 5 years. Thus, it can be seen that in 2014 foreign direct investments financed entirely the current account deficit, but their value in absolute terms is much lower than in the period preceding the financial crisis (in the period 2007-2008, the annual average of FDI was 8,000 million euro).

Figure 3: The evolution of the real GDP, domestic demand and current account, 2004-2014



Source: National Bank of Romania, Eurostat, Fiscal Council's calculations

The external debt of Romania decreased in nominal terms by 3.84% in 2014 to a level of 94.30 billion euros, its share in GDP decreasing from 67.97% to 62.86%. The medium and long-term external debt amounted 80.30% of total external debt at the end of the previous year, respectively 75.72 billion euro, its share being similar to the one from December 31st, 2013. The short-term external debt recorded a reduction of 3.29% to a level of 18.58 billion euro (19.70% of total external debt).

Due to the repayments made, the debt to the IMF was lower at the end of 2014 compared to the same period of the precedent year by 4.25 billion euro, respectively reaching a level of 1.58

billion euro. More precisely, there were decreases both in the level of the debt component for financing the budget deficit (-0.96 billion euro) and in that of the monetary authority (-3.29 billion euro). The downward trend of the external debt was as well due to the decrease of private external debt, especially in the context of deleveraging in the banking sector. In order to maintain an adequate level of international reserves, also in 2014, the Ministry of Public Finance launched several Eurobonds that led to an increase of the external public debt from 29.06 billion euro at the end of 2013 to 31.8 billion euro at the end of last year.

In 2014, non-government loans[2] declined in real terms, decreasing with 4.22% in December 2014 compared to the same period of 2013, similar to the previous year developments (-4.74%). The downfall was again driven by the foreign currency denominated-loans, which decreased by 10.7% in euro equivalent, while the dynamics of domestic currency denominated-loans recorded an increase in real terms of about 7%, in December 2014 compared to December 2013. The still high level of households' indebtedness, the preservation of risk aversion of economic agents and the increase in capital requirements for financial institutions in the EU (imposed by Basel III regulations), which involved an accelerated pace of deleveraging in the banks and their subsidiaries in Central and Eastern Europe (CEE) were the main factors that led to the contraction of lending. The level of non-performing loans entered on a downward trend in the context of accelerating the balance sheets clean up and changing NBR regulations. An improvement can be seen in the liquidity banking system, the loans/deposits ratio reducing below 100% since July, then continuing its downward trend, the registered level at the end of 2014 being around 91%.

The maintenance of the lending activity in negative territory in 2014 is attributable to the credit dynamics of non-financial corporations and banks (real contraction of 6.3% at the end of the year), but also the households loans registered a downward trend (a decrease of 1.9% in real terms), mainly on the account of the foreign currency component. Households' lending in domestic currency (+15%, in real terms) was fueled by the increase of mortgage loans compared to the end of 2013, evolution favored by the decreasing trend of interest rates and by the modification of the "First Home" program coordinates – exclusively in local currency starting with the second half of 2013.

Regarding the developments in the labor market, in 2014 the average number of employees continued to increase to a level of 4,508 thousand people[3], advancing by 1.4% compared to 2013, in the context of an increasing number of jobs created by the private sector (+1.6%) and the public sector (+1%). On the other hand, at the end of 2014, the unemployment rate calculated according to the criteria of the International Labor Office (ILO) decreased by 0.3 pp

[2] Source: NBR, Monthly Bulletin, March, 2015

[3] According with Workforce Balance, NCEF estimates, The preliminary Autumn Forecasts 2014.

respectively from 7.1% in December 2013 to 6.8%. The total number of unemployed registered at the National Agency for Employment (NAE) decreased from 512 thousand in December 2013 to 478 thousand people in December 2014, the registered unemployment rate decreasing from 5.65% to 5.29%.

In 2014, the average gross wage[4] per total economy was 2,360 lei, up with 5.3% from 2013, while net average wage was 1,706 lei, increasing by 5.17%, compared to 2013. Considering an average inflation of 1.1%, the real wage increased by approximately 4.1%. The positive trend of the average salary was mainly driven by the growth of wages in the private sector[5] (+6.1%), due to the productivity gains. During the same period, average wages in the public sector advanced in nominal terms by 2.43%.

The evolution of the main macroeconomic indicators in 2014 compared with the forecasts considered in the revised Fiscal Strategy for 2014-2016 (adopted in November 2013) are summarized in the following table:

[4] According to NIS, TEMPO online, the average wage by national economic activities NACE Rev. 2.

[5] The private sector is approximated by removing public administration and defense sectors, education and health and social assistance.

Table 1: Macroeconomic indicators in 2014 (FS forecast versus effective)		
	Revised Fiscal Strategy 2014-2016	**Effective 2014**
	- % yoy -	
GDP		
GDP (million lei)	658,615.0	666,637.3
Real GDP	2.2	2.8
GDP deflator	3.0	1.8
GDP components		
Final consumption	1.7	6.0
Private consumption expenditure	1.6	6.2
Government consumption expenditure	1.7	5.0
Gross fixed capital formation	4.0	-7.2
Exports (volume)	5.5	8.1
Imports (volume)	5.4	7.4
Inflation rate		
End of period (December 2014)	3.0	0.83
Annual average	2.4	1.1
Labor market		
Unemployment rate at the end of period	4.8	5.29
Average number of employees[6]	1.4	1.3
Gross average wage	5.2	5.3

Source: National Institute of Statistics, National Commission for Economic Forecasting

[6] Differences between NCEF forecast and the reported effective level is due to the different methodology: while NCEF uses as a reference forecast the workforce balance, the effective figures are from NIS monthly buletine which includes only economic agents with more than 4 employees.

III. Fiscal policy

III.1. The assessment of objectives, targets and budgetary indicators

Under article 61, paragraph (2) of the FRL, the Fiscal Council's Annual Report must contain "*a discussion and analysis of the implementation of the fiscal policy set forth in the Fiscal Strategy and Annual Budget approved in the previous budget year*" and will include:

a) An ex post evaluation of the macroeconomic and budgetary forecasts set out in the Fiscal Strategy and the annual budget to which the Annual Report corresponds, including the reporting, where applicable, of any persistent deviations in the same direction of macroeconomic forecasts compared to actual data, which were recorded over a period of at least 4 consecutive years;

b) An assessment of progress against the fiscal policy objectives, targets, and indicators set out in the Fiscal Strategy and annual budget to which the Annual Report corresponds;

c) An assessment of the Government's compliance with the principles and rules of this law during the preceding budget year;

d) Recommendations and opinions of the Fiscal Council in improving the conduct of fiscal policy consistent with principles and rules of this law in the current budget year.

According to article 33, letter b) of the FRL, the fiscal framework section of the Fiscal Strategy may be revised when there is a significant worsening of the forecast for macroeconomic indicators and other assumptions that underpinned the previous Fiscal Strategy. The Fiscal Strategy for the period 2014-2016 approved in May 2013 was updated in November of the same year, concomitantly with the preparing of the budget proposal for 2014, the Government approach being considered partly justified given the estimation of significant deviations from the initial assessment for 2013 of the budget revenues, which constitute the starting point for the budget projection for the period 2014-2016. The motivation for a negative review of the projected budget revenues was the performance for the first three quarters significantly below the expectations, despite of a GDP dynamics higher than initially projected for 2013, while the economic advance had a different composition from that initially envisaged (prevalence of the net exports instead of domestic absorption, with a negative impact on budget revenues), and the efficiency of the tax collection has deteriorated. In comparison with the initial strategy, the achievement of the medium-term objective (MTO) that was scheduled for 2014 according to the Convergence Programme 2014-2017 has been postponed to 2015. Given the fact that the draft budget for 2014, initiated in November 2013 was accompanied by the updating of the

Fiscal Strategy and the law of the ceilings, which implies an identical fiscal framework for 2014 in both documents, the obligation of the Fiscal Council to *ex ante* assess in the Annual Report the compliance with the objectives, targets and indicators established through the Fiscal Strategy and the budget is reduced to an analysis of the projections contained in the draft budget. In order to illustrate the changes that occurred in the fiscal framework for the period 2014-2016 it will be also considered the targets that were set out in the initial Fiscal Strategy for 2014-2016, even if they no longer exerted constraints at the level of the fiscal policy.

The general consolidated budget for 2014 was based on a similar macroeconomic forecast scenario with the one taken into account in developing the Fiscal Strategy for 2014-2016, the economic growth being estimated at 2.2% in real terms. With the increasing of the deficit target according to *cash* standards for 2013 from 2.1% to 2.5% of GDP, the draft budget for 2014 envisaged a budget deficit target of 2.2% of GDP or 14.49 billion lei, higher than the initial target of 1.8% of GDP (corresponding to a level of 12.19 billion lei) assumed through the Fiscal Strategy for 2014-2016 from May 2013. Regarding the budget deficit target for 2014 determined according to ESA 2010 methodology, this was also upward revised to 2.2% of GDP from 2% of GDP as in the previous version of the strategy.

The final budget execution recorded the achievement of the deficit target, both according to cash methodology as the budget deficit was 1.87% of GDP, or 12.49 billion lei and according to ESA 2010, given a deficit of 1.48% of GDP, or 9.92 billion lei. Significant differences in terms of a reduced budget deficit compered to original targets with around 0.3 pp of GDP in cash standards and with about 0.7 pp of GDP in European standards are mainly explained by the failure of the investment expenditure, especially of the projects funded by external grants (-0.84% of GDP compared to the initial program). Moreover, the gap between the cash budget balance and that according to ESA 2010 can be mainly explained by the decision to pay in advance the installment for 2015 regarding some salary related rights earned by court decisions which payment was staggered over five years, these affecting the cash execution in the sense of a higher deficit, while the ESA 2010 execution is affected to the contrary, given the additional revenues (social contributions and income tax) resulting from this decision.

In terms of fiscal policy rules, the nominal ceilings for the general government balance in 2014, its total expenses (excluding income from post-accession EU funds, pre-accession funds, and financial assistance from other donors) and personnel expenditure were established by Law no. 355/2013[7] (see *Table 2* below). The budget execution does not confirm compliance for all the indicators above mentioned. Thus, the personnel expenses at the end of the year exceeded the nominal ceiling established by the Law no. 355/2013 with 2,440.8 million lei, given that the installment for 2015 regarding some salary related rights earned by court decisions was paid in

[7] Law approving ceilings for indicators specified in the Fiscal Strategy.

advance, exceeding the limit of 7.3% of GDP with 0.24 pp, while the nominal GDP was higher than envisaged in the budget's construction. Falling within the ceiling for GCB balance and total expenditure occurred in the context in which the increasing of the personnel expenditure was lower than the reduction of the expenditure for projects funded by external grants.

Table 2: Nominal ceilings for GCB balance, total and personnel expenditure						
	Law no. 355/2014			Budget execution 2014		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
million lei	**-14,710.0**	**216,662.2**	**48,006.1**	**-12,493.2**	**215,137.9**	**50,246.9**
% of GDP	*-2.2%*	*32.4%*	*7.3%*	*-1.87%*	*32.27%*	*7.54%*

** Excluding financial assistance from the EU and other donors*

The first budget revision approved at the end of July 2014, increased the general consolidated budget revenues with 1.54 billion lei and expenditure with 1.81 billion lei compared to the original approved budget, the upward revision of the deficit being 270 million lei. Compared to the limits of the ceilings stipulated by Law 355/2013, the proposed nominal levels of GCB deficit, the GCB primary deficit, the personnel expenses and the total expenses excluding financial assistance from the EU and other donors exceeded the thresholds of the above mentioned Law[8], being inconsistent with the fiscal rules established by article 12, letter b) and c) of FRL, as well as article 17 paragraph 2, which prohibits the increase of personnel expenses during the budget amendments, art. 24 which prohibits the increase of the total spending of the GCB during budget amendments other than for paying debt service and financial contribution of Romania to the EU budget and article 26 paragraph 5 which reaffirms the obligation of respecting the ceilings imposed by the law for the next budget year.

At the level of revenues, the budget revision envisaged an increase by 1.54 billion lei. Excluding the impact of compensation schemes (supplementing the initial scheme with 748 million lei) and the changes in the accounting treatment of sale and purchase operations of goods from the state reserves (with impact on the capital income of 917.2 million lei) that artificially increased revenues by 1.66 billion lei, the earnings appeared to be adjusted slightly negative, i.e. by 128 million lei. The income aggregates to which, in the context of the execution at mid-year, were made reductions compared to the original budget were: personal income tax (-1.27 billion lei), VAT (-1.75 billion lei), social contributions (-504 million lei), while the upward revisions of the

[8] Overruns of the thresholds by + 50 million lei for GCB deficit, + 166 million lei for the primary deficit, + 85 million lei for personnel expenses and 1.59 bn. lei for total expenditure exclusively for EU financial assistance and other donors.

projection occurred at the level of the property taxes (+1.26 billion lei, given the favorable difference between the actual and initially estimated level of the special constructions tax), at the level of other taxes on goods and services (+808 million lei based on additional revenue from *clawback* tax and from the deregulation of the prices from natural gas sector), the non-fiscal revenue (+708 million lei as a result of the additional revenue expected to be collected from the sale of emission allowances for greenhouse gases), and in the case of corporate income tax (+423 million lei).

At the level of the budgetary expenditures, the increase of 1.81 billion lei was also largely explained by the impact of the swap scheme meant to clear the outstanding obligations to GCB, plus the impact of the change in the accounting treatment of sale and purchase operations from the state reserve (with impact on capital expenditure of 917.2 million lei), without which the increase would have been only 142 million lei. Excluding the impact of compensation schemes, the following spending categories were increased: the personnel expenditure (+289 million lei), the goods and services expenditure (+830 million lei), the contingency reserve fund (+299 million lei). There have been revised downward: the capital spending (excluding the impact of the change in the accounting treatment regarding the sale and purchase operations from the state reserve), by 1.15 billion lei; the subsidies by 250 million lei; the interest payments by 116 million lei.

Compared with the approved parameters in the context of the first budget revision, the second budget revision realized in September envisaged a decline of the estimated general government revenues by 1.32 billion lei and spending by 1.37 billion lei, the deficit target being revised marginally downwards to 14.71 billion lei (lower with 48 million lei), representing 2.2% of GDP.

Considering individual revenue items of the consolidated general budget, the largest downward revision came from the incorporation in the budgetary projection of the impact of reducing from October the 1st, 2014 the employer's social security contributions (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 for two months of cash-based execution. Significant downward revisions were made at the level of the projected 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). These negative revisions at the level of certain categories other than social contributions were, however, almost entirely compensated by the upward changes (without swaps) at the level of revenue projections regarding the VAT receipts (+544.8 million lei) and the corporate income tax (+190.5 million lei). The Fiscal Council expressed in its opinion on the second budget revision, serious reservations regarding the proposed upward revision for the projection of VAT receipts and about the estimated inflows from the post-accession EU funds of which the ultimate beneficiary is the public sector. Excluding the impact of compensation schemes, 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). Meanwhile, the allocations for the following categories have been significantly increased: 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 (+367 million lei). In essence, compared to the programmed levels in the first budget revision, the allocations for investment expenditure were 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 were added the savings on interest payments, was used to offset the impact of the reduction in the social security contribution rate on budgetary revenue, in order to ensure the convergence to the deficit target.

The Fiscal Council's opinion on the second budget revision reported the violation (by derogation) of the rules regarding the budget revisions as stated by article 12 letter b) and c), d article 24, and article 26, paragraph (5) of the FRL that states 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.

Furthermore, although article 23, paragraph (2) of FRL prohibits the approval of more than two budget amendments during a year, the Government decided in December 2014 to realize a third budget revision. Compared to the budget approved on the occasion of the second budget amendment, in the third budget amendment the GCB revenues increased by 1,796.6 million lei, the expenditure by 1,797.5 million lei, attracting a marginally increase of the budget deficit by 1 million lei. The main change introduced by this third budget revision was the use of the fiscal space created by the reduction of about 1.8 billion lei for capital spending to pay in advance, compared to the initial programmed rescheduling for certain salary rights earned by court decisions, increasing the personnel spending by 2.4 billion lei compared to the level targeted by the second budget revision at the end of September. The payment of these rights has generated additional revenue for the personal income tax (307.3 million lei) and social contributions (1,091.4 million lei), these income categories explaining almost all the increase at the level of total budgetary revenue. At the level of total budgetary expenditure, excluding the two above mentioned categories, in addition there were 1.1 billion lei of supplementary spending for current expenses. The increases were located at the chapters: goods and services spending, other expenses, transfers between government units and projects funded by external non reimbursable funds and were partial offset by the reduction of the estimates for the interest payments and the use of the budget reserve fund allocations. In its opinion on the proposed amendment, the Fiscal Council maintained his reservations already formulated in the context of the second budget amendment regarding the extremely optimistic levels for the projection of VAT receipts and for the estimated inflows from the post-accession EU funds.

Thus, the third budget revision induced either new violations of the fiscal rules (article 12, letters a), b), c) and g), article 17 paragraph (2) and article 23 paragraph (2) of the FRL), or an increase in the size of the existing violations, so that the Government evades the responsibility of their observance by recourse to derogations from almost all the legal provisions which establish fiscal rules.

The way the budget process was conducted in 2014 put into question the relevance of the fiscal rules and the commitment to respect the fiscal discipline. The effectiveness of a fiscal rule is determined by the constraint that it exerts on the fiscal policy formulation. The ease with which the fiscal rules have been repeatedly circumvented this year, with the recorded violations in the years that have passed since the adoption of the Fiscal Responsibility Law in 2010, highlights the weakness of the constraints exerted by the fiscal rules from the FRL and raises serious doubts on the commitment to meet the future fiscal rules established by taking into national law the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact).

The evolution of the key budgetary aggregates during 2014 according to cash standards is presented in *Table 3.*

Table 3: The evolution of the main budgetary aggregates during 2014 (billion lei)						
	Fiscal Strategy 2014-2016	Initial budget	First revision	Second revision	Third revision	Budget execution 2014
Total revenues	**223.8**	**216.0**	**216.7**	**215.6**	**217.4**	**212.8**
Fiscal revenue	128.5	125.3	124.8	125.4	125.7	124.4
Social contributions	58.2	57.8	57.3	56.3	57.4	57.3
Post-accession and pre-accession EU funds, financial assistance from other donors	14.4	14.8	14.8	14.5	14.8	11.1
Total expenditure, of which :	**236.0**	**230.4**	**231.5**	**230.3**	**232.1**	**225.3**
Current expenditure, of which	217.1	212.7	214.0	212.4	216.0	209.1
Projects from EU funds	22.9	20.3	20.3	17.8	18.2	14.7
Capital expenditure	18.9	17.8	17.6	17.9	16.1	17.1
Budget deficit	**-12.2**	**-14.5**	**-14.8**	**-14.7**	**-14.7**	**-12.5**

Source: Ministry of Public Finance

Note: Amounts without the compensation schemes

The results of the budget execution in the fiscal year 2014 were lower than the forecasts of the third revision; both revenue and expenditure have registered developments below expectations. On the revenue side, the gap from the estimated amount to be collected was about -4.6 billion lei, mainly due to a very poor performance of the EU funds absorption (-3.7 billion lei, confirming the reservations expressed by the Fiscal Council on the occasion of the second and third budget revision regarding the projection of this budgetary aggregate) and lower than projected receipts corresponding to the fiscal revenues (-1.3 billion lei) - in particular VAT receipts, also confirming the reservations expressed by the Fiscal Council on the occasion of the second and third budget revision on the projection of this budgetary aggregate, to the non-fiscal revenues (-0.6 billion lei) and to the capital revenues (-0.6 billion lei), but was partially offset by other amounts received from the EU for operational programs financed under the convergence objective (+1.5 billion lei). Regarding the expenses, they fell by 6.8 billion lei, the main categories that registered reductions being the expenditures on projects financed through post-accession EU funds (-3.5 billion lei, the reduction was operated in order to accommodate the failure to collect EU funds), expenditures with goods and services (-2.4 billion lei), transfers between government units (-0.53 billion lei), other transfers (-0.38 billion lei), social assistance (-0.3 billion lei). Thus, the budgetary deficit in cash terms at the end of the year was significantly lower than the level estimated in the third revision.

Table 4: The development of budgetary expenditure and revenue according to ESA 2010

	2009	2010	2011	2012	2013	2014	Changes 2014 to 2013	Changes 2014 to 2009
Total revenue (% of GDP)	**31.7**	**32.9**	**33.8**	**33.5**	**33**	**33.4**	**0.4**	**1.7**
Fiscal revenue	17.1	17.7	19.1	19.1	18.6	19	0.4	1.9
Indirect taxes, out of which:	10.7	11.8	13	13.1	12.8	12.8	0	2.1
VAT	6.5	7.5	8.6	8.4	8.3	7.8	-0.5	1.3
Excises*	3.1	3	3.1	3.1	3.1	:	:	0
Direct taxes, out of which:	6.4	6	6.1	6	5.9	6.2	0.3	-0.2
PIT	3.6	3.4	3.4	3.6	3.5	3.6	0.1	0
CIT	2.4	1.8	1.8	1.7	1.7	1.8	0.1	-0.6
SSC	10	9.3	9	8.8	8.7	8.6	-0.1	-1.4
Other current revenue	1.6	2.7	2.3	2.5	2.6	2.9	0.3	1.3
Total expenditure (% of GDP)	**40.6**	**39.6**	**39.1**	**36.4**	**35.2**	**34.9**	**-0.3**	**-5.7**
Intermediate consumption	6.3	5.4	5.7	5.8	5.6	5.2	-0.4	-1.1
Compensation of employees	10.7	9.5	7.8	7.7	8	7.7	-0.3	-3
Interest payments	1.5	1.5	1.6	1.7	1.7	1.6	-0.1	0.1
Social assistance	13.2	13.7	13.1	12.1	11.7	11.9	0.2	-1.3
Subsidies	1.1	1	0.9	0.7	0.6	0.5	-0.1	-0.6
Other current expenditure	1.5	1.9	2.1	2.5	1.9	2.2	0.3	0.7
Gross fixed capital formation	6	5.7	5.4	4.8	4.5	4.3	-0.2	-1.7
Budget deficit (% of GDP)	**-8.9**	**-6.6**	**-5.3**	**-2.9**	**-2.2**	**-1.5**	**0.7**	**7.4**

Source: Eurostat

*Note: *for 2014 data are not available yet, the difference 2009-2014 refers to 2009-2013*

The fiscal consolidation initiated in 2010 in order to correct the existing major imbalances regarding the public finances position, was characterized by an alert pace, Romania succeeding in a relatively short period of time a significant budget deficit reduction, expressed according to

ESA 2010 standards, from 8.9% of GDP in 2009 to 1.5% of GDP in 2014. The fiscal adjustment in the period 2009-2014 by 7.4 pp of GDP considering ESA 2010 standards was performed by cutting spending by 5.7 pp of GDP and increasing revenues by 1.7 pp of GDP. The expenditure reductions were made primarily in the personnel expenses (-3 pp of GDP), gross fixed capital formation (-1.7 pp of GDP) and social assistance (-1.3 pp of GDP). On the budgetary revenue side, the growth by 1.7 pp of GDP in 2009-2014 was mainly due to the increase of the legal VAT rate from 19% to 24% in 2010, so the VAT revenues rose during 2009-2013 by 1.3 pp of GDP, offsetting the decline in receipts from the social security contributions (-1.4 pp of GDP) and those from the corporate income tax (-0.6 pp of GDP). The budget deficit reduction from 2.2% to 1.5% of GDP according to ESA2010 standards in 2014 was achieved by reducing spending by 0.3% of GDP and by increasing revenues by 0.4% of GDP. Thus, revenues were higher by 0.4% of GDP, mainly as a result of the increase of the fiscal revenues by 0.4 pp of GDP while adjustments to budget expenditure occurred mainly in the intermediate consumption (-0.4 pp of GDP), compensation of employees (-0.3 pp of GDP), gross fixed capital formation (-0.2 pp of GDP), interest payments (-0.1 pp of GDP), and subsidies (-0.1 pp of GDP).

Regarding the budget execution according to cash standards, the year 2014 compared to the previous year recorded an improvement of the budget deficit expressed as a percentage of GDP of 0.6 pp of GDP, the revenues recording an increase of 0.7 pp of GDP and expenditure an increase of 0.2 pp of GDP. Compared to 2013, the main budgetary revenues registered a favorable development, pointing out in this regard the amounts received from the EU (+0.3 pp of GDP, and yet significant below the program, respectively by 0.56% of GDP), receipts from excise duties (+0.3 pp of GDP), property taxes (+0.2 pp of GDP), while a significant negative trend registered the VAT receipts (-0.5 pp of GDP). On the expenditure side, the reduction of investment spending by 0.2 pp of GDP, of expenses with goods and services by 0.1 pp and of interest payments by 0.2 pp of GDP offset the increase in personnel expenses (+0.3 pp of GDP) and in subsidies (+0.1 pp of GDP). Considering the period 2009-2014, the fiscal adjustment according to cash standards was performed by reducing budgetary expenditure by 4 pp of GDP and increasing budgetary revenues by 1.3 pp of GDP.

Table 5: The development of budgetary revenue and expenditure according to cash methodology										
	2009	2010	2011	2012	2013	Initial budget 2014	Execution 2014	Changes execution to initial budget 2014 to 2013	Changes 2014 to 2013	Changes 2014 to 2009
Total revenue (% of GDP)	**30.8**	**31.6**	**32.1**	**32.4**	**31.4**	**32.5**	**32.1**	**1.1**	**0.7**	**1.3**
Fiscal revenue	17.1	17.4	18.5	19.1	18.7	18.9	18.7	**0.2**	**0.1**	**1.6**
PIT	3.6	3.4	3.4	3.5	3.6	3.6	3.6	**0.0**	**0.0**	**0.0**
CIT	2.1	1.9	1.8	1.8	1.7	1.7	1.8	**0.0**	**0.1**	**-0.3**
Property tax	0.7	0.7	0.7	0.7	0.7	0.8	0.9	**0.1**	**0.2**	**0.2**
VAT	6.7	7.4	8.5	8.5	8.1	8.2	7.6	**0.1**	**-0.5**	**0.9**
Excises	3.1	3.3	3.4	3.4	3.3	3.6	3.6	**0.3**	**0.3**	**0.5**
SSC	9.4	8.6	9	8.7	8.5	8.7	8.6	**0.1**	**0.1**	**-0.8**
Non fiscal revenue	3.3	3.7	3.2	3.1	2.7	2.6	2.6	**-0.1**	**-0.1**	**-0.7**
Donations	0.6	0.8	0.1	0.1	0.0	0.0	0.0	**0.0**	**0.0**	**-0.6**
Amounts received from the EU for payments made	0.4	1	1.1	1.3	1.4	2.2	1.7	**0.8**	**0.3**	**1.3**
Total expenditure (% of GDP)	**38.0**	**37.8**	**36.3**	**34.8**	**33.8**	**34.7**	**34.0**	**0.9**	**0.2**	**-4.0**
Personal expenditure	9.2	8	6.8	6.8	7.3	7.2	7.5	**-0.1**	**0.3**	**-1.7**
Goods and services	5.5	5.6	5.6	5.8	6.1	5.9	5.9	**-0.1**	**-0.1**	**0.4**
Interest payments	1.2	1.4	1.6	1.8	1.7	1.7	1.5	**0.0**	**-0.2**	**0.3**
Subsidies	1.4	1.3	1.1	1.0	0.8	0.9	0.9	**0.1**	**0.1**	**-0.5**
Projects financed from post-accession grants	0.5	1.4	1.9	2.2	2.2	3.0	2.2	**0.8**	**0.0**	**1.7**
Social protection	12.5	12.8	12	11.2	10.7	10.7	10.7	**0.0**	**0.0**	**-1.8**
Capital expenditure	4.3	3.6	4.1	3.2	2.8	2.7	2.6	**-0.1**	**-0.2**	**-1.7**
Budget deficit (% of GDP)	**-7.2**	**-6.2**	**-4.2**	**-2.5**	**-2.5**	**-2.2**	**-1.9**	**0.3**	**0.6**	**5.3**

Source: Ministry of Public Finance

Further, this chapter will include an analysis of the structural budget balance in Romania given that the fiscal targets are defined primarily in terms of structural deficit followed by a detailed examination on the developments of the main budgetary revenue and expenditure aggregates, and pursued by an assessment of the public debt dynamics and its determinants based on a medium term projection.

III.2. The structural budget balance in Romania

The signing and ratification by Romania of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union in 2012 stipulates a fiscal framework based on rules, with a benchmark in the case of Romania of a structural deficit target of maximum 1% of GDP[9] . The TSCG's provisions were incorporated into the national law by amending the Fiscal Responsibility Law no. 69/2010 in December 2013. Given that at the time of the 2014 budget preparation this rule was not respected and in the context in which the headline deficit for 2013 was under 3% of GDP, the preventive arm's provisions of the Stability and Growth Pact were applying for Romania, involving compliance with the calendar of convergence towards MTO.

Thus, the draft budget for 2014 targeted a structural deficit of 1.7% of GDP, respectively a structural adjustment pace of 0.3 pp of GDP compared to the estimated level for 2013 from that time (November 2013), respectively of 2% of GDP. However, the budget execution for 2013 indicated a level of the headline deficit according to the European methodology of only 2.2% of GDP, corresponding to a structural deficit of 1.1%. In this context, compliance with the target for 2014 would have been equivalent to a slight appreciation in the structural budget balance, achieving the MTO being set for 2015, given that the planned deficit of aggregate demand was lower than the present day evaluation.

The budget execution for 2014 indicate, however, a level of the structural deficit of only 0.6% of GDP, corresponding to achieving the MTO, given that the headline deficit, according to the European methodology, registered a level of 1.4% of GDP, lower than the target of 2.2% of GDP and with 0.8 pp lower compared to the previous year. The more than expected decrease of the budget deficit in 2014 is mainly explained by the under-execution of investment spending, particularly of projects funded by external grants. **Basically, once the achievement of MTO was met, the fiscal consolidation process initiated in Romania in 2010 ended, other fiscal**

[9] The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union requires the contracting parties to ensure convergence towards country-specific MTO, imposing a structural deficit limit of 0.5% of GDP, respectively 1% for the member states with a public debt significant below 60% of GDP. In the case of Romania, the structural deficit has to be maximum 1% of GDP.

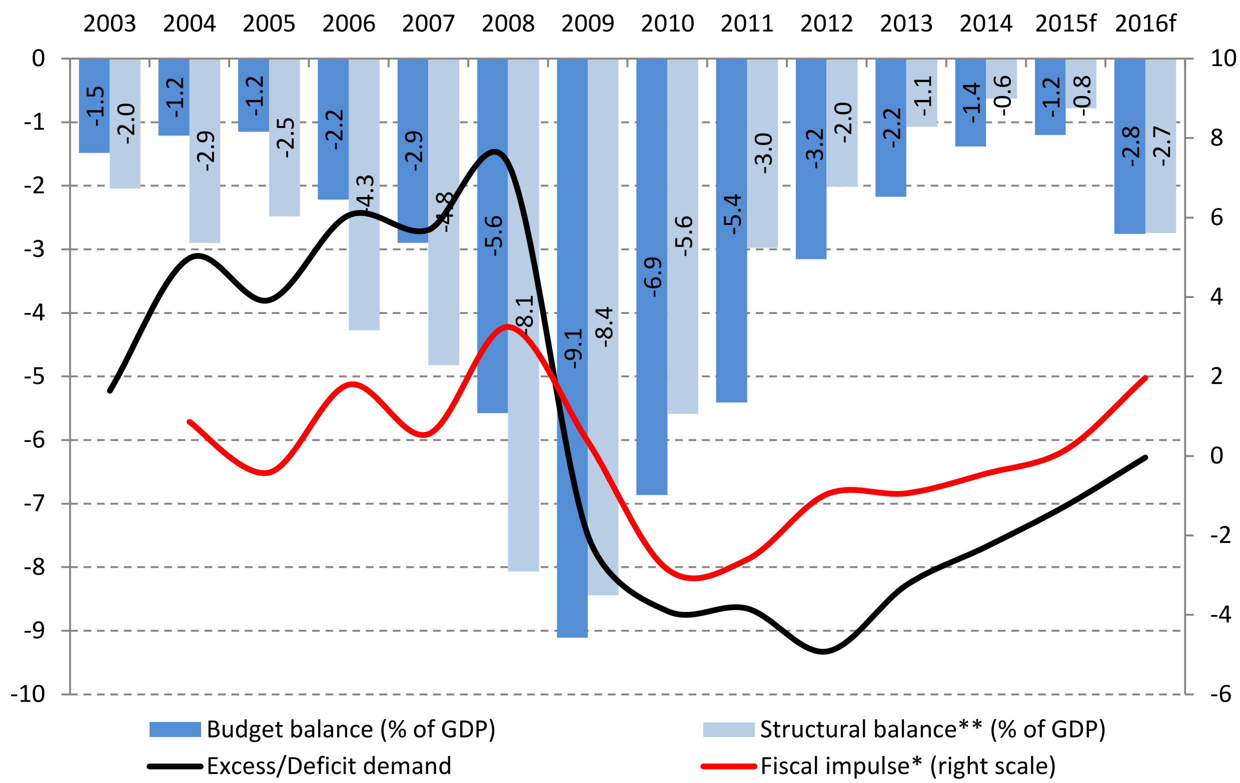
adjustments not being necessary. However, it should be taken into account the fact that defining the target in terms of structural deficit implies a target for the headline deficit appropriately adjusted according to the economic cycle. Thus, given that the output gap in the following years is projected to enter on positive territory, compliance with the structural deficit target of 1% of GDP will be equivalent to the registration of headline deficit levels lower than this level (the cyclical component of the budget balance will be positive).

The structural budget balance, despite the fact that it better reflects the fiscal position of an economy, presents also a number of disadvantages, the most important being related to the uncertainties associated with its estimates. Thus, the value of the structural balance depends on the level of output gap, an unobservable variable that is often subject to more or less significant revisions according to the review of statistical data and methodology used.

Compared to the previous version of the Annual Report of the Fiscal Council, the structural deficit in the case of Romania has been reassessed by the European Commission from 3.8% to 3% of GDP for 2011, from 2.5% to 2% of GDP for 2012, from 1.7 to 1.1% of GDP for 2013, as a result of output gap's revaluation in the sense of a higher aggregate demand gap than the previous estimates, that involved a negative cyclical component of the structural deficit higher in absolute terms and therefore a lower level of the structural deficit. Given the last projection of the European Commission on the output gap of -2.3% in 2014, corresponding to a cyclical component of -0.8%, reaching a headline deficit of 1.4% of GDP according to the European methodology implies a positively exceeding of the 1% of GDP structural deficit MTO, ie a structural deficit of 0.6% of GDP.

In 2009-2014, the structural deficit was reduced from 8.4% of GDP to 0.6%, the average rate of adjustment of 1.56 pp per year being extremely fast (see *Figure 4*); at the same time we have to remember that the starting level was high, which required a rapid adoption of decisive measures to ensure the sustainability of the fiscal policy. It should be noted that this adjustment was made mostly in 2010 and 2011, when the structural deficit was reduced on average by 2.73 pp per year, the fiscal consolidation being achieved mainly on the expenditure side through reforms in the public wages, in the pension system and in the budgetary programming. At the same time, on the revenue side, the most important measure was the increase in the standard VAT rate from 19% to 24% since July 2010.

Figure 4: Structural deficit, fiscal impulse and excess demand



*Defined as variation in the structural balance (% of GDP) (+ stimulus effect ,- contractionary effect)
** For the period 2003-2009, the data refer to the cyclically adjusted budget balance

Source: AMECO, Fiscal Council`s calculations

Romania practiced in the past 10 years a significant pro-cyclical fiscal policy, stimulating strongly but useless and counterproductive the economy in times of economic expansion (2004-2008) and slowing the economy when it was operating below potential (2010-2014), contributing to the exacerbation of business cycle fluctuations and to deepening the accumulated imbalances in the economy (*Figure 4*). Basically, the pro-cyclicality of the fiscal policy during the pre-crisis economic boom has exhausted the required fiscal space to stimulate the economy during the recession that followed, the need to reduce the budget deficit during the crisis (primarily due to funding constraints) therefore implying, inevitably, maintaining the pro-cyclicality of the fiscal policy. Consequently, the automatic, beneficial and stabilizing action of the cyclically deficit (the automatic stabilizers) was canceled by the pro-cyclical discretionary policy.

It is very important to mention that in September 2015 the new Fiscal Code entered into force , and even if differs from the previous draft versions adopted by the Government in March 2015 and by the Parliament in June 2015 (by postponing some fiscal loosening measures in 2017 instead of 2016 such as: eliminating the tax for special constructions, except the agricultural constructions, eliminating the higher fuel excise, reduction of the dividends' taxation at 5%; in addition the reduction of the VAT rate from 24% to 20% starting on the 1st of January 2016 and then to 19% starting on the 1st of January, 2017), involves a major risk of deterioration of the public finances position, in the absence of coherent measures to compensate the significant loss of revenue related to tax cuts. Furthermore, an emergency ordinance was adopted aimed at extending the application scope of the reduced VAT rate of 9% for food products and restaurant services starting with the 1st of June 2015, whose budgetary impact at least in 2015 would be covered in the Government's vision by the amounts collected in addition to the program by the NAFA in the first part of the current year. Also, in October this year, the Fiscal Code was amended again, the current form involves applying a year earlier, from 1st Janurary 2016, the rate of 5% on dividend income for individuals and businesses, differentiation of the applicable tax rates on microenterprises turnover to a level less than or equal to that of today, extending the applicability of the reduced VAT rate of 9% for potable water and for irrigation in agriculture.

Given these measures, the European Commission forecasts for 2015 a small deviation of the structural deficit (+0.2 pp of GDP), a value lower than the adjustor of 0.25 pp of GDP allowed for jointly funded projects and a considerable deviation of the structural deficit in 2016 compared to MTO by +1.7 pp of GDP, while the headline deficit is projected to increase by 1.6 pp of GDP at the end of 2016, exclusively on behalf of worsening the structural component due to the adoption of the new Fiscal Code, partially reversing the significant progress made in recent years. It is worth mentioning that the EC forecasts differ from the ones of the Romanian authorities included in the 2015-2018 Convergence Programme, aimed at compliance with the MTO also in 2016.More precisely, the important deficit increasing measures included in the draft of the Fiscal Code adopted by the Government in March, 2015 are contained in the spring 2015 European Commission's forecasts, but they aren't in the Convergence Programme, although this would be required by the Code of good practices.

Essentially, Romania would again initiate an expansionary fiscal policy in the context in which the output gap will most likely turn positive starting with 2016, and the Fiscal Code entered into force in 10th September 2015. Given the fact that compared to 2008 the public debt is significantly higher (39.8% of GDP at the end of 2014 compared to 13.2%), it is difficult to imagine the existence of a fiscal space to stimulate the economy in times of recession, being identifiable even risks to the public debt sustainability. Moreover, such a policy is in flagrant contradiction with the rules established by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and by the Fiscal Responsibility Law no. 69/2010, including the subsequent amendments.

III. 3. Budgetary revenues

The revenues of the general consolidated budget, without the impact of the compensation schemes, increased by 6.91% in 2014 compared to the previous year, up to 212.81 billion lei, respectively 31.92% of GDP. Compared to 2013, the share of budgetary revenues in GDP increased by 0.7 pp of GDP, the growth being localized at the following categories of revenues: excise duties (+0.30 pp of GDP), amounts received from the EU on account of the payments made (+0.27 pp of GDP), other amounts received from the EU for operational programs financed under the Convergence objective[10] (+0.23 pp of GDP), property taxes (+0.24 pp of GDP), other property taxes (+0.15 pp of GDP), corporate income tax (+0.11 pp of GDP). On the other hand, negative developments in terms of share of GDP were recorded by VAT receipts (-0.43 pp of GDP), the use of goods, authorizing the use of property or the conduct of activities (-0.26 pp of GDP, the reduction in this case being explained by the inclusion in 2013 of the temporary revenue from renting the frequency bands[11]) and non-tax revenues (-0.10 pp of GDP).

Compared to the initial budget, the budget revenues were by 0.47 pp of GDP lower, mainly due the development below the expectations at the level of EU funds absorption, the difference between the final value and the initial planned one being of -0.56 pp of GDP. This underperformance of the budget revenues was mitigated by achieving a plus of 0.23% of GDP (1.52 billion lei) from other amounts received from the EU for operational programs financed under the Convergence objective, not included in the draft budget. The gap between the final execution and the initial forecast for the fiscal revenues, reached -0.14 pp of GDP, the major difference compared to the original projection being located at the level of the VAT revenues (-0.50 pp of GDP, respectively, a minus of 3.4 billion lei), a phenomenon partly explained by the higher VAT repayments made in 2014, particularly in the last quarter, and the base effect related to the reduction of VAT on bread, flour and wheat starting 1st September 2013. The dynamics of the fiscal revenues was positively influenced by the property tax revenues (+0.17[12] pp of GDP compared to initial estimates), other general taxes on goods and services which recorded an increase of 0.12[13] pp of GDP, and also by the superior development compared with the expectations at the level of the corporate income tax (+0.12 pp of GDP), despite the introduction of the measure regarding profit tax exemption for reinvested profits from 1st July

[10] A subchapter recently introduced in the classification of public finance indicators (in October 2014).

[11] This category represents one-off revenues.

[12] On the account of a positive difference between the projected revenues from the tax on special constructions, compared with the achievements of about 1 billion lei.

[13] The gap between the initial projections and the execution for the supplementary revenues from the liberalization of the prices for natural gas and from the claw-back tax, of about 0.8 billion lei.

2014, but in the case of the cash budgetary execution only one quarter of profit tax receipts was affected for the last year.

The final execution for excise duties[14], the use of goods, authorizing the use of property or the conduct of activities and other taxes was in line with the expectations envisaged in the draft budget. The budgetary execution for personal income tax and social contributions recorded minor deviations from the anticipated trajectory in the draft budget, as a result of the additional revenues generated by the decision regarding the payment in advance, compared to the initial programmed rescheduling of certain salary rights earned by court decisions, amounting to 2.4 billion lei at the third budget revision which offset the impact of lower than expected execution in the case of the personal income tax, respectively, the impact generated by reducing social security contributions for employer by 5 pp from 1st October 2015, in the case of the social contributions revenue.

III.3.1. VAT and excises

The **VAT** receipts, without the impact of the compensation schemes, recorded in 2014 a level of 50.4 billion lei, respectively 7.56% of GDP, significantly below the amount envisaged in the draft budget by about 3.4 billion lei, despite an advance of the relevant macroeconomic base (final consumption of households and NPISH[15]) of 5.8%. Moreover, VAT revenues have declined also compared to the year 2013 amounting to 0.53 billion lei, corresponding to a dynamics of -1.11%. The significant underperformance of this category of budgetary revenues can be partially explained by the failure of public investment expenditures compared to the programmed level (-7.4 billion lei), by the higher VAT refunds made in 2014 (3.24 billion lei, respectively with 19.74% more compared with 2013), the three months postponement of the excise duties increase on fuel (excise falls under the tax base of VAT) and the base effect of reducing VAT rate on bread, flour and wheat starting 1st September 2013. Excluding the impact of the higher VAT refunds, the VAT gross receipts increased by 3.36% in 2014 compared to 2013.

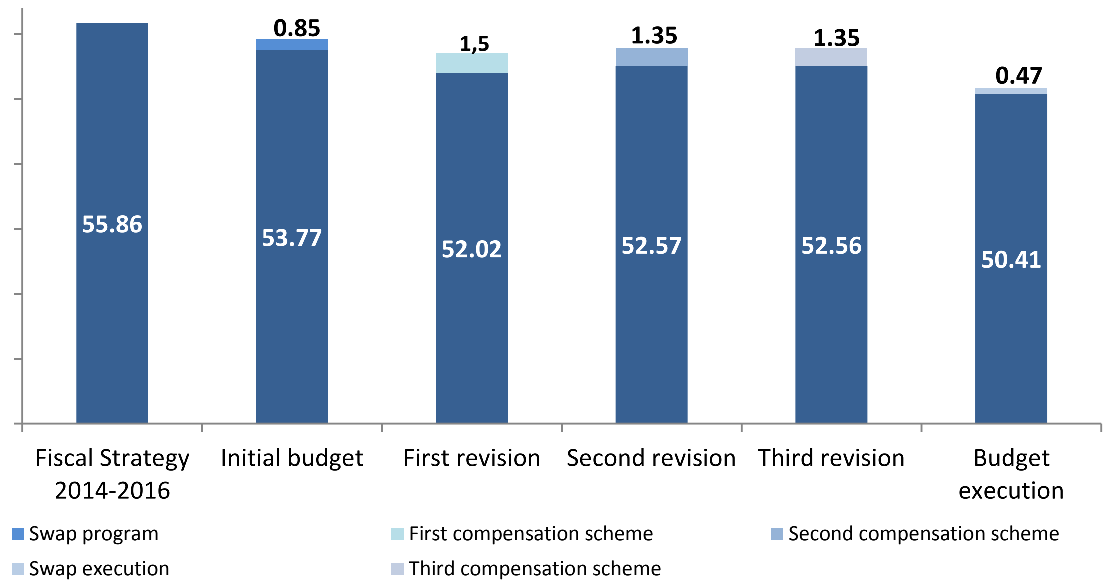
It should be noted that in the draft budget for 2014, the compensation scheme that would affect the VAT revenue, was projected at 0.85 billion lei. Subsequently, through the three budgetary revisions, this amount was increased up to 1.35 billion lei, but this rise was not

[14] Although in this case, the postponement by three months of the application of higher fuel excise was decided after the approval of the initial budget.

[15] Non-profit institutions serving households.

reflected at the level of the final execution, as the VAT receipts corresponding to the swap scheme totaled only 0.5 billion lei.

Figure 5: VAT revenues in 2014 (billion lei)



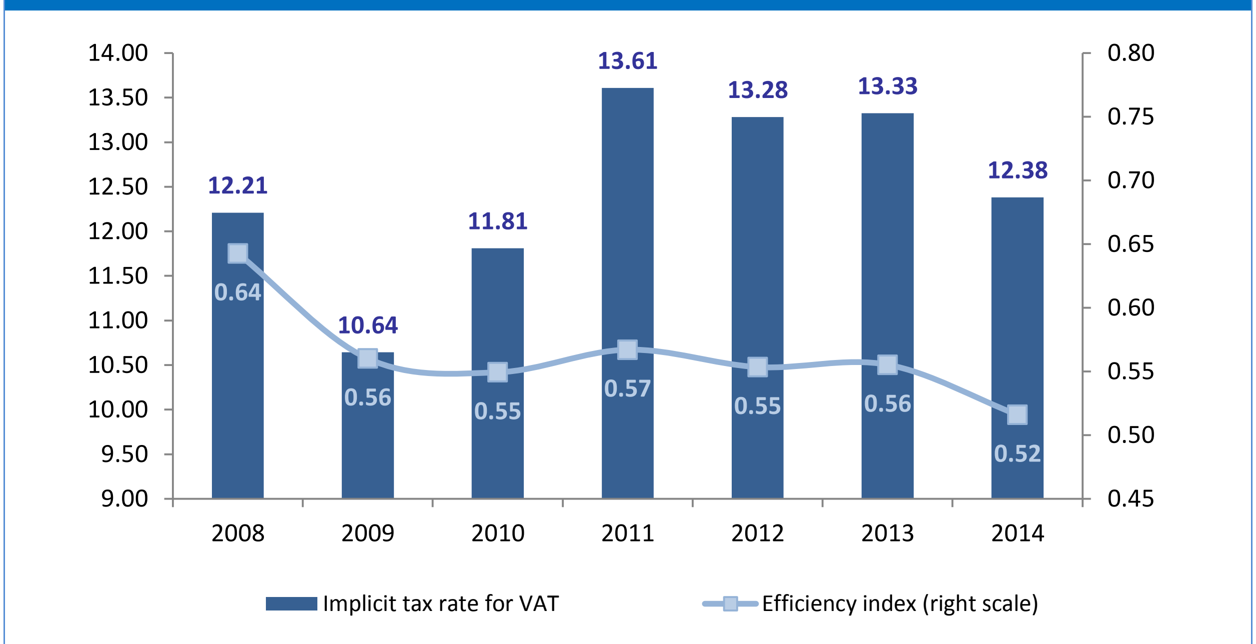
Source: Ministry of Public Finance

An ex-post analysis on the measure of reducing VAT rate on bread, flour and wheat could be conducted in the context of the government estimates indicating a VAT receipts recovery on the background of increased voluntary compliance/reducing tax evasion. This analysis is more relevant as in the Government's view the main source of compensation for the negative revenue gap induced by the comprehensive package of tax cuts proposed for the period 2015-2019, is represented by the additional revenues generated by reducing tax evasion. Thus, analyzing the average number of monthly VAT documents filed by companies with activities targeted by the VAT rate reduction on bread, flour and wheat, we notice a 1.1% decrease in 2014 compared to the previous year, up to a level of 2,340, which is not likely to confirm an increase of the number of taxpayers in the taxed economy. Also, the monthly average of VAT receipts for the products with the reduced VAT rate decreased by -54.5%, in the period October 2013 - December 2014 compared to September 2012 - September 2013, which is in line with with estimated first round impact of the reduction in VAT rate. It is true that the measure can be regarded as having a social character (as, after applying this measure, the prices were equivalently reduced), and also as a manner to support the correct economic agents facing the unfair competition from those belonging to the black economy. However, applying this measure has shown that simply reducing the VAT rate does not diminish the tax evasion, effective control measures being absolutely necessary to be taken.

Assessing the efficiency of tax collection by the ratio of the implicit tax rate (defined as the ratio between the actually collected revenue for a specific type of tax and the corresponding macroeconomic tax base) and the statutory tax rate, we note that the VAT efficiency index of taxation for Romania decreased significantly compared with the period before the economic crisis, being a common phenomenon in the group of new EU member states in the Central and Eastern Europe (NMS10). Following a relative stability of the index in the period 2010-2013, a significant deterioration occurred in 2014, probably on the basis of an increased tax evasion.

The budget execution at the end of 2014, expressed according to ESA 2010 standards also indicates a significant decrease of the VAT revenue dynamics (-1.67%) compared to the relevant macroeconomic tax base (+5.8%). The level of taxation efficiency compared to the previous year deteriorated, as the efficiency index dropped from 0.56 in 2013 to 0.52 in 2014. Effectively, in 2014 Romania's revenue from VAT receipts represented only 12.38%, compared to a standard rate of 24%. If we exclude the impact of VAT rate reduction on bread, flour and wheat (about 241 million lei in 2014 compared to 2013 and considering the application of the measure from 1st September 2013), the implicit tax rate increased marginally by 0.02 pp, to a level of 12.4% and the efficiency index remains practically constant.

Figure 6: The evolution of the implicit tax rate and efficiency tax index for VAT in Romania



Source: Fiscal Council's calculation

The VAT efficiency index for Romania of 0.52 in 2014 is significantly lower than in the case of Estonia (0.84), Bulgaria (0.74), Czech Republic (0.74) and Slovenia (0.73). Romania has collected 7.6% of GDP in 2014 from VAT revenue (ESA 2010), compared to 8.76% of GDP in Estonia, 8.47% in Slovenia and 9.19% in Bulgaria, while the standard VAT rate in these countries was 20% and 22% respectively (compared to a level of 24% in Romania). In the year 2014, a lower efficiency of taxation as defined above was observed only in Poland.

Although, it must be noted that the differences in the efficiency index of taxation also reflect the structural differences between economies, since the higher percentage of rural population in Romania is revealed in a higher share of the self-consumption component and farmhouse market (non-taxable). Moreover, Aizenmann J. and Y. Jinjarak (2005) [16], examining a panel of 44 countries in the period 1970-1999, concludes that the VAT collection efficiency is negatively related to the share of agriculture in GDP, and directly proportional to the degree of urbanization and the trade openness of the economy – the corresponding indicators for the three variables for Romania being unfavorable. In addition, it should be noted that this method of computing the VAT efficiency indicator does not take into account the impact of the reduced VAT rates and other components of GDP that are subject to VAT (i.e., a part of the intermediate consumption and a part of the fixed gross capital formation - see the *tax evasion chapter*).

Table 6: Taxation efficiency - VAT

Country	Standard VAT* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
BG	20.0	20.0	20.0	14.0	15.1	14.8	0.70	0.75	0.74	4	2	2
CZ	20.0	21.0	21.0	14.3	15.0	15.5	0.72	0.71	0.74	2	4	3
EE	20.0	20.0	20.0	16.7	16.1	16.8	0.84	0.81	0.84	1	1	1
LV	21.5	21.0	21.0	11.6	11.8	12.1	0.54	0.56	0.58	8	8	7
LT	21.0	21.0	21.0	12.1	11.9	11.9	0.58	0.57	0.57	6	6	8
HU	27.0	27.0	27.0	17.1	17.1	18.7	0.63	0.63	0.69	5	5	5
PL	23.0	23.0	23.0	11.5	11.3	11.6	0.50	0.49	0.50	10	10	10
RO	24.0	24.0	24.0	13.3	13.3	12.4	0.55	0.56	0.52	7	9	9
SI	20.0	20.0	22.0	14.3	15.6	16.0	0.71	0.74	0.73	3	3	4
SK	20.0	20.0	20.0	10.4	11.3	11.8	0.52	0.56	0.59	9	7	6

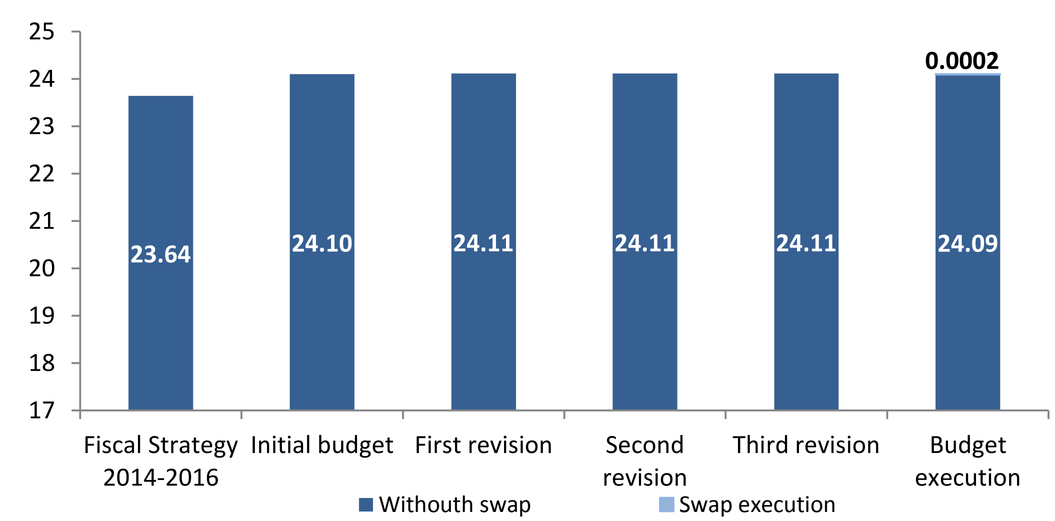
Source: European Commission, Eurostat, Ministry of Public Finance, Fiscal Council's calculations
* If standard rates have been modified during the year, a weighted average of standard rates has been reported.

[16] Aizenmann J., Jinjarak Y, "The Collection Efficiency of the Value Added Tax: Theory and International Evidence", National Bureau of Economic Research Working Paper no. 11539, August 2005.

** Calculated as a ratio between "VAT revenues" (ESA code D211R) and "Households and NPISH Final Consumption Expenditure" (ESA code P31_S14_S15 ESA). In Romania, the revenues for 2012, 2013, and 2014 include additional receipts due to implementation of compensation scheme for clearing arrears (+1,571 million lei in 2012, +854.7 million lei in 2013, +473,1 million lei in 2014).
*** Computed as a ratio between the implicit and legal tax rate.

The revenue collected from the **excise** duties in 2014 amounted to 24.1 billion lei (3.6% of GDP), in line with the initial projections envisaged in the draft budget, while being by 14.16% or by 2.9 billion lei higher compared to the previous year. This development reflects the increase of the excise duty on fuel due to introducing the tax of 7 euro cents/liter of fuel (the estimated annual impact according to the Government being of 1.84 billion lei), abandoning the practice of using for the excise duty calculation the reference exchange rate EUR/RON announced by the European Central Bank from 1st October, instead using the indexation of the exchange rate registered in 2013 with the average inflation rate of September 2013 of 4.77% (estimated budgetary impact of 0.89 billion lei) and the increase of the excise duty on cigarettes as scheduled. It should be noted that increased excise duty for fuel was applied with a delay of 3 months (starting 1st April 2014), but the revenues from excises equaled the original estimates, most likely due to a conservative assessment of the budgetary impact of this discretionary measure.

Figure 7: Excises, 2014 (billion lei)



Source: Ministry of Public Finance

III.3.2. Direct taxes

The revenues from the **corporate income tax** according to cash standards, in amount of 12.18 billion lei, without the compensation schemes (in the amount of 57.2 million lei), registered a significant increase of 11.57% in 2014 (+1.26 billion lei), higher than the estimates of the initial budget (by about 802.6 million lei), based on a better than expected evolution for the revenues collected from the non-financial economic agents (+9.91%, respectively 1.07 billion lei) facilitated by the reduction of the number of insolvencies[17] and also by lower tax refunds overpaid by the commercial banks[18]compared to the previous year, so that the aggregate profit tax paid by the commercial banks at the end of 2014 increased by 222.7 million lei.

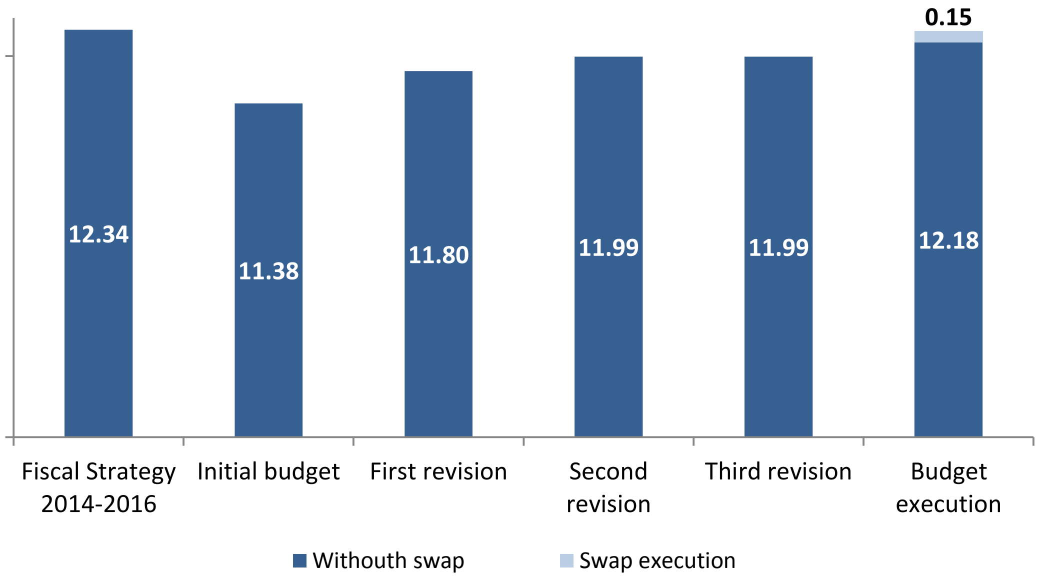
In the first half of 2014 it was introduced a discretionary measure regarding the corporate tax exemption for reinvested profits for certain categories of fixed assets which, from a fiscal perspective, is equivalent with the complete recovery of eligible investments in the first year of utilization (limited to the accounting profit from that year). This legislative measure is temporary, being applicable to eligible investment made between July 1st, 2014 - December 31st, 2016 and the annual budgetary impact estimated by MFP was about 600 million lei, while the Fiscal Council's updated estimations indicate a budgetary revenue loss of 1.6 billion lei. In 2014 the cash execution would have been affected only at the level of a quarter, yet, according to the data, there is no evidence of a major budgetary impact of this measure, as the profit tax revenue collected in October 2014 were by 172.83 million lei, respectively by 6.45% higher than in the same period of 2013. However, significant negative effects for the budgetary revenues

[17] According to the National Trade Register Office (NTRO), the number of companies which became insolvent in 2014 was by 30.05% lower than in 2013 (20,696 companies in 2014). At the same time, the number of companies registered in 2014 (101,627) decreased by 18.58% compared to 2013. The insolvency rate calculated as the ratio between the newly opened insolvency cases reported to the number of active companies decreased from 4.11 % in 2013 to 2.76% in 2014.

[18] The taxpayers commercial banks - Romanian legal entities and branches of banks in Romania - foreign Romanian legal entities have the obligation, under the Fiscal Code to declare and pay annual corporate income tax (completing the statement until 25 March the following year), with quarterly prepayments updated with the inflation index. Since in 2013 the banking system recorded a profit of 49 million lei (is the first year with profit for the banking system after 2009), compared with an aggregate loss of -2.34 billion lei in 2012, the adjustment made in the first part of 2014 to advance payments in 2013 meant tax refunds for the overpaid corporate income tax lower in 2013 than in the previous year. Also, payments in 2014 had as a basis the slightly better profits recorded in 2013. For 2014, the banking system had, however, a significant loss, reaching -4.34 billion lei, being explained by the efforts of banks to respect the NBR Directive which requires " clean-up measures“ of the balance sheets that led to higher provisions set up by the credit institutions to offset non-performing loans.

from this category may occur in stages by 2016 (the period covered by this facility), as the adjustment of the firms' investment plans is a long term action.

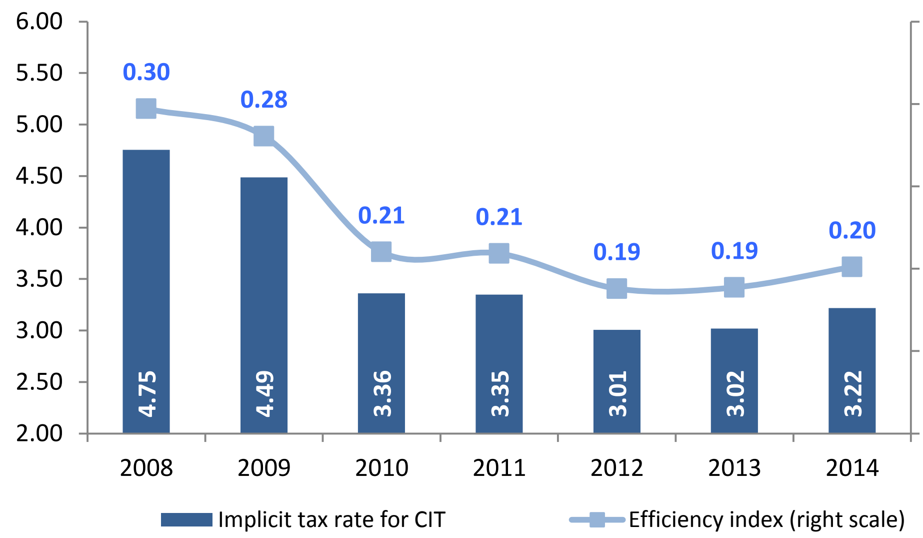
Figure 8: Corporate income tax, 2014 (billion lei)



Source: Ministry of Public Finance

The nominal revenues from the corporate income tax, without the compensation schemes, remained significantly below the pre-crisis levels. This trend can be observed also by considering the efficiency index, expressed according to ESA 2010 standards, which showed a significant reduction in the period 2008-2012 (in line with developments in NMS 10); *Figure 9* suggests a direct link between the effectiveness of collection and the cyclical position of economy. After the resumption of economic growth in 2011, the efficiency index seems to have stabilized. While in cash terms the dynamic of the profit tax receipts was 11.57% in 2014 compared to 2013, according to ESA 2010 standards, the increase was 12%, indicating an improvement in the efficiency index in 2014, as the corporate income tax revenues have advanced at a superior rate compared to the relevant macroeconomic base (the gross operating surplus, +5.08%).

Figure 9: Implicit tax rate and efficiency tax index for corporate income tax in Romania



Source: Fiscal Council's calculations

Table 7: Taxation efficiency – corporate income tax

Country	Legal corporate income tax (%)			Implicit tax rate* (%)			Taxation efficiency index**			Rank		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
BG	10.0	10.0	10.0	3.5	4.4	4.4	0.35	0.44	0.44	1	1	1
CZ	19.0	19.0	19.0	6.3	6.5	6.7	0.33	0.34	0.35	2	2	2
EE	21.0	21.0	21.0	3.4	4.2	4.5	0.16	0.20	0.22	9	5	5
LV	15.0	15.0	15.0	3.3	3.4	3.6	0.22	0.23	0.24	4	4	4
LT	15.0	15.0	15.0	2.5	2.7	2.8	0.17	0.18	0.18	8	9	8
HU	20.6	20.6	20.6	3.2	3.0	3.4	0.15	0.15	0.17	10	10	9
PL	19.0	19.0	19.0	4.1	3.4	NA	0.22	0.18	NA	5	8	NA
RO	16.0	16.0	16.0	3.0	3.0	3.2	0.19	0.19	0.20	7	7	6
SI	18.0	17.0	17.0	3.4	3.3	3.3	0.19	0.19	0.19	6	6	7
SK	19.0	23.0	22.0	4.6	5.5	5.9	0.24	0.24	0.27	3	3	3

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

* Calculated as the ratio between "direct taxes paid by enterprises" (ESA code D.5R (S11+S12)) and "gross operating surplus and gross mixed income" (ESA code B2G_B3G).

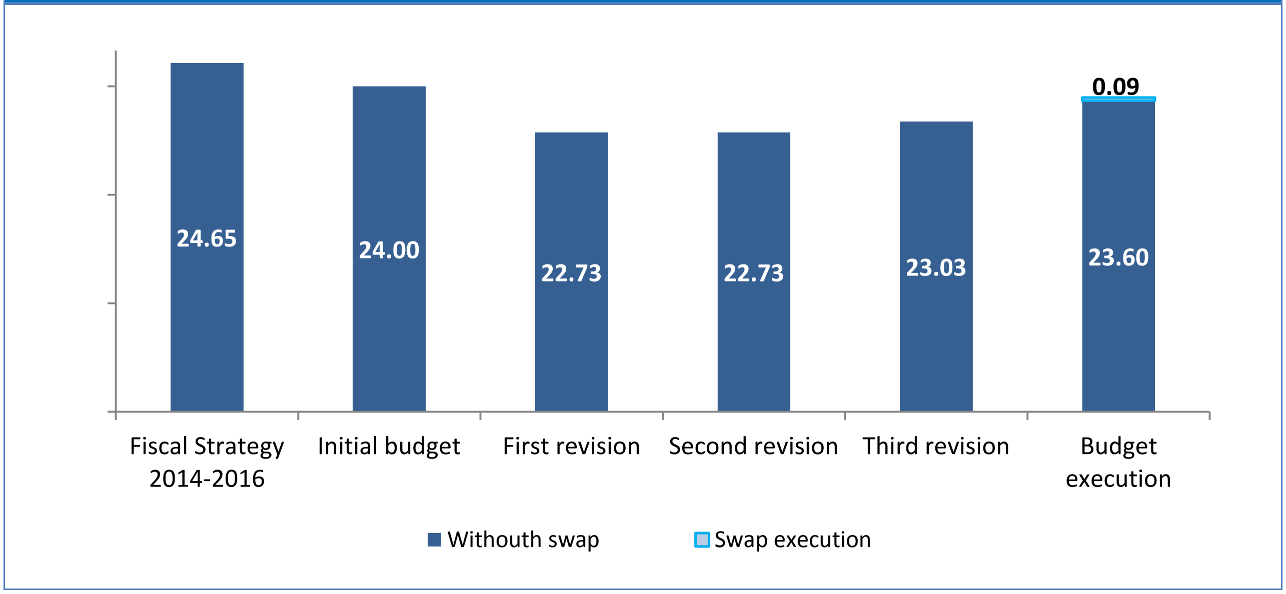
** Computed as a ratio between the implicit and legal tax rate.

Compared to other countries from Central and Eastern Europe[19], in 2014 Romania was ranked on the sixth position, as in 2013, given that Poland was not taken into account for 2014, due to the unavailability of data, with an efficiency index of 0.20 and an implicit tax rate of 3.2% (calculated as the ratio of direct taxes paid by enterprises and gross operating surplus from national accounts, as an approximation of the actual tax base). It may be noted that Romania, like most countries in the region recorded a slight increase in the collection efficiency compared to the previous year.

The receipts from the **personal income tax** expressed in cash standards, in amount of 23.6 billion lei, performed below expectations, being under the initial budget estimates by about 397.9 million lei (-1.66%), but exceeding the revenues collected in 2013 by about 870.4 million lei (+3.83%). The dynamics of this budgetary aggregate reflects an increase of 5.3% of the average gross wage in the economy, but also the increase of the average number of employees (+1.3% compared to 2013), exclusively due to an increase in the number of jobs created by the private sector, while the number of public employees has remained relatively constant. The spread between the original program and the execution would have been even higher in the absence of the decision by paying in advance for the year 2015 the tranche of 2.4 billion lei for certain salary rights earned by court decisions, that generated additional revenue from the income tax of about 260 million lei, while comparing with the initial programs, the supplementation of the amounts paid for certain salary rights earned by court decisions from 900 million lei in 2013 to 4.6 billion lei in 2014 generated a surplus from personal income tax receipts of about 420 million lei.

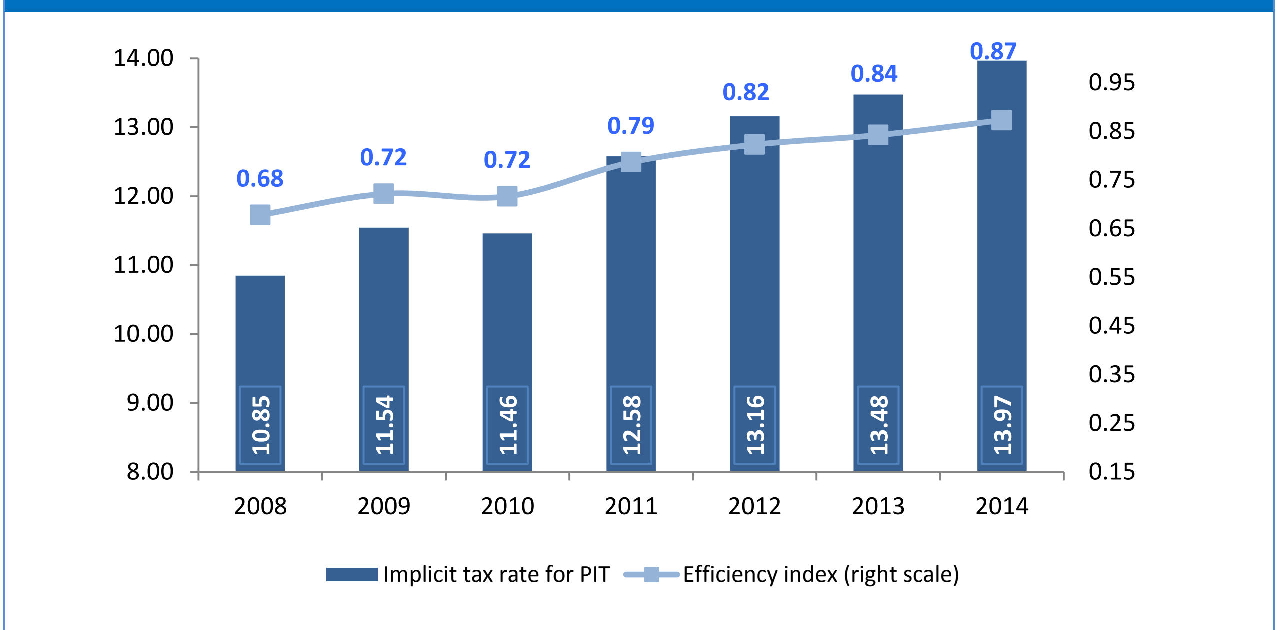
[19] Poland is not included in the ranking for the year 2014 due to unavailability of data on the gross operating surplus in national accounts.

Figure 10: Personal income tax, 2014 (billion lei)



Source: Ministry of Public Finance

Figure 11: The evolution of the implicit tax rate and taxation efficiency index for personal income tax in Romania



Source: Fiscal Council's calculations

Comparing the evolution in 2014 with that from 2013, the dynamics of the personal income tax revenues expressed in ESA 2010 standards (+7.07%) is higher than that in cash terms (+3.83%), also being superior to that of the macroeconomic base (gross wages in national accounts, from which were excluded the social contributions paid by employees, which increased by 3.32%), equivalent to an improvement in the collection efficiency. However, the level of this indicator remains quite high (0.87), the period 2008-2014 being characterized by a consistent improvement of the collection efficiency, the personal income tax receipts and the wages have constantly advanced at a rate higher than that recorded by appropriate macroeconomic basis.

The figures should be interpreted with some caution, given that in the recent years, the successive increases of salaries in nominal terms were not accompanied by a revision of the income tranches on which tax deductions are granted. Thus, a given dynamics of the gross wages can generate higher revenues from personal income tax, without being necessarily based on an increase in the efficiency of collection. When analyzing the results some reservations are required, motivated by the fact that the direct taxes paid by the population include other forms of taxes (i.e. taxes on capital gains, on interest revenue and pension benefits, on dividends received by individuals), not only on wages but unfortunately, there are no available detailed data on the different categories of taxes paid by the population in order to consider only the taxes on wages.

Table 8: Taxation efficiency – personal income tax

Country	Legal corporate income tax (%)			Implicit tax rate** (%)			Taxation efficiency index ***			Rank		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
BG	10.0	10.0	10.0	9.0	8.6	9.2	0.90	0.86	0.92	1	1	1
CZ	15.0	15.0	15.0	8.7	9.1	9.2	0.58	0.61	0.61	9	7	7
EE	21.0	21.0	21.0	15.4	15.8	16.0	0.74	0.75	0.76	5	5	5
LV	25.0	24.0	24.0	17.5	16.2	15.7	0.70	0.68	0.65	6	6	6
LT	15.0	15.0	15.0	11.5	11.7	11.7	0.76	0.78	0.78	4	3	3
HU	16.0	16.0	16.0	12.5	12.4	12.2	0.78	0.78	0.77	3	4	4
PL	25.0	25.0	25.0	14.5	14.4	NA	0.58	0.58	NA	8	8	NA
RO	16.0	16.0	16.0	13.2	13.5	14.0	0.82	0.84	0.87	2	2	2
SI	27.0	27.0	27.0	12.9	12.0	12.0	0.48	0.45	0.44	10	10	9
SK	19.0	22.0	22.0	11.7	11.8	11.8	0.61	0.54	0.54	7	9	8

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

* For countries with progressive taxation system (Poland, Slovenia), the figure reported is the average tax rate (Poland - with two tax rates system) or central rate (in Slovenia - with three tax rates system).

** Computed as the ratio between "revenues from direct tax paid by the population" and personal income tax base defined as gross wages from the national accounts from which social

insurance contributions paid by employees were deducted. For the Czech Republic and Hungary, the personal income tax base is “compensation of employees”, which includes social security contributions paid by employers, given the use of the “super grossing” in computing the personal income tax due.
*** Computed as a ratio between implicit tax rate and legal tax rate.

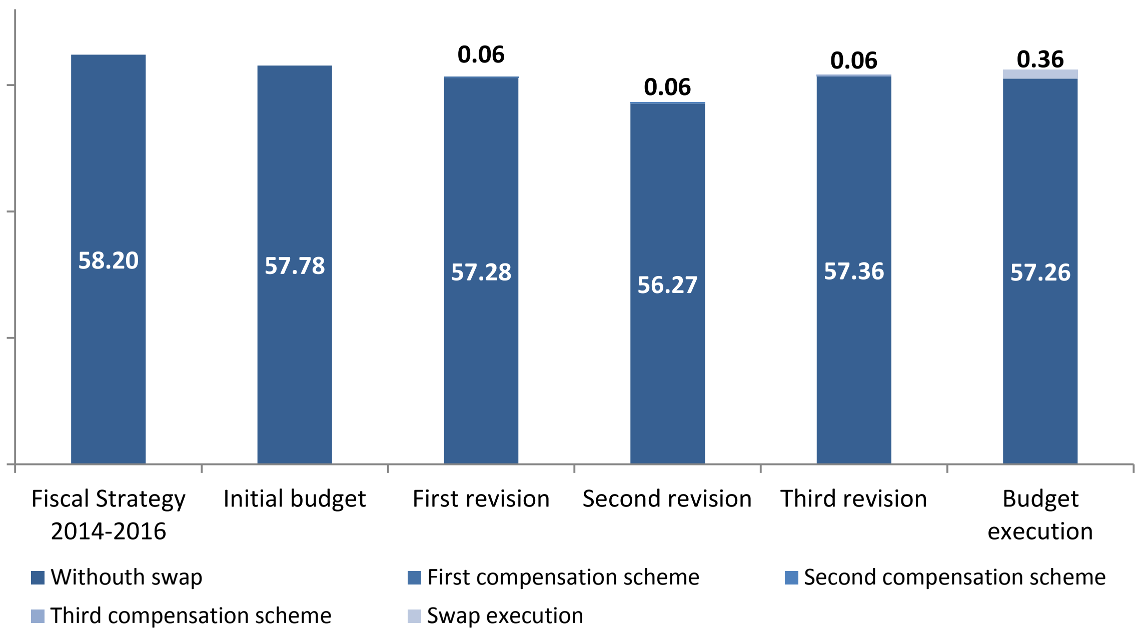
Compared with other countries in the region, Romania maintained its second position in the sample[20], with an efficiency index of 0.87 and an implicit tax rate of 14% (calculated as the ratio of direct taxes paid by households and gross wages from national accounts - including shadow economy, for which social security contributions paid by employees were deducted from salaries).

III.3.3. Social contributions

The revenues from social contributions, without the impact of compensation schemes, amounted to 57.3 billion lei at the end of 2014 in cash standards, by 0.91% or 524 million lei higher than the initial estimates (57.78 billion lei), while the impact of the discretionary measures implemented during the year was not included in the original budget. Thus, on the occasion of the second budget revision, the revenues were revised downward by about 1 billion lei as a result of the decision to reduce the employer social security contributions by 5 pp from 1st October 2014, while the third rectification increased the projected revenue for this budgetary aggregate mainly as a consequence of the decision to pay in advance the tranche for 2015 (2.4 billion lei) of the amounts paid for certain salary rights earned by court decisions.

[20] There is no data available regarding the gross wages in the national accounts for Poland in 2014.

Figure 12: Social security contributions, 2014 (billion lei)



Source: Ministry of Public Finance

Compared to 2013, the receipts from social contributions, without the impact of the compensation schemes, increased by 5.35%, respectively, being by 3.32% higher than the dynamic recorded by the relevant macroeconomic base (gross wages in the national accounts). The dynamics of the social security contributions was adversely affected in 2014 by the increase of the scheduled amounts transferred[21] to the Second Pension Pillar, and positively influenced by supplementing the amounts paid for certain salary rights earned by court decisions to 4.6 billion lei (including the payment in advance for the tranche for 2015) compared to 900 million lei in 2013. In the table below, are presented the social contributions revenues, adjusted with the impact of several factors that have influenced the evolution of this budgetary aggregate in 2011-2014[22], in order to reflect more accurately the dynamics of the receipts from social security contributions.

[21] The contribution rate diverted to the private pension fund increases by 0.5 pp per year, starting on 1st January of each year so that in 2014 the share was 4.5%, compared to 4.0% in 2013, 3.5% in 2012 and 3% in 2011.

[22] In the years 2012-2013 the social contributions revenues from GCB were adversely affected by the repayment of amounts illegally collected from pensioners representing social health insurance contributions. The Constitutional Court decided in April 2012 that the health insurance contribution applies only to pension income exceeding 740 lei, deducting this amount from the tax base and the

Table 9: Social security contributions (million lei)					
		Budget execution 2011	Budget execution 2012	Budget execution 2013	Budget execution 2014
Adjusted series[23]	**1**	**50,637.30**	**51,658.30**	**54,378.90**	**57,612.10**
Swap	2	726.00	407.60	31.10	357.00
Second Pension Pillar	3	1,976.20	2,501.30	3,125.20	3,877.18
Amounts illegally withheld / refunded to retirees	4	(1,051.30)	262.80	788.50	-
Gross series *	**5=1-2+3+4**	**50,836.10**	**54,014.80**	**58,261.50**	**61,132.18**
* of which executory titles		-	191.9	287.8	1508.6

Source: Fiscal Council's calculations

Thus, if the unadjusted series are considered, it appears that in 2014 the social contributions revenues, amounting to 61.13 billion lei, registered also a favorable trend, but the surpassing of revenues collected in 2013 was of only 4.9% (+2.87 billion lei), being negatively influenced by the repayment of the amounts illegally collected from the pensioners. It is true that the reduction in social security contributions paid by employer from 1st October 2014, had a negative impact on the cash budget execution for two months of about 1.1 billion lei, but it was approximately equaled by the favorable impact of paying in advance for certain salary rights earned by court decisions. Consequently, in comparable terms, the dynamics of this budgetary aggregate is actually very similar to that observed in the GCB execution.

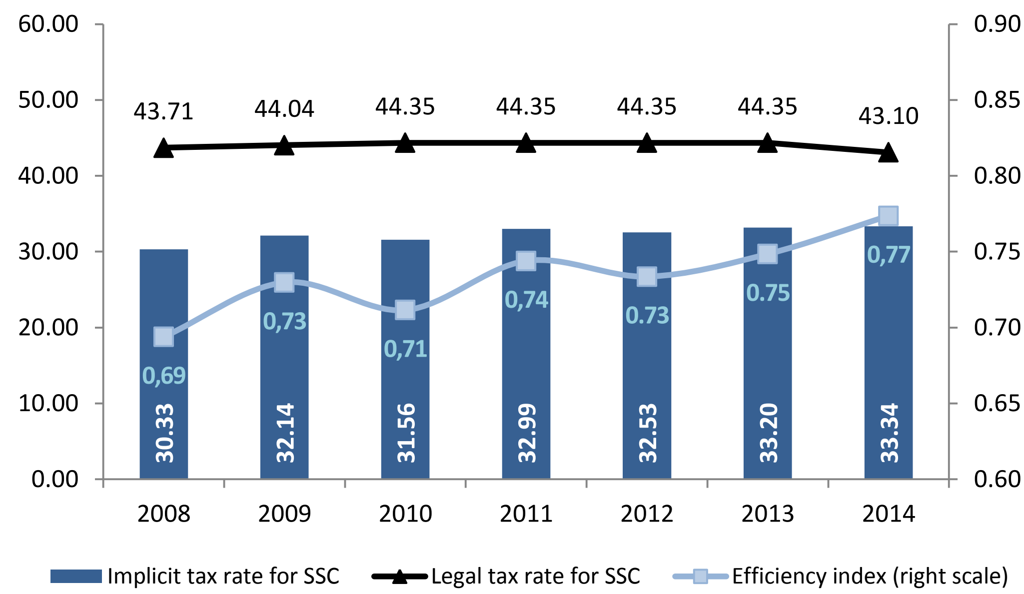
The social contributions revenues dynamics according to ESA 2010 (+3.78%) was higher by about 0.5 pp than of the relevant macroeconomic base (+3.32%) - respectively the gross wages in the national accounts, while the social contribution rates have been reduced. This implies a marginal improvement of the implicit tax rate from 33.2% in 2013 to 33.34% in 2014, while the statutory rate decreased from 44.35% to 43.1%. Consequently, the taxation efficiency index increased to 0.77 in 2014 from 0.75 in the previous year, following a similar trend registered in 2013. Compared to the previous version of the Fiscal Council's Annual Report, the taxation efficiency for social contributions improved in 2013, against a deterioration previously

Government decided to refund these amounts, withheld illegally, in equal monthly installments during the period June 2012 - September 2013.

[23] It is that contained in the budget execution.

determined[24], and this is owed to the recalculation of the dynamics for the gross wages in national accounts made by Eurostat simultaneous with the transition to ESA 2010 standards.

Figure 13: The development of the implicit tax rate and taxation efficiency index for social security contributions in Romania



Source: Fiscal Council's calculations

* Legal tax rate was calculated as a weighted average of rates applicable in 2014: 44.35% in the first 9 months of the year and 39.35% respectively from 1 October.

In comparison to other countries in the region[25], Romania was ranked on the seventh position regarding the efficiency of the social contributions collection, the same as in 2013, given that Poland was not taken into account for 2014, due to the unavailability of data. However, the implicit tax rate was below the level registered in several countries that impose a lower level of social security contributions. Thus, even if from the perspective of the aggregate statutory contribution rate our country ranked fourth in the region (after Slovakia, Hungary and the Czech Republic), Romania's implicit tax rate is slightly lower than the one of Slovenia, which statutory rate of social security contributions is lower with 5 pp. An improvement in the taxation efficiency index to a level equal to the one of Slovenia (this country being ranked on

[24] Recalculation of these indices based on Eurostat revised data for the years 2012 and 2013 (including modifications from ESA 95 to ESA 2010 methodology) indicate an increase of the implicit taxation rate and efficiency index in 2013 compared to 2012, opposite trends to those noted according to data available for the last year's edition of the Fiscal Council Report.

[25] There is no data available regarding the gross wages in the national accounts for Poland in 2014.

the third position relative to the taxation efficiency index) would have generated additional budget revenues of 10.5 billion lei (approximately 1.6% of GDP) in 2014.

Table 10: Taxation efficiency – social security contributions

Country	Legal tax rate for SSC* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
BG	31.0	31.0	31.0	21.6	21.9	23.1	0.70	0.71	0.74	10	9	8
CZ	45.3	45.3	45.3	47.6	48.2	48.5	1.05	1.07	1.07	2	2	1
EE	37.2	36.0	36.0	33.6	32.3	31.3	0.90	0.90	0.87	4	5	5
LV	35.1	35.1	34.1	26.9	24.4	23.2	0.77	0.69	0.68	8	10	9
LT	40.1	40.1	40.0	35.8	35.6	36.0	0.89	0.89	0.90	5	6	4
HU	47.0	47.0	47.0	36.1	36.4	36.9	0.77	0.78	0.78	7	7	6
PL	39.6	39.6	39.6	42.2	42.6	NA	1.06	1.08	NA	1	1	NA
RO	44.4	44.4	43.1	32.5	33.2	33.3	0.73	0.75	0.77	9	8	7
SI	38.2	38.2	38.2	34.6	34.7	34.9	0.91	0.91	0.91	3	4	3
SK	48.6	48.6	48.6	43.3	47.0	45.8	0.89	0.97	0.94	6	3	2

Source: European Commission, Eurostat, Ministry of Public Finance, Fiscal Council's calculation

* Aggregate data for employer and employee. Where rates were changed during the year, weighted average was used.

** Computed as the ratio between "actual social contributions" (cod ESA D.611) and "gross wages and salaries" (cod ESA D11). For Romania, 2011 and 2012 the budget revenues include additional receipts due to implementation of compensation scheme for clearing arrears (+476 million lei in 2012, +31.1 million lei in 2013 and +357.1 million lei in 2014).

*** Computed as the ratio between implicit and legal tax rate.

III.4. Budgetary expenditures

The budgetary expenditures, without the compensation schemes (in amount of 1,025.6 million lei), have registered a rate of growth (+4.88% compared to the previous year) close to the GDP growth (+4.56%), reaching at the end of the year, 225.30 billion lei, thus slightly increasing its share in GDP by 0.1 pp, from 33.7% to 33.8%. The main budgetary expenditure categories that registered a higher dynamics than total spending were other expenses (+32.9%), subsidies (+18.2%), personnel expenses (+8.5%), while lower dynamics than the average were registered by goods and services (+2.7%), capital expenses (-6.2%) and interest spending (-5.2%). Compared to the initial budget for 2014, the budgetary expenditures were reduced by 5.15 billion lei, respectively by 0.77% of GDP, mainly due to the decline of the projects financed through post-accession EU funds by 5.58 billion lei compared to the initial targets, equivalent of 0.84% of GDP, this underperformance being caused by missing the targets in terms of EU funds absorption.

Figure 14: Quarterly revenues of the GCB in 2014 (million lei)

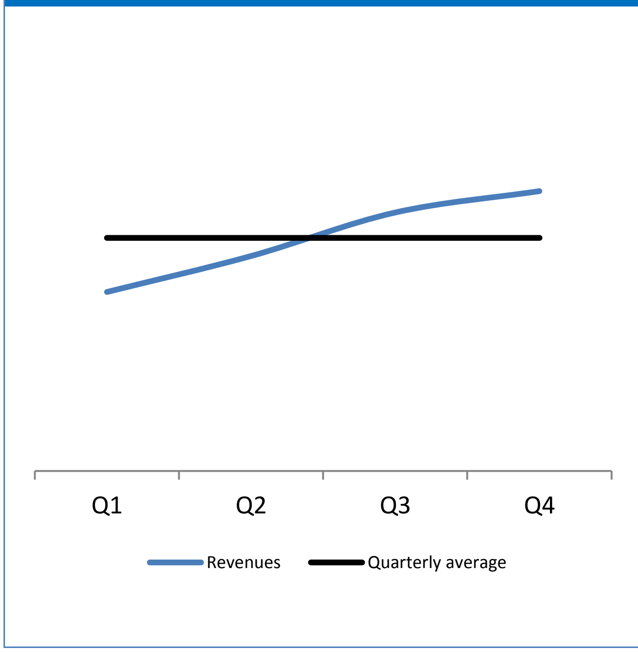
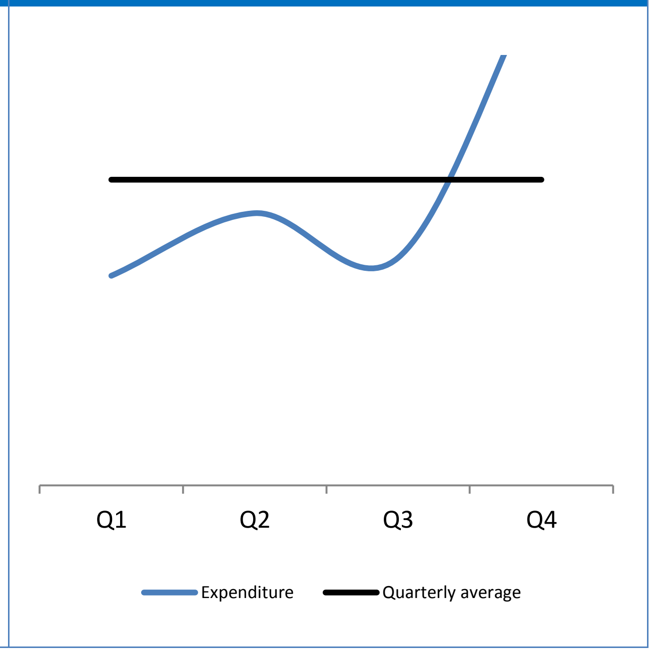


Figure 15: Quarterly expenditure of the GCB in 2014 (million lei)



Source: Ministry of Public Finance

Note: The amounts are without the compensation schemes.

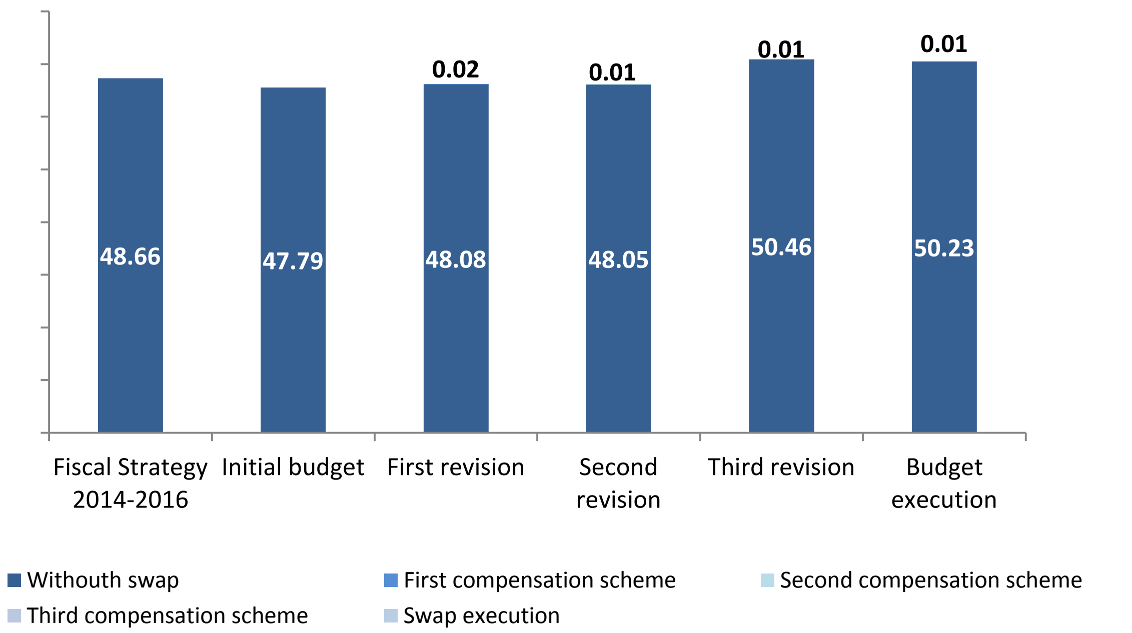
Also in 2014, the quarterly evolution of the general consolidated budget expenditures still indicates a spending acceleration in the last quarter of the year, even with a superior pace compared to the previous year. Specifically, the total spending in Q4 2014 reached 70.83 billion lei, (compared with 59.78 billion lei in Q4 2013), by 39.24% higher than in the previous quarter (while in the previous year the advance was 17%), and by 18.50% compared to Q4 2013 (in 2013 the spending in Q4 were approximately equal to Q3). About 50% of the spending hike in Q4 2014 compared to the previous quarter was caused by the acceleration of capital spending that increased sharply (+176% compared to Q3), the expenses regarding the projects financed through non-reimbursable external funds (+125%), and for about 35% due to the increases in goods and services expenses (+52%) and personnel expenses (+23%).

The expenditure concentration in the last quarter highlights serious weaknesses in the budgetary programming process although the principle of prudence might partial justify the postponement of some expenditure until the projection regarding the budgetary revenue has a lower degree of uncertainty. Fiscal Council recommends a lower quarterly volatility of the budgetary expenditures, which is otherwise the declared intention of the Government for the 2015 budgetary programming.

III.4.1. Personnel and social assistance expenditure

The execution for the personnel expenses increased by 2.46 billion lei compared to the amount considered in the draft budget for 2014. Initially, estimated at a level of 47.79 billion lei, the execution for the personnel expenses was 50.23 billion lei respectively 7.54% of GDP, exceeding the ceiling considered for this category of expenditure (48 billion lei) by 2.2 billion lei, despite the fact that the average number of employees in the public sector was slightly lower than was originally planned. This evolution is explained mainly by the decision to pay in advance the installment for 2015 for certain salary rights earned by court decisions, while payments were staggered in the period 2012-2016. Thus, although initially the amounts on the account of the court decisions for 2014 totaled 2,200 million lei, these were supplemented by 2,400 million lei on the occasion of the third budget revision, given that the underachievement of certain categories of expenditure, particularly of the investment spending, generated a significant fiscal space. Also, compared to the initial projections, the decision to diminish the employer social security contributions by 5 pp from 1st October 2014, has generated a reduction in personnel expenses of about 270 million lei, corresponding to two months of cash execution, but the execution of these expenses indicates that the reduction was offset by additional spending of approximately the same amount, compared to originally planned figures of this budgetary aggregate.

Figure 16: Personnel expenditure in 2014 (billion lei)

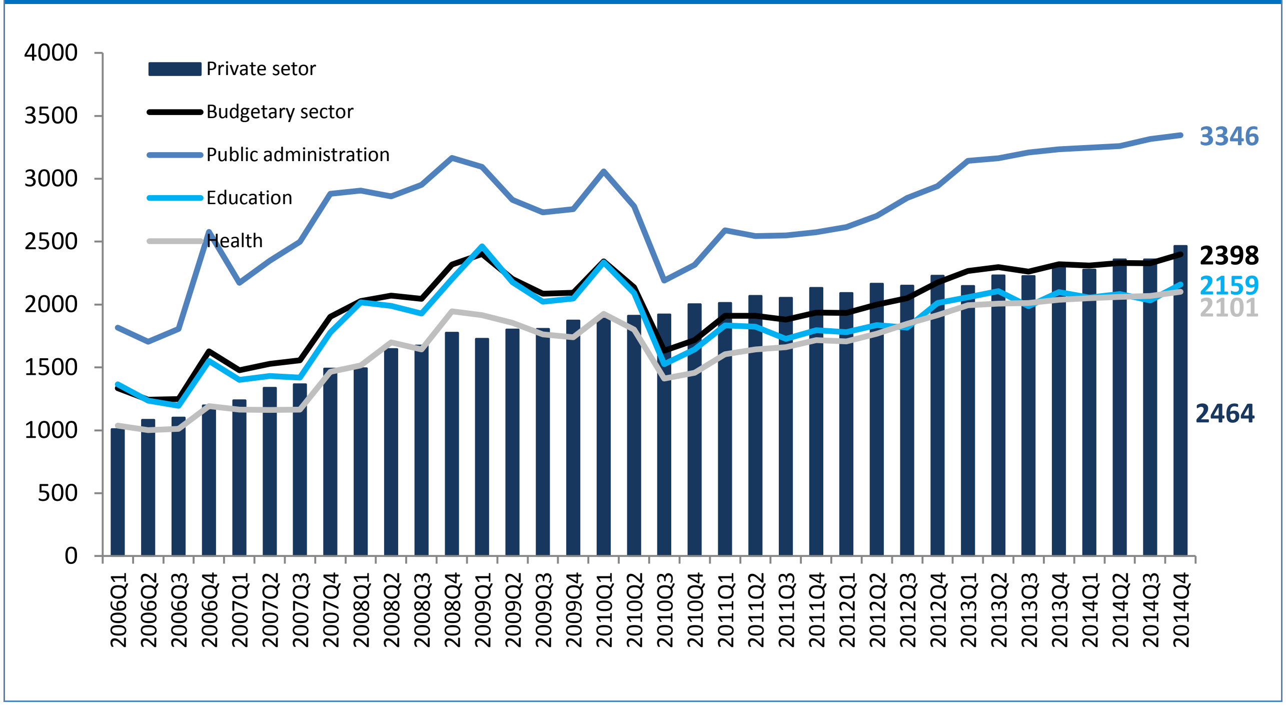


Source: Ministry of Public Finance

Compared to 2013, the personnel expenses increased by 3.9 billion lei, respectively by 8.5%. This increase, can be mostly explained, 8 pp respectively, by the supplementation of payments related to the obligations regarding the executory titles for certain categories of employees, amounting to 4.6 billion lei from 0.9 billion lei in 2013. Much lower influences are attributable to the minimum wage increase from 800 lei/month to 850 lei/month from 1st January 2014 and to 900 lei/month from 1st July 2014 that led to an increase in spending of 344 million lei in 2014 and also to the increase of salaries for the young categories of employees with lower incomes, these two measures being considered in drafting the budget.

Following these increases, the average wage in the public sector reached 2,342 lei, by 2.4% higher than in 2013 and approximately equal to that from the first quarter of 2010 (2,343 lei).

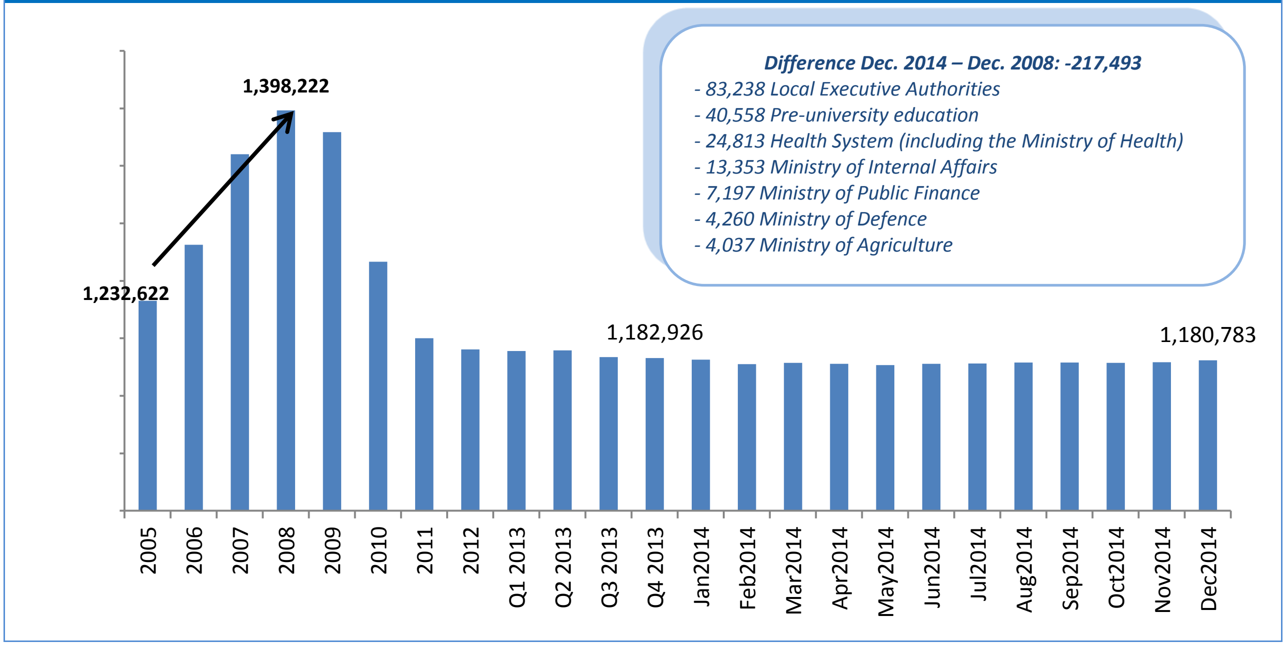
Figure 17: Average gross earnings in the private and public sector in the period 2006-2014 (lei/month)



Source: National Institute of Statistics, Fiscal Council's calculations

The public employment decreased by 217,439 workers between December 2008 and December 2014, reaching 1.18 million employees at the end of the last year (*Figure 17*), after an increase of 165,600 persons recorded in the period 2005-2008. Practically, most of the staff reductions took place in 2009-2011, when the number of employees in the public sector declined by about 198,000, whereas in the period 2012-2014 the reduction was approximately of 20,000 persons. The adjustment recorded in the period 2008-2014 was due mainly to the introduction of the rule of "one new employee to 7 departures from the system" (applied until 2012, inclusively) and took place at the level of local executive authorities (-83,238 persons), pre-university education (-40,558 persons), the Ministry of Health (-24,813 persons), the Ministry of Internal Affairs (-13,353 persons), the Ministry of Public Finance (-7,197 persons) and the Ministry of Agriculture (-4,037 persons). On the other hand, during the same period, increases were recorded at the Ministry of Justice (+2,520 persons), Ministry of Labour, Family and Social Protection for the Elderly (+1,631 persons) and the Ministry of Economy (+1,534 persons), Ministry of Regional Development and Public Administration (+898 persons) and the General Secretariat of the Government (+513 persons). In the initial budget for 2014, it was considered financing a maximum number of 1,185,000 persons in the public sector; the monthly average of occupied positions during the last year was equal to 1,178,705, which indicates enclosing within the initial limits. Compared to the previous year, the number of employees at end of 2014 declined marginally, respectively by 2,143 persons.

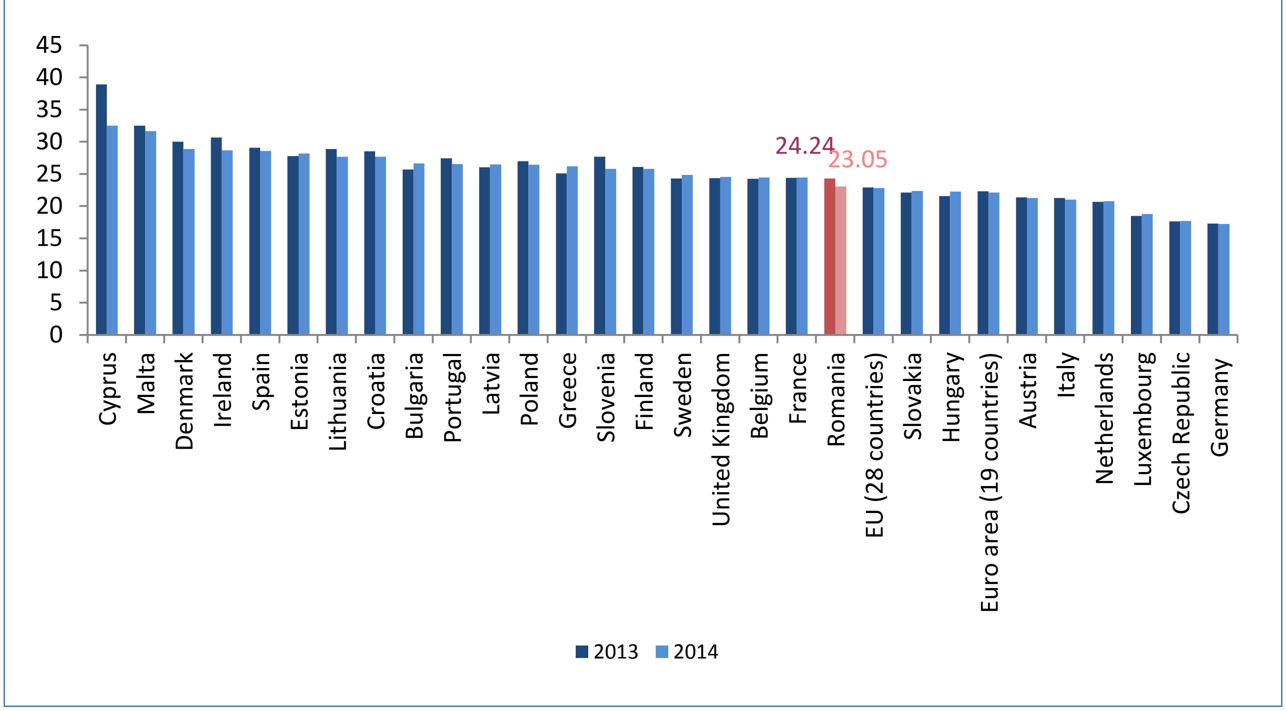
Figure 18: The evolution of the public sector employment in the period 2005-2014



Source: Ministry of Public Finance

The adjustment made in the 2009-2012 period is mainly the result of applying the rule of "one new employee to 7 departures from the system" given that most of the exit from the system was achieved through voluntary dismissal or retirement. The abandonment of this rule starting from 2013 was designed to reduce the adverse selection and allow some changes in the structure of the personnel. Thus, the reductions in 2009-2012 was achieved only to a small extent based on qualitative criteria, such as reducing personnel where it was identified a surplus of employees whereas hiring personnel in the sectors with personnel deficit on the basis of cost standards rigorously defined and thus establishing an optimum level of operation. The Fiscal Council considers this approach to be appropriate and recommends that the new appointments to be made in the identified sectors with personnel deficit, even by transfer of posts from the sectors with personnel surplus to the sectors with personnel deficit, also having in view the strict framing in the wage bill previously approved.

Figure 19: Wage bill as a share of total budget revenues in EU28 countries

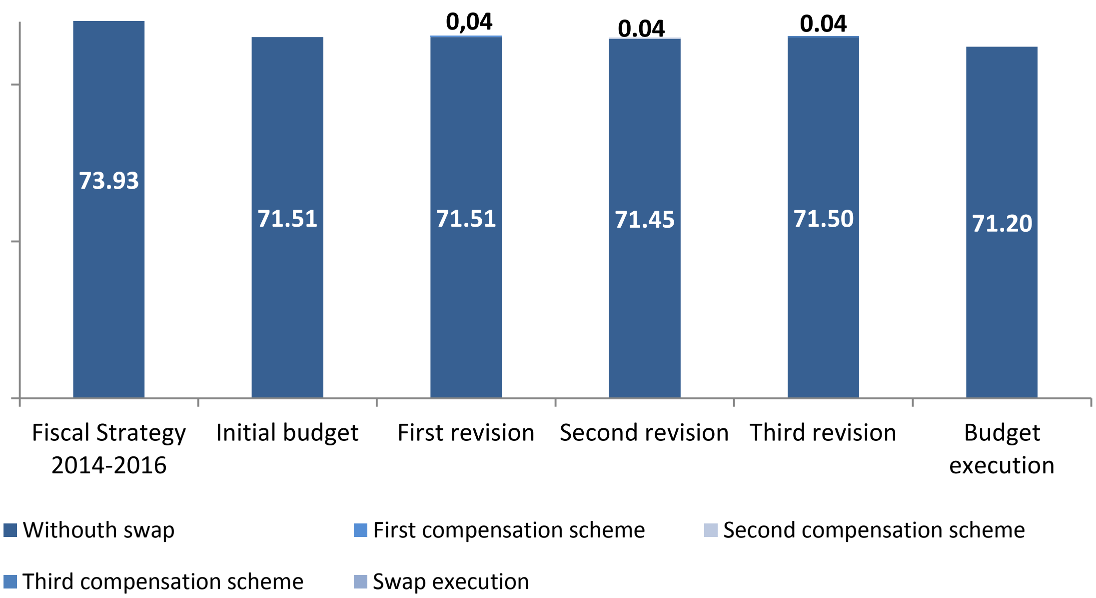


Source: Eurostat

Compared to other European Union's countries, Romania's position in terms of the wage bill in the public sector as a percentage of the total collected revenues, has improved due to the fiscal consolidation measures undertaken since mid-2010. If in 2010, the wage bill as a share of total budgetary revenues placed Romania in the first half of the ranking (the 10th position out of 27 countries), 2014 accordingly to ESA 2010 data, revealed a better ranking for our country, respectively 20th position, but compared to the year 2011, Romania lost two positions in this ranking (from 22th to 20th position), due to the recovery of wages and to an increase of wages for some categories of state employees. Moreover, Romania registered a higher percentage of the wage bill in the public sector in the total revenues compared to similar economies such as the Czech Republic, Hungary, or Slovakia.

The social assistance expenditures registered a lower level in 2014 compared to the projections of the draft budget, being revised downward during the three budgetary revisions. Estimated in the initial budget at a value of 71.5 billion lei, the level of social assistance expenditure, without the compensation schemes recorded a final value of 71.2 billion lei, by 0.43% (equivalent to about 300 million lei) less than the initial budget.

Figure 20: Social assistance expenditure in 2014 (billion lei)



Source: Ministry of Public Finance

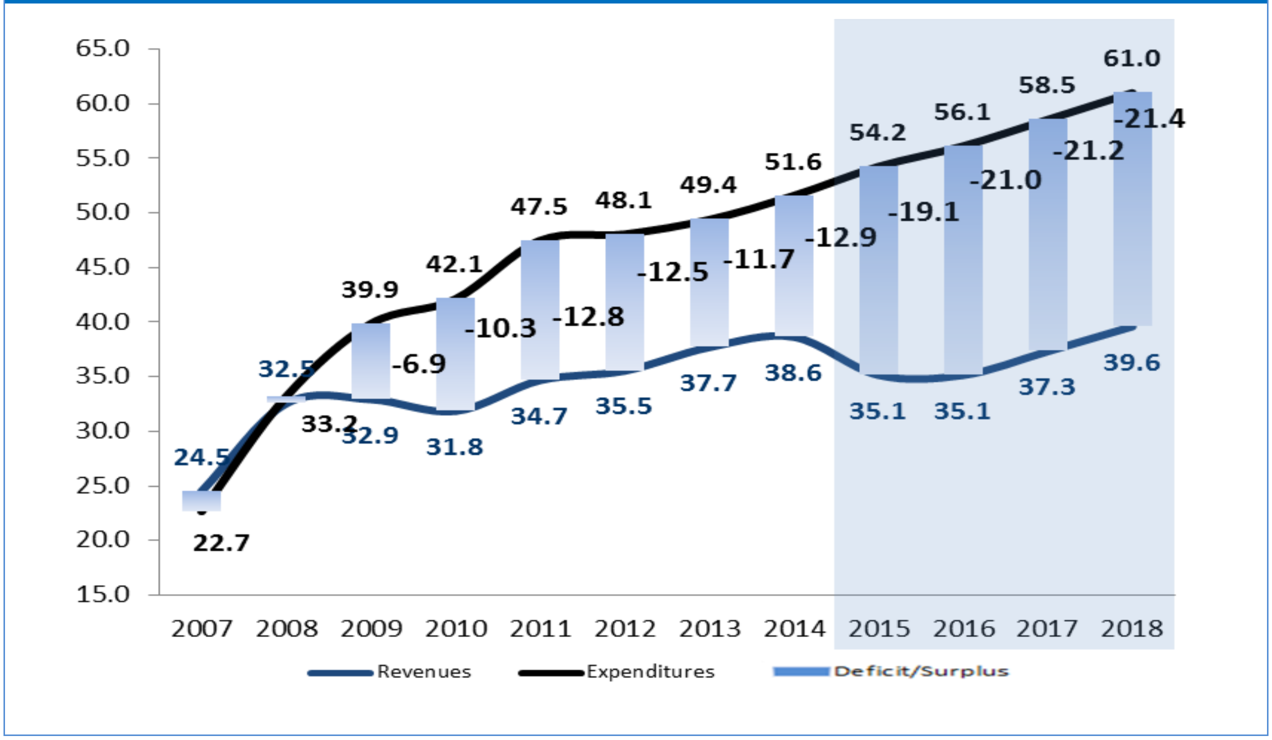
Compared to 2013, the social assistance expenditure increased by 4.13% (due to the pension point indexation by 3.76% and also to the increase in the minimum guaranteed wage), their share in GDP falling by 0.25 pp respectively to a level of 10.68%, while nominal GDP advanced by 4.56%. The share of the social assistance expenditure in Romania is significant, however, and the problem of the structural deficit of the public pension system is not yet solved. Thus, pension expenses are unsustainable in relation to the contributions collected, even if some measures were undertaken in order to improve this shortcoming in the medium and long run[26].

Since 2009, the social security budget deficit has widened significantly to a value of 12.9 billion lei in 2014, and the estimated trend for the following years (2015-2018) shows a significant deepening mainly due to the decision regarding the reduction of the employer social security contributions by 5 pp, that represents a source of funding the pension system. From the perspective of the deficit as a percentage of GDP, the execution indicates a decrease from 2.3% in 2011 to 1.94% in 2014 and it is true that, in real terms the fiscal effort is lower, but the estimates for the following years reveal a significant increase of the deficit to 2.69% of GDP in 2015, 2.80% of GDP in 2016 and 2.56% of GDP in 2018. In essence, compared to the previous

[26] The Law No. 263/2010 regarding the unitary system of public pensions modifies the indexation system, increases the standard retirement age and introduces more stringent criteria for early retirement.

version of the Fiscal Council's Annual Report, the forecasted deficit for the period 2015-2019 widened by 6-7 billion lei, this amount representing the budgetary impact of the legislative measure regarding the reduction of the social security contributions.

Figure 21: The evolution of revenues and expenditures of the social security budget (billion lei)

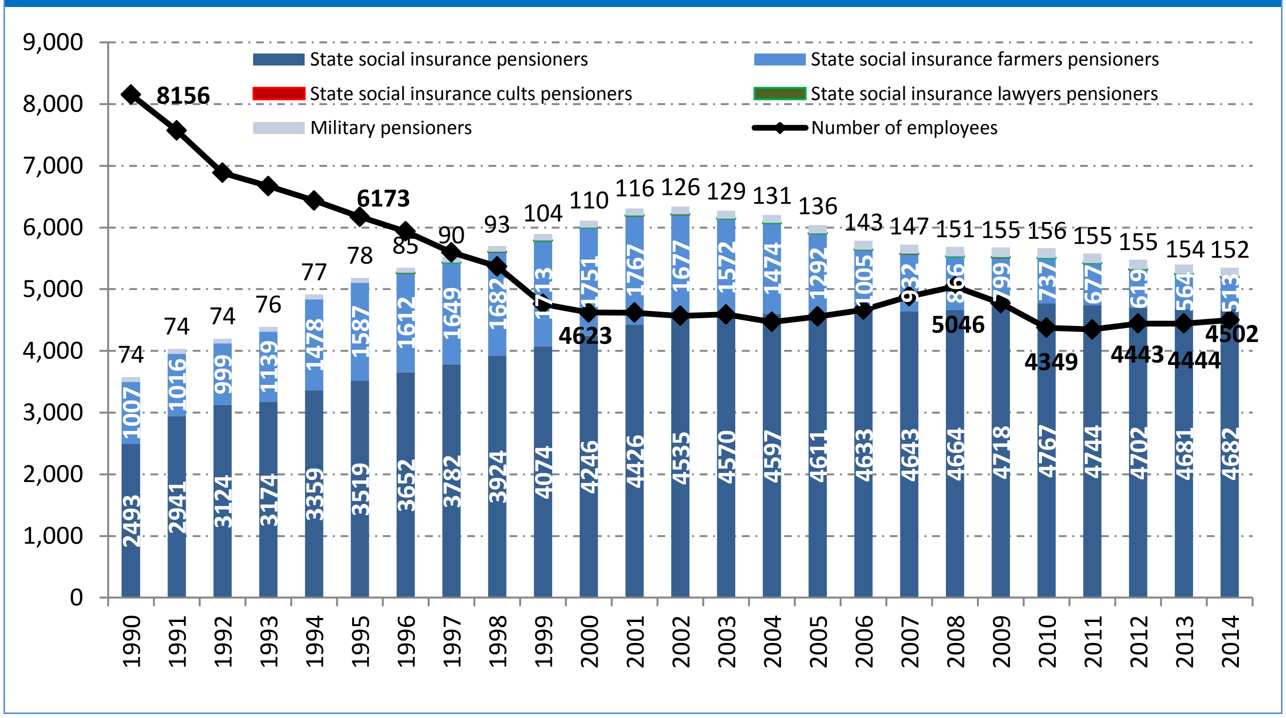


Source: Ministry of Public Finance, cash standard data

The deficit of the state social insurance budget has occurred on the account of excessive social security budget expenditure in the period 2007-2009 (+75.8%) in the context of a favorable dynamics of the social contribution revenue during the period preceding the financial crisis as a result of the economic boom and also anticipating to maintain this trend in the future. Unfortunately, a significant share of the social contributions revenue augmentation has proven to be cyclical, the further developments invalidating the optimistic forecasts that led to the significant increase of the pension point. Thus, the decision to increase certain permanent expenditures such as those related to pensions should take into account the trend of contributions revenues, as well as the forecasts regarding the employees-pensioners ratio, especially in the context of amplified demographic aging, as, for instance, from 1st January 2015 the elderly population of 65 years and over outnumbered the young people of 0-14 years (3,419 thousand compare to 3,304 thousand) according to NIS. It also became evident the need to find an indexation rule to ensure long-term sustainability of social insurance budget instead of discretionary approach of the past. The new pension law should support in long-term achieving this objective under the condition of legislative stability and the rigorous implementation of its provisions.

In conclusion, the precarious financial position of the pension system has been significantly influenced by the massive increases in spending in the period 2007-2009 and the strict application of the new indexing point system should contribute to containing pension expenditure. Also, on the revenue side, reducing social security contributions for the employer by 5 pp starting 1st October 2014 is expected to significantly contribute to deepening the deficit of the pension system in the near future.

Figure 22: The evolution of the number of pensioners versus the number of employees



Source: NIS, less the number of employees for 2014 for wich the source is NCP, Winter Forecast 2015

The ratio between the number of contributors and the number of beneficiaries fell very sharply in the last 25 years, from 2.28 employees per retiring in 1990 to only 0.82 employees per retiring in 2014, the number of the state social insurance pensioners having an increasing trend, while the number of employees had a decreasing trend, especially until 1999-2000. However, in recent years, the ratio has improved from 0.77 employees per retiring in 2010 to 0.82 employees per retiring at the end of last year, but placing below 0.88 registered in 2008.

A measure aiming to improve the medium and long term financial situation of the social insurance budget is the new pension law (Law no. 263/2010 on the unified public pension system) through which it have been pursued a number of objectives designed to correct the imbalances recorded in the pension system:

- decoupling the evolution of the pension point from the evolution of the nominal[27] wage, by indexing the pension point with 100% of the inflation rate, plus 50% (this percentage drops to 45% starting with 2021 and subsequently decreases by 5 pp per year until 2030, when it reaches 0%) of the real increase in gross average wages, realized during the previous year;
- integration in the unified public pension system of the persons belonging to special systems (military pensions), as well as of the persons who obtain income from liberal professions;
- introduction of more stringent requirements regarding the access to early pension and to disability pension;
- calculating all pensions based on the contribution principle, respectively in a direct correlation with the level of the income for which social security contributions were paid;
- increase of the retirement age due to increased life expectancy of the population and the gradual equalization – until 2030 – of the complete contribution period for women and men.

Nevertheless, the intention to return to the special pension system eliminated in 2010 and the proposed new special pensions jeopardize the sustainability of reforms initiated earlier and could generate new pressures on social security budget deficit. The new legislative proposals introduce new rules, ensuring better conditions for early retirement and generous computing formulas based on the salary earned before retirement (instead of formulas based on contributions generally applied in the pension system, taking into account salaries earned during the entire career). It should be noted, however, that the unitary pension system currently applied provides better conditions for some categories of workers, in order to compensate for particularly dangerous working conditions and shorter careers.

Thus, on 20 April 2015 it was issued a decree promulgating the law amending the Law no. 223/2007 regarding the status of civil aeronautical professional personnel in the civil aviation in Romania reestablishing the service pensions and stating that pilots and aircrew receive service pension amounting to 80% of average gross wage in the last 12 months of activity, preceding

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[27] The value of a pension point as previously established by Law 19/2000 was updated by indexing with at least the inflation rate, but the pension point value could not be less than 37.5% of the gross average wage used for drafting the social security budget, starting 1st January 2008, respectively, not less than 45% of the gross average wage used for drafting the social security budget, starting with 1st January 2009.

the month in which they demand for retirement. The Law 223/2015 establishes military pension scheme[28], the main objective being the reconfirmation of military pensions system, considering the special status of the military, the soldiers, and gradation professionals, the police officers and other employees of the defense system, public order and national security. This change will basically imply the reoccurrence of the provisions of the Law no. 164/2001 regarding the military pensions which was repealed on 1st January 2011 with the entry into force of Law no. 263/2010 on the unitary public pension system. Civil servants and employees of Parliament (Law 215/2015), as well as diplomatic and consular staff (Law 216/2015) will also benefit from the special pension legislation. The Law 215/2015 assures the reintroduction of increased pensions for employees of Parliament stipulates that at the retirement age, these categories of employees with a contribution of 30 years, of which at least 14 years in the structures of Parliament, will receive service pensions amounting to 80% the average gross income in the last 12 months before retirement. In addition, employees with more than 14 years seniority will receive 1% of the average income calculated for each additional year. For a period of 4-14 years in Parliament structures, service pension amount will be reduced by 1% for each year missing from the age of 14.

Another newly introduced category of special pensions, according to the initiative that amended the Statute of parliamentarian, is the one for deputies and senators who will be entitled, upon request at the standard age for retirement and after the exercise of their mandate to a monthly allowance[29] for parliamentary work, which will be based on the number of mandates, this indemnity applying also to those which no longer have the quality of parliamentarian. The legislative proposal for amending and supplementing Law no. 96/2006 on the Statute of Deputies and Senators which provides special pensions for parliamentarians was adopted on 16 June 2015 in the joint meeting of the plenary of the Chamber of Deputies and the Senate, the Government previously giving a negative opinion on this draft legislation, using as argument the IMF agreement. The draft law must be enacted by the President of Romania, however.

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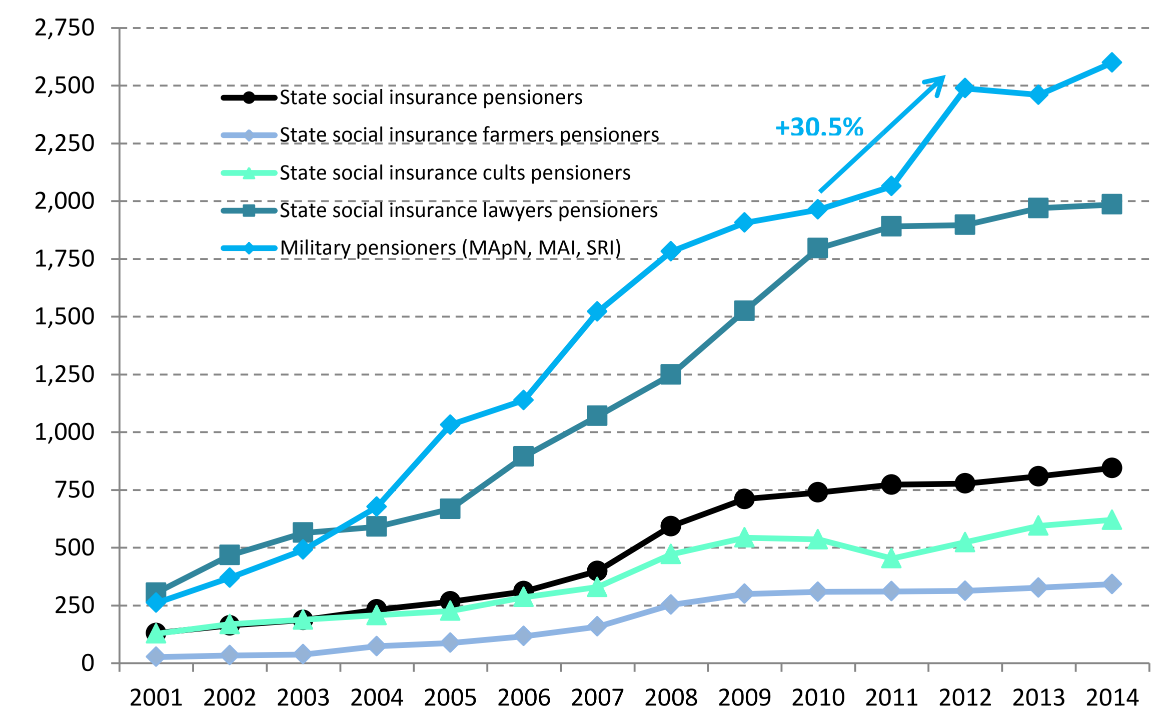
[28] The pension calculation base is the average of all gross revenues of 6 consecutive months in the last 5 years of activity. On the average obtained it will be possible to add an increase of no more than 15%, and the amount of the pension is 80% of the calculation base. The law provides that pensions for military, police and officials with special status established under other laws being currently under payment for which recalculation are made, will remain the same, if the current one is higher than that resulting from the application of the new law, or it will increase if the new conditions are more favorable.

[29] The amount of the allowance is limited for 3 mandates and is the product obtained by multiplying the number of months of mandate allowance with 0.55% of monthly gross allowance realized in the previous month before the retirement request. For incomplete mandates, the allowance is calculated in proportion to the actual exercised mandate, but not less than 6 months of parliamentary activity.

Thus it can be noted that a reduction of the link between pension contributions and future accrued pension rights which has the potential to generate a negative impact on long-term sustainability of the pension system, especially since other professional groups will be also encouraged to push for the restoration/establishment of privileges.

Figure 23: The evolution of the average pension (lei) in the period 2001-2014



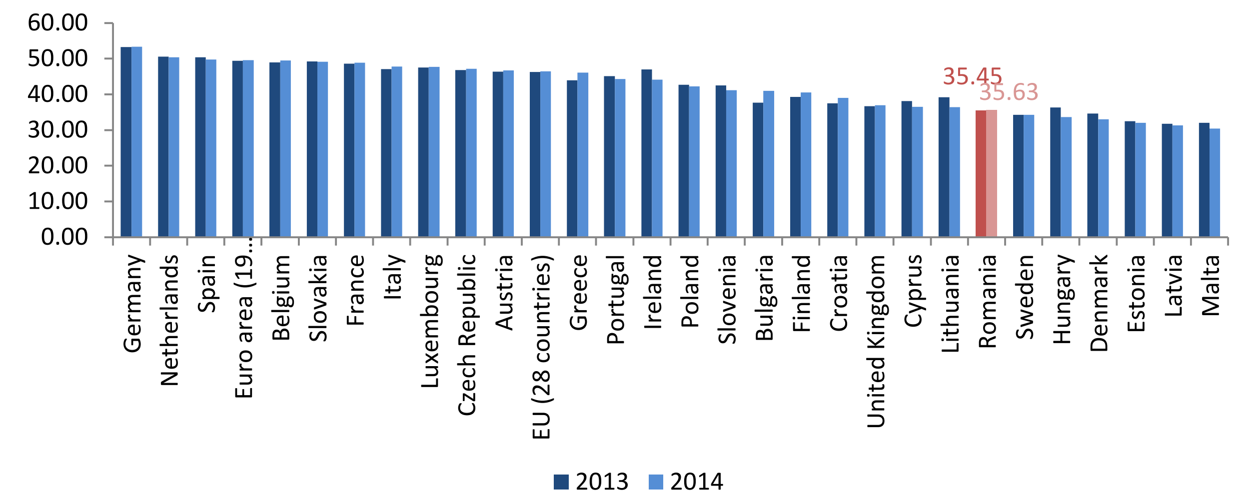
Source: NIS

In 2014, the average monthly pension was 846 lei, higher by 5.09% over the previous year, as a result of the pension point indexation by 3.76%[30] respectively by 28.6 lei. Pensions paid from the social insurance budget were situated at an average level of 845 lei, while those for farmer's pensioners were on average 342 lei. However, military pensions reached a monthly average equal to 2,600 lei, by 5.6% more than in 2013. It is worth noting that the average monthly pension corresponding to beneficiaries from defense system, public order and national security increased by approximately 32.4% during 2010-2014, subsequently the recalculation according to Law no. 119/2010 and Government Emergency Ordinance no. 1/2011, even in the

[30] For 2014, the 3.76% increase of the pension point was determined based on the average inflation rate in 2012 (3.33%) plus 0.43%, representing 50% of the real growth of the average gross wage from the same year. Thus the pension point value increase in 2014 from 762.1 lei to 790.7 lei.

circumstances that the initial forecasts indicated a decline in the value of these pensions after applying the contribution principle.

Figure 24: Social security expenditure as a share of total budgetary revenues in EU28



Source: Eurostat

In the year 2014 Romania dropped one place[31] compared to 2013 regarding the share of social security expenditures in total revenues, placing in the second half of the EU member states ranking. However, even this category of expenditure has a lower share in total budget revenues compared to the EU average, it registered a significantly higher level compared to the social contributions collected.

The Fiscal Council notes the manifestation of an obvious trend reversing the pension reforms designed to ensure long-term financial sustainability and even a worsening of the situation regarding the granting of special pensions and plead strongly in favor of maintaining the progress made in recent years both in terms of the principles introduced (exclusive use of the principle of contribution in determining the pension value) and in terms of strict compliance with the pension's indexation mechanism as introduced by the new pension law.

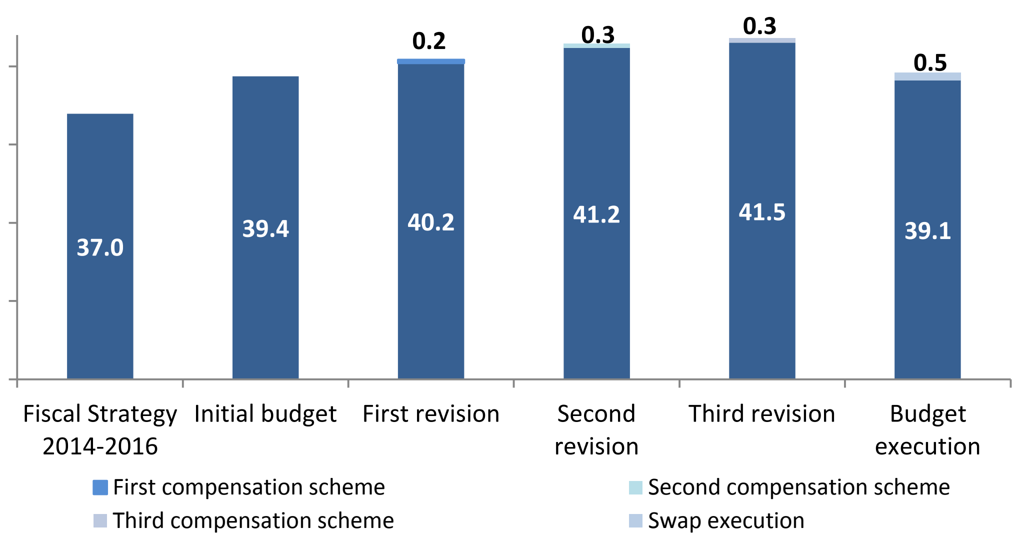
III.4.2. Goods and services expenditures

The execution of goods and services expenditures net of the impact of compensation schemes registered a lower level than the one envisaged in the draft budget (-0.27 billion lei), exceeding however by 2.1 billion lei the level considered in the Fiscal Strategy for the period 2014-2016,

[31]Placed on 22[th] postion out of 28 countries.

respectively 37 billion lei. Initially estimated at 39.4 billion lei, the final amount of this category of expenditure, reached a level of 39.1 billion lei, namely 5.86% of GDP, lower by 0.14 pp compared to the year 2013.

Figure 25: Goods and services expenditures in 2014 (billion lei)



Source: Ministry of Public Finance

Expenditures on goods and services were revised upwards during each budget amendment introduced in 2014, the latest Government estimates indicating higher spending by about 2.1 billion lei compared to the draft budget even if, unlike the previous years the clawback tax receipts were included in the initial budget, as this category was used in the past as a source to finance additional spending on goods and services. The motivation for these changes was not explained by the Government in the substantiation notes accompanying the proposals for the budget revisions and the final execution has recorded an even lower level compared to initial estimates by about 0.3 billion lei. It is worth mentioning that the execution of this expenditure category was affected by the implementation of a swap scheme for clearing outstanding obligations to the budget amounting to a higher level than the one included in the budget revisions, but the details of these schemes were not accurately defined.

It is worth to mention also that in 2013 this category of spending was significantly affected by the implementation of EU Directive 7/2011[32] on combating late payment in commercial

[32] This states that "contracts between firms should provide limited payment terms, as a general rule, at 60 calendar days." In addition, it should be provided specific rules regarding the commercial transactions for the supply of goods and services by enterprises to public authorities, rules to establish, in particular, payment terms that do not normally exceed 30 calendar days, unless the contract

transactions that involved a financial effort of 2.58 billion lei while the impact of this measure in 2014 was only of 0.44 billion lei. Thus, although compared to 2013 the goods and services expenditures net of the impact of compensation schemes grew only by 2.1% (+0.8 billion lei), if we eliminate the impact of the application of Directive 7/2011 which had a significant but one-off effect on this category of expenditure, the increase is about 8.2% (2.94 billion lei), superior to the nominal GDP growth (+ 4.56%).

The Fiscal Council notes that this budgetary aggregate seems to be very difficult to control. If in 2011-2013, the initial programmed level of goods and services expenditures has been significantly exceeded, this development being partly explained by the clawback tax receipts, not included in the initial budget; in 2014 the execution has registered a level close to the draft budget, despite the projected major increases on the occasion of the budget revisions.

Table 11: Evolution of goods and services expenditures in the period 2011-2014 (billion lei)

	Fiscal Strategy	Initial budget	First revision (without *swap*)	First compensation scheme	Second revision (without *swap*)	Second compensation scheme	Budget execution (without *swap*)	Swap execution
2011	28.54	28.62	29.32		29.98	0.13	31.64	0.13
2012	31.26	31.74	32.78	0.25	33.18	0.50	34.04	0.41
2013	33.88	37.25	39.27	0.50	38.52	1.00	38.30	0.28
2014	36.97	39.36	40.19	0.22	41.50*	0.28*	39.10	0.49

Source: Ministry of Public Finance

* The amounts relate to the third revision.

The Fiscal Council appreciates there are serious deficiencies in the budgetary programming, the credibility of the initial estimates regarding the trajectory of this chapter of expenditure being seriously affected given the historical developments and also a lack of transparency, as the projections for this category of expenditures were not accompanied by explanations justifying their evolution. In this regard, the Fiscal Council recommends the inclusion in the substantiation notes accompanying the draft budget or the budget revisions of detailed explanations to support the forecasted dynamics of the goods and services expenditures as well as the *ex-post* explanations to be included in the half year/annual reports elaborated by the Ministry of Finance, detailing the causes that led to deviations from the programmed level, especially if these are of significant amplitude. Such an approach is more than necessary as the main driver of the fiscal adjustment projected for 2015 is reducing goods and services expenditures by 0.23

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expressly provides otherwise, which must be objectively justified by the nature or by the specific features of the contract, but not exceeding, in any case, 60 calendar days.

pp of GDP, the estimated dynamics of this expenditure category in nominal terms being only 1.6%, significantly lower than the projected dynamics for nominal GDP (+ 5.75%).

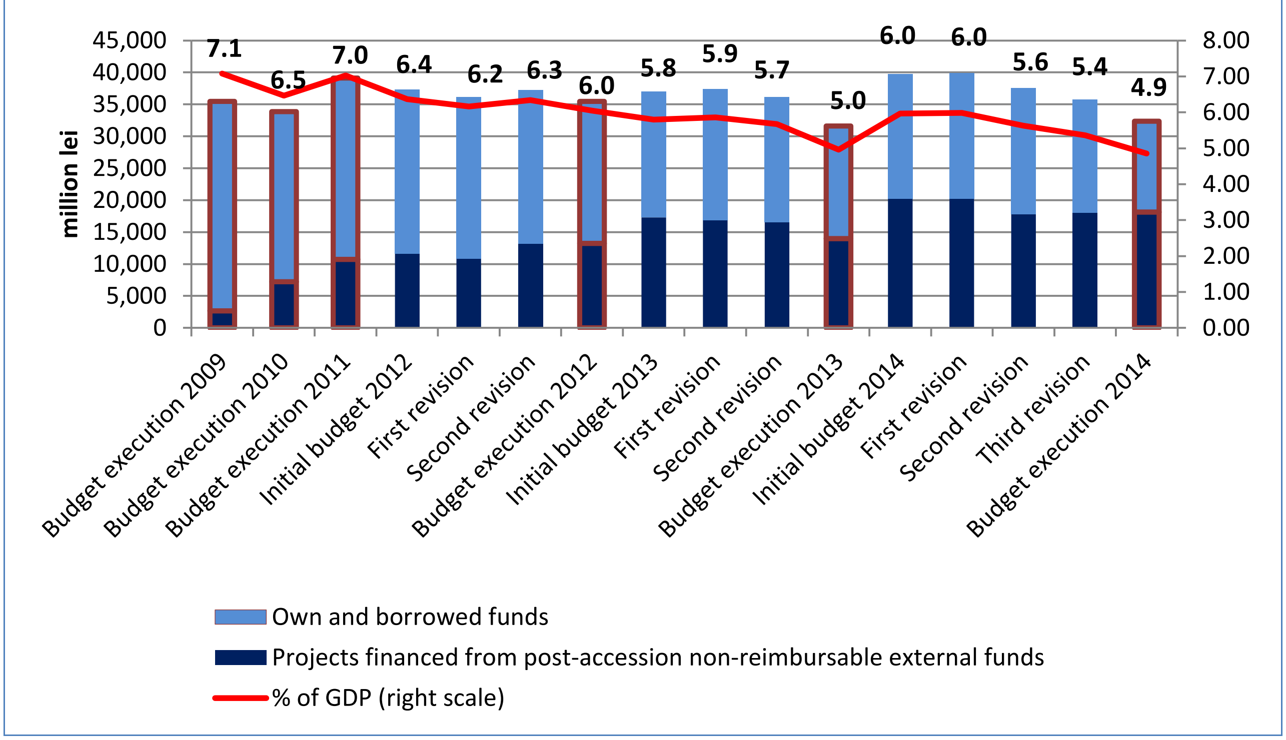
III.4.3. Public investment expenditures

Investment expenses include, according to the budget classification, capital expenditures (non-financial assets), projects funded by external post-accession grants, expenditure for reimbursable programs, capital transfers and other transfers related to investments.

Compared to the previous year, in 2014, public investment expenses, considering all budget items of this category, including swap compensation schemes, increased in nominal terms by 2.4%, respectively from 31.6 billion lei to 32.4 billion lei in cash standards, the growth rate in real terms being 0.6% (their share of GDP diminished from 4.96% to 4.85%). Compared to the previous 5 years, the execution of investment spending recorded in 2014 the lowest level as a percentage of GDP, the difference between the average from 2009-2013 and 2014 being very high, respectively -1.34 pp of GDP or about -21.6%, the reduction of investment spending representing in fact a way of achieving the short-term fiscal targets, but with possible negative effects on the medium and long term.

Moreover, the analysis of the actual execution compared to the planned investment expenditures from the initial budget or established through revised budgets during 2012-2014 reveals constantly significant deviations, as the executions are invariably below the estimates of the initial and the revised budgets and the negative gap between the initial and the effective amounts of investment spending as a percentage of GDP in 2014 reached the highest level over the last three years (1.11% of GDP in 2014 compared to a negative gap of 0.84% of GDP in 2013 and one of 0.32% of GDP in 2012).

Figure 26: Investment expenditures in 2014 (million lei)



Source: Ministry of Public Finance

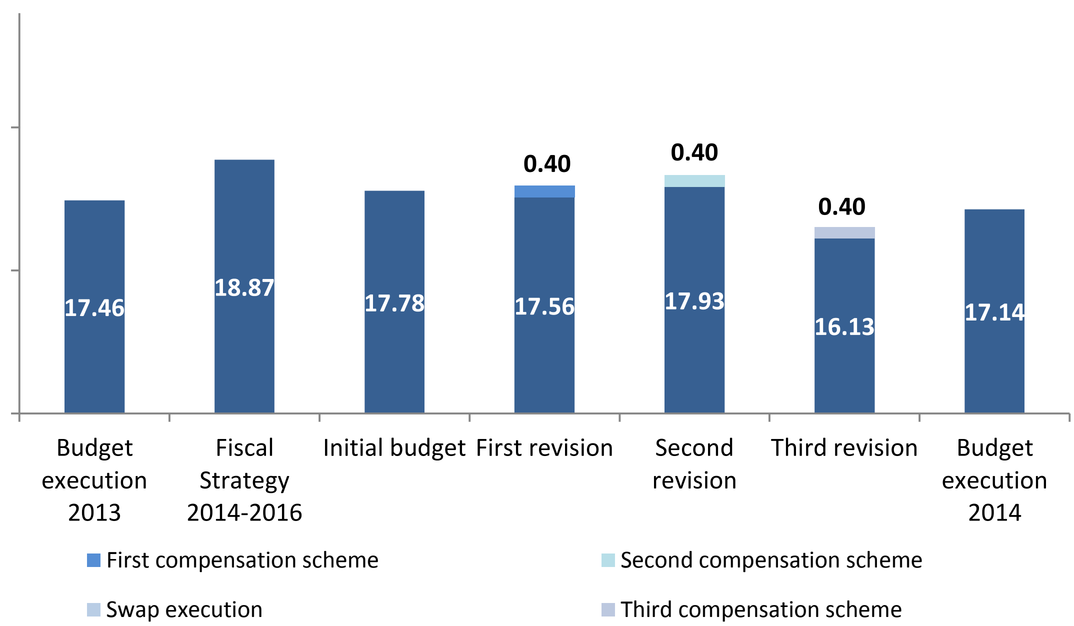
Moreover, it is worth noticing that in the initial budget for 2014 it was intended to maintain the same approach of the previous year regarding the financing of investment spending, respectively limiting the allocations from the state budget in favor of projects financed from European funds. In this respect, for the 2014 budget it was envisaged a bigger share of the external sources (by increasing EU funds absorption) in the total investment expenditures, respectively, reducing the share of internal sources (capital expenditure), a correct and welcomed approach in the opinion of the Fiscal Council, thus freeing financing resources that could be used for fiscal consolidation or other purposes.

Nonetheless, the initial plan to substitute capital expenditures with non-reimbursable European funds did not function neither in 2014, investment spending being by 7.4 billion lei lower than the amount estimated in the initial budget (respectively by 1.11% of GDP), mainly as a result of the underachievement of revenues from external post-accession funds by -5.6 billion lei (about - 0.84% of GDP).

In 2014, the capital expenditure, net of the compensation schemes impact, were projected in the initial budget at a slightly higher level (by about 330 million lei) compared with the actual spending from the previous year, but the final execution registered a decrease of the capital expenditures by approximately 650 million lei compared to the initially programmed level

(-3.62%), respectively by about 300 million lei lower than in 2013 (-1.81%). It should be noted that during 2014 there was a change in the accounting treatment for the transactions of the sale of goods from the state reserve (with a symmetrical impact on revenue and capital expenditure of 917.2 million lei) and after adjusting for this factor, the decrease in capital expenditures was approximately 1.56 billion lei compared to the initial program (-8.8%) and about 1.2 billion lei (-7.06%) compared to the level registered in 2013. It is noteworthy that the swap scheme decided at the budget amendments that should have affected this category of spending by 400 million lei was not observable in the final execution from 2014.

Figure 27: Capital expenditures in 2014 (billion lei)



Source: Ministry of Public Finance

The projects financed by post-accession external funds (NREF), although higher compared to 2013 (+0.7 billion lei) had an evolution far below expectations, being significantly lower than the level projected in the initial budget (-5.6 billion lei), representing the main cause of the major underperformance of the investment spending. Although this underperformance had no impact on the deficit, as the decline of investment projects implied savings in terms of co-financing and ineligible expenditure, the failure in European funds absorption induces negative effects on economic growth both in terms of direct effects (the reduction of public investment) as well as propagated effects, while there are also major risks regarding the disengagement of these funds. In fact, the EC assessment of progress in 2014[33] stated that although the structural funds could contribute significantly to the financing of the major investment projects, the project implementation continued to face major obstacles and energy and transport infrastructure continued to hamper Romania's economic growth.

Missing the target for the projects funded by external post-accession grants is correlated with the EU funds absorption rate, for which the underachievement of the revenues in 2014 compared to the initial budget was -3.7 billion lei (-0.56 % of GDP). Expenditure regarding the projects funded by reimbursable programs that have a very small share in the total investment outlays were at the level programmed by the second budget rectification, and slightly above that of the third budget amendment (by 15 million), but represents only 54% of the initial budget projection, respectively 68% of the achievements of 2013.

Figure 28: Projects funded by external post-accession grants in 2014 (billion lei)

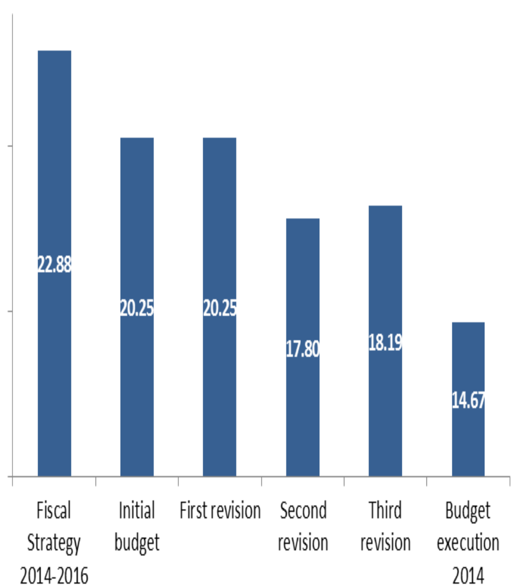
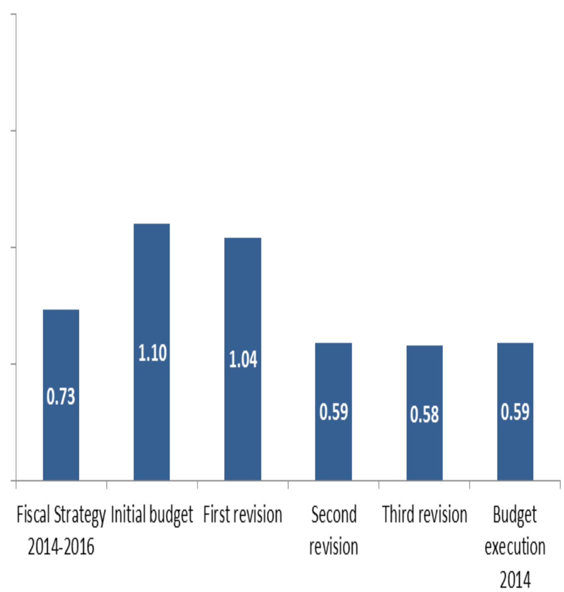


Figure 29: Expenditure funded from reimbursable funds in 2014 (billion lei)



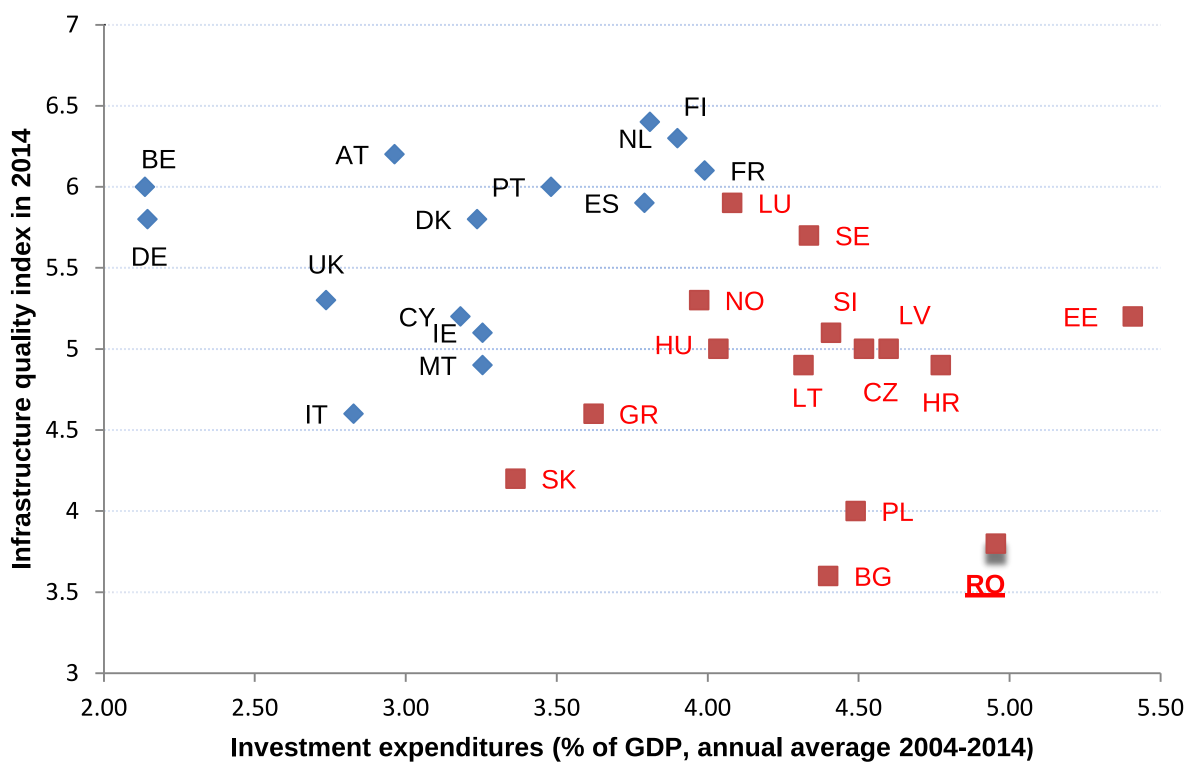
Source: Ministry of Public Finance

From another perspective, considering the average spending for public investment as a share of in GDP over the last decade, Romania ranked second among EU member states (after Estonia), while in terms of the share of public investment in total budget revenues Romania ranked first, but the infrastructure quality places our country on the penultimate position within the same group of countries (surpassing only Bulgaria). Thus, according to the Global Competitiveness

[33] *Country Report Romania 2015 Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*, EC, Bruxelles, 26.2.2015 SWD(2015) 42 final.

Report 2014-2015 Romania is ranked on the 88th position[34] (out of 144 countries) in terms of the overall quality of infrastructure, respectively on the 121th position[35] (out of 148 countries) regarding the quality of roads.

Figure 30: Public investment expenditures and infrastructure quality



Source: EUROSTAT, World Competitiveness Report 2014-2015

Clearly, there are high efficiency reserves regarding the use of public funds allocated to investments and the Government initiated during 2013 - March 2014 a reform of the public investment management[36] which was welcomed by the Fiscal Council. Unfortunately, the new legal framework is not fully operational and the envisaged projects prioritization is not yet realized. The Fiscal Council advocates for the effective application of the new legal framework

[34] A better position compared with the assessment in Global Competitiveness Report 2013-2014 (place 106/148).

[35] A position ahead compared with the previous report (145/148).

[36] In accordance with the requirements of the new legal framework, prior to approving the budget, the MPF is obliged to present to the Government the list of prioritized significant public investment projects to be financed through the state budget, which are selected according to opportunity, economic and social justification, financial affordability, period remaining until the completion of Romania's commitments to international financial institutions.

and notes that the reform of the public investment management is currently still in an early stage. Moreover, considering the developments from 2014, we can conclude that the reduction in investment spending was not due only to fiscal consolidation purposes, but seems to reflect an administrative inability to perform the planned investment projects, especially in the case of those funded by external grants.

III.4.4. The contingency reserve fund and the intervention fund at Government's disposal

According to the Public Finance Law no. 500/2002, article 30 paragraph (2), the contingency reserve fund at Government's disposal is allocated to line credit officers from state government and local governments, based on Government's decisions to finance urgent or unforeseen expenditures incurred during the year. The legal framework provided by the Law no. 500/2002 specifies only in general terms the allowed allocations from the contingency reserve fund (respectively for "unexpected or urgent" situations) without explicitly specifying the categories of expenses that can be undertaken from this fund or the allocations amount, thus providing space for discretionary and non-transparent allocations. Moreover, both the Fiscal Council[37] and the Court of Accounts have repeatedly called for the legislative clarification of the allowed destinations for the allocations from the contingency reserve fund and also for the manner of use, but these demarches have not changed the legal framework in the desired direction.

During the recent years, the Government issued a series of emergency ordinances that established the use of money from the contingency reserve fund beyond the framework stated in the Public Finances Law no. 500/2002. Thus, also throughout 2014 many derogations[38] from the provisions of article 30 paragraph (2) and/or (3) of the Public Finance Law no. 500/2002 were issued, thus allowing the allocation of funds in order to finance expenditures related to several fields, including cultural, religious, sports and health both at the central and local level that cannot be provided from the approved budget. In addition, derogations were granted to the Ministry of National Education for universities to pay court decisions having as object salary related rights, to the Ministry of National Defense for paying the contracted equipment and logistics support elements for equipping the army. Moreover, as in the previous years, the Government has initiated emergency ordinances which provided the possibility of allocating funds from the contingency reserve fund to pay arrears; in 2014 the beneficiaries of these

[37] See annual Reports for 2010, 2011, 2012 and 2013.

[38] GEO No. 2/2014, GEO No. 8/2014, GEO No. 27/2014, GEO No. 32/2014, GEO No. 52/2014, GEO No. 57/2014, GEO No. 58/2014, GEO No. 65/2014, GEO No. 69/2014, GEO No. 71/2014, GEO No. 83/2014, GEO No. 88/2014, GEO No. 92/2014.

exceptions were the Ministry of Health, the Ministry of Justice and the Ministry of Transport. Although clearing the state outstanding payments towards the economic agents is an important element for improving their liquidity position and for promoting economic growth, the allocations from the contingency reserve fund for this purpose can be justified only on the short term. In the medium term, the solution is to improve the budget programming process and to find viable solutions for eliminating the structural causes that lead to the accumulation of arrears.

Thus, it is noted the Government's repeated appeal for exemptions from the Public Finance Law no. 500/2000 setting out uses of the contingency reserve fund that cannot be classified as urgent or unforeseen expenditures. Although the reduction of arrears or the payment of enforceable titles represent valid objectives, they should be included in the draft budget or during budget revisions at the corresponding expenditure items, and they should not affect the contingency reserve fund.

The utility of a contingency reserve fund lies in the flexibility given to the Government regarding the annual budget execution, particularly for covering urgent or unforeseen expenditures. The opportunity of including a contingency reserve fund into the general budget is confirmed by the literature on budget programming, which also highlights the necessity of finding a balance regarding the dimension of such a fund. Thus, a too low level of the contingency reserve fund might be insufficient to cover unforeseen expenditures, while an oversized fund might grant too much power for the authorities to make excessive outlays, without the Parliament's approval.

The Court of Accounts, in its Public Report for the year 2013, identified the following problems regarding the use of the reserve fund: oversizing budgets during the budgetary programming, while the amounts not spent were used for supplementing the contingency reserve fund, the lack of clear and formalized criteria for classifying the expenditures that can be financed from the contingency reserve fund, malfunction of the internal control systems, the absence of control by the MPF to verify the degree of achievement of the final objective provided by the law through which the reserve fund has been allocated. It was also found that there were no significant changes in the legislative process through which money from the reserve fund are allocated and also considering how their distribution and utilization are performed, the situation being similar to the previous years, respectively by letting at the discretion of the initiators of Governments' decisions the expenditure evaluation and the classification of expenses to be financed from these funds. Thus, the contingency reserve fund was increased by about 5 times during the financial year 2013 compared to the initial budget, by allocating significant amounts for uses that cannot be classified as urgent or unforeseen expenditures (such as supporting cults or some investment objectives without a motivation for their urgency over other pending investment objectives). The Court of Accounts report concludes that "the contingency reserve fund at Government's disposal was not used for the purpose for which it was created, which gave the possibility to be used in certain situations, without transparent criteria, as a way to supplement the budgets of authorizing officers, without the need of including the allocations in the budget and approving by the Parliament."

This report studies the use of the contingency reserve fund at Government's disposal during 2014, based on the Government's decisions published in Romania's Official Journal which allocate amounts from the budget reserve fund to line credit officers and to specific destinations.

Figure 31: Total contingency reserve fund allocations (billion lei)

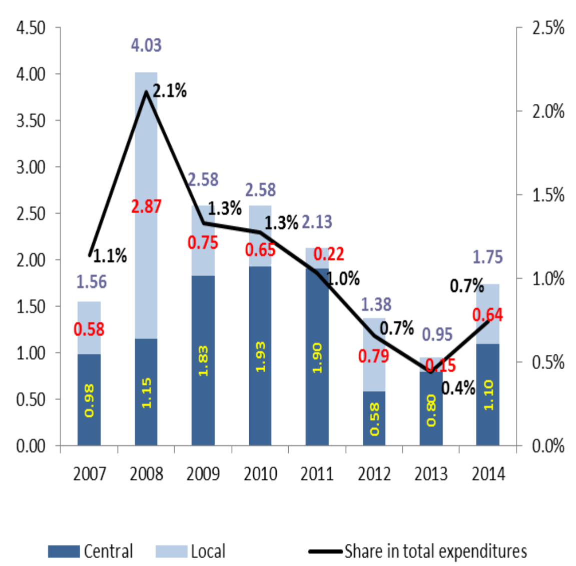
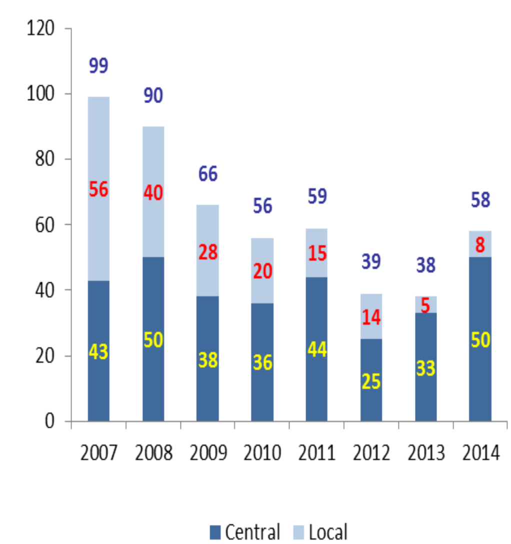


Figure 32: Number of Government decisions regarding contingency reserve fund allocations



Source: Fiscal Council's calculations based on Government's decisions regarding the contingency reserve fund allocations

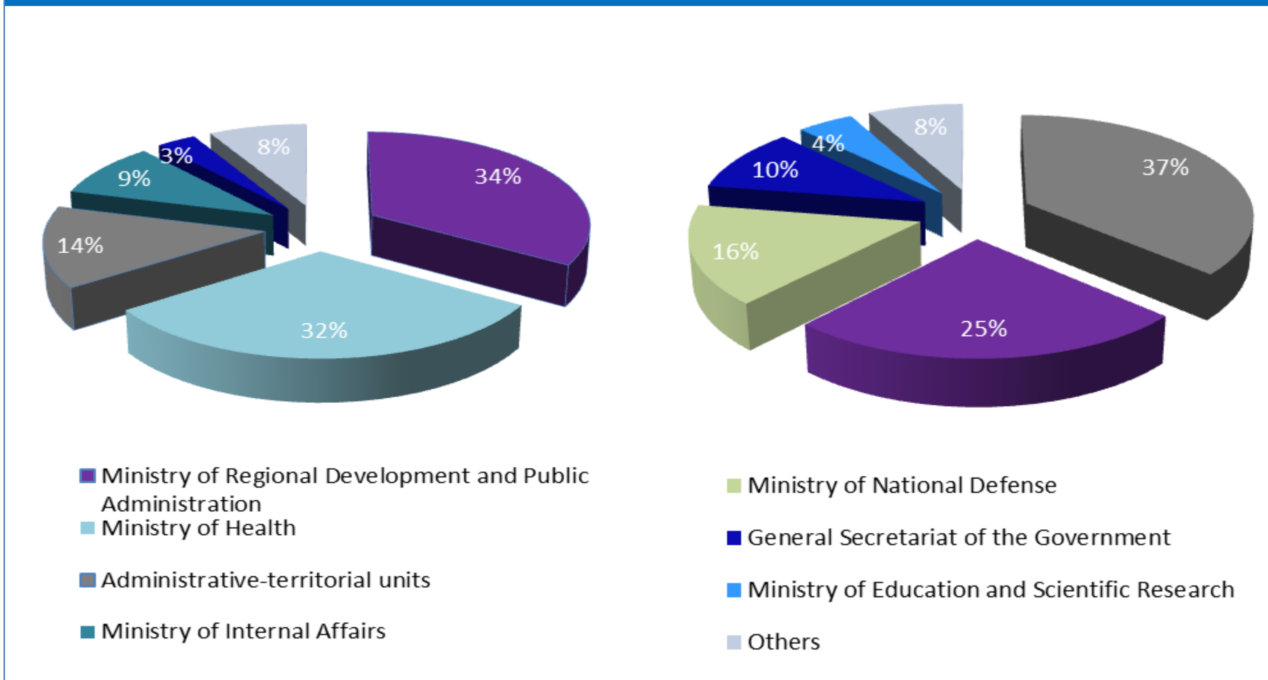
According to the Government's decisions, in 2014 there were allocated from the contingency reserve fund approximately 1.75 billion lei (0.7% of the total), of which about 1.1 billion lei to the central administration and 0.65 billion lei to the local authorities. Compared to the previous year, **the allocations from the reserve fund have increased by around 795 million lei, respectively by 83.68%,** on the account of bigger transfers to the local authorities by 494 million lei, while the amounts directed to the central administration augmented with almost 300 million lei.

In 2014 it can be noticed a deterioration of the contingency reserve fund use that indicates a change in the government behavior compared to the 2009-2013 period, in terms of the amounts spent, as well as considering the number of Government decisions promoted in order to allocate money from the reserve fund. This situation might be put in the context of the election year, but can be explained also by the lessening of the constraints on the public finances position, as the budget deficit was significantly lower than in the previous years, while the space of maneuver that the Government had for meeting the fiscal targets was relatively higher.

In 2014, 168.3 million lei were initially allocated trough the State Budget Law that represents approximately 9.6% of the final expenses from this fund. The amount initially approved by the Parliament is permanently modified during the budgetary year, this situation being possible as a result of the expansion of the reserve fund by cancelling budgetary credits from some of the authorizing officers. This practice makes it more difficult to track the amounts spent from the contingency reserve fund and constitutes an additional argument for the discretionary nature of the formation and utilization of this fund.

Figure 33: The Beneficiaries of allocations from the contingency reserve fund (% of total allocations)

2013 **2014**



Source: Fiscal Council's calculations based on Government's decisions regarding contingency reserve fund allocations

In 2014, as shown in *Figure 33*, the main beneficiaries of allocations from the contingency reserve fund at the Government's disposal were: the local authorities, with a share of 37% of the total amount spent from the reserve fund, the Ministry of Regional Development and Public Administration that received 25% of allocations, the Ministry of National Defense (16%) and the General Secretariat of the Government (10%). In 2013 the largest allocations from the reserve fund at the Government's disposal were directed to the Ministry of Regional Development and Public Administration (34% of total), the Ministry of Health (32%, mostly to pay arrears) and to local authorities (14%). Analyzing the allocations during the last 2 years, it is noted that the main beneficiaries are represented by the administrative-territorial units with 640 million lei in 2014 and 133 million lei in 2013 and the Ministry of Regional Development and Public Administration with 437 million lei in 2014, respectively 321 million lei in 2013.

Considering the international best practices in the field and the Court of Accounts conclusions, the Fiscal Council considers as absolutely necessary the implementation of urgent measures to amend the legislation that regulates the contingency reserve fund use, reiterating the recommendation on the explicit identification of expenditure that can be made from the contingency reserve fund and a higher transparency, including through reporting on a regular basis to the Parliament about the use of this fund. Thus, detailing the contingency reserve fund allocations, presenting the conditions and criteria of allocations and a breakdown between line credit officers are required. The Fiscal Council also recommends limiting the amounts that can be distributed and used from this fund as a share of total budgetary expenses, a level of 1% being apparently adequate for the ***urgent expenses***, given the previous developments. Moreover, the reserve fund application should be accompanied by an increase in transparency – possible by implementing the principles outlined in the IMF Manual on Fiscal Transparency.

According to article 30, paragraph (4) of the Public Finance Law no. 500/2002, the intervention reserve fund at Government's disposal is allocated, based on government decisions, to some authorizing officers of the state and local budgets, to finance urgent expenditures designed to eliminate the effects of natural disasters and to support the individuals affected. If the possible destinations of the allocations from the contingency reserve fund can be interpreted differently, in the case of the intervention fund, the allocations' destinations are clearly indicated in the law, the existence of such a fund being fully justified. During a year, this fund may be increased by allocations from the contingency reserve fund, depending on the needs regarding the amounts that are necessary for the removal of the effects of natural disasters. In 2014, the amounts allocated from the intervention reserve fund at Government's disposal amounted to approximately 307 million lei and their destinations are in accordance with the Public Finance Law.

III.5. The public debt

The interest expenses decreased in 2014 by 556 million lei (respectively with 5.2%) compared to 2013, their share in GDP decreasing from 1.69% to 1.53%, in the conditions of a 4.6% nominal GDP advance. The final value of this expenditure chapter was lower than projected in the original budget by 1024 million lei (0.15% of GDP) as a result of the significant decrease in financing costs recorded in 2014 while the full manifestation of this effect on interest expenses will take place in time, as debt issued in the past will reach maturity and will be refinanced at the more favorable current costs.

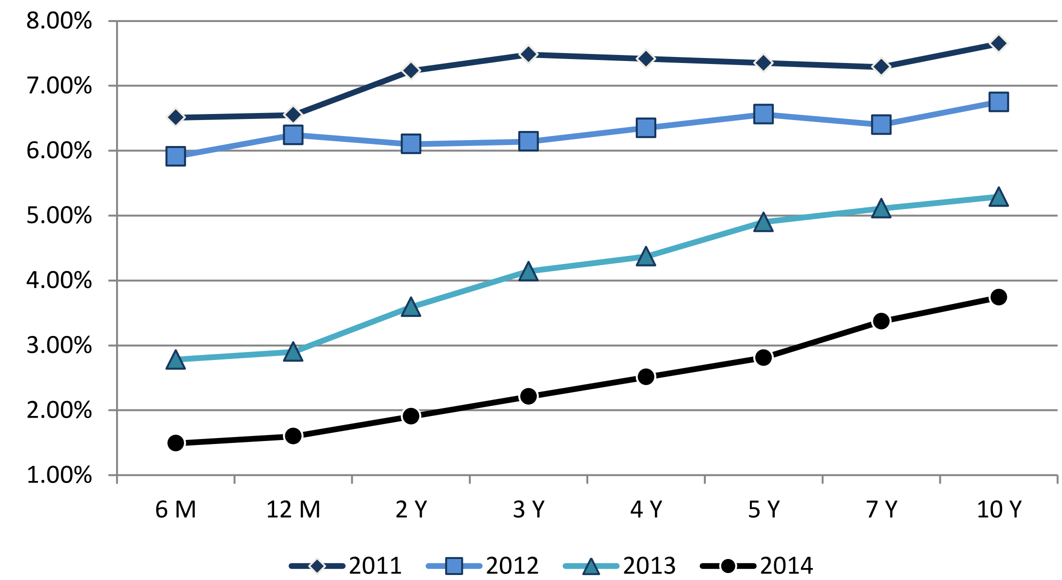
The public debt continued to rise in 2014, but with a higher pace than in 2013, its share in GDP increasing, according to ESA 2010 methodology, to 39.8%[39] from 38% at the end of 2013, despite of a lower budget deficit in 2014, compared to 2013, respectively 1.5% of GDP and of lower interest paid for contracting loans. The growth rate of the public debt increased, compared to the 0.7 pp of GDP advance in 2013, due solely to the additional raise of the Treasury reserves to finance in advance the budget deficit and to the increase of the buffer for protection against the manifestation of adverse conditions in the financial markets. The role of this buffer is to provide in advance the financing needs and its establishment is undoubtedly a cautious approach, but the size of such a fund should be carefully evaluated considering the significant interest expenses arising from such a strategy. According to national standards, the public debt increased to 44.1% of GDP at the end of 2014, compared to 42% in 2013 and 41% in 2012.

The average interest rate paid on public debt declined from 5% in 2013 to 4.44% in 2014, and this decline should continue in the coming years given the much lower current expenses for debt refinancing and the relatively low average maturity of the public debt. The cost of attracting new resources in national currency registered a positive development in 2013-2014, the government bonds yields dropping significantly compared to the level of about 6% at the end of 2012, as a result of the inclusion of the bonds issued by the Romanian State in the calculation of the GBI-EM Global Diversified index series by JP Morgan, as well as due to reaching the fiscal targets and a liquidity surplus in the financial markets. Also to this development has contributed the decision of the rating agency Standard & Poor's which included Romania in the category of investment grade countries since July 2014. Considering the conditions of the end of 2014, it can be observed a decline in bond yields for those with short-terms maturity (less than 1 year) at about 2%, as well as for those with longer-terms maturity (over 5 years) at about 2.8%, these halving within 12 months, while for the 10-years term the financing costs decrease is lower, i.e. up to a level of about 4%, compared to 5.3% at

[39]The Gross Domestic Product for 2014: 666,637 billion lei.

the end of 2013. Regarding the cost of attracting new resources in foreign currency from the external markets, the state was able to finance itself cheaper in 2014 compared to 2013 for the issuances of the government bonds denominated in euro, the yields obtained were 3.7% in April 2014, and respectively 2.97% in October 2014 compared to the levels of over 4.15% in the previous year, while those denominated in U.S. dollars, the cost increasing to 5.02% in January 2014 from 4.5% in February 2013.

Figure 34: The evolution of financing costs in national currency in the period 2011-2014



Source: National Bank of Romania

The central administration debt[40] represented at the end of 2014 95.04% of the total public debt, compared to 94.4% in 2013, while local debt represented only 4.96%, slightly decreasing from the level of 5.6% registered in the previous year. Government bonds have the largest share in total debt, cumulating 36.6% of the total (compared to 38.9% in 2013), followed by state loans which represents 26.2% (compared to 31.2% in 2013) and euro-bonds with 23.9% (compared to 18.2% in 2013), while the treasury bills provided 3.8% of total public debt financing (compared to 4.1% in 2013). Thus, two trends can be noted in the management of public debt: on the one hand, a higher proportion of maturing debt is refinanced through financial markets, being preferred longer maturities, while the attracted amounts from external markets experienced a significant increase in the desire to diversify the sources of funding, but also to strengthen the international reserves.

[40] According to the national methodology.

Regarding the maturity structure of government securities newly issued in 2014, the trend of attracting longer-terms resources initiated in last year continued. Therefore, the treasury bills with maturities lower than 1 year totals only 11% of new loans in 2014, while the share of funding over longer periods advanced significantly compared to 2009-2012, the bonds with maturities longer than 1 year accumulating 89% of the new loans. Under these conditions, the average residual maturity of government securities issued on domestic market increased in 2014, compared to 2013 (to 4.39 years from 3.52 years). Increasing the share of longer-term state financing was favored both by lower yields, excess liquidity in the financial markets as well as an improved risk perception regarding Romania.

The debt structure by currencies reveals a slight increase in the share of loans in national currency to 45.05% in 2014 from 44.3% in 2013, while the euro financing registered a slight decrease to 45% of total in 2014, from about 46.2% in 2013, the declared intention for the next period of Ministry of Public Finance being the increase of the amounts in national currency attracted from the domestic market. The loans contracted by the state from the U.S. market increased the share of dollar funding from 6.5% in 2013 to 8.8% in 2014, under the conditions of materializing the intention to diversify the public debt financing.

In order to forecast the future evolution of the public debt in the coming years, its dynamic as a share of GDP can be expressed by the following formula, derived from the budget identity.

$$\boldsymbol{\frac{d_t}{y_t} = (1 + \lambda_t) \times \frac{d_{t-1}}{y_{t-1}} + \frac{pb_t}{y_t} + sfa_t}$$

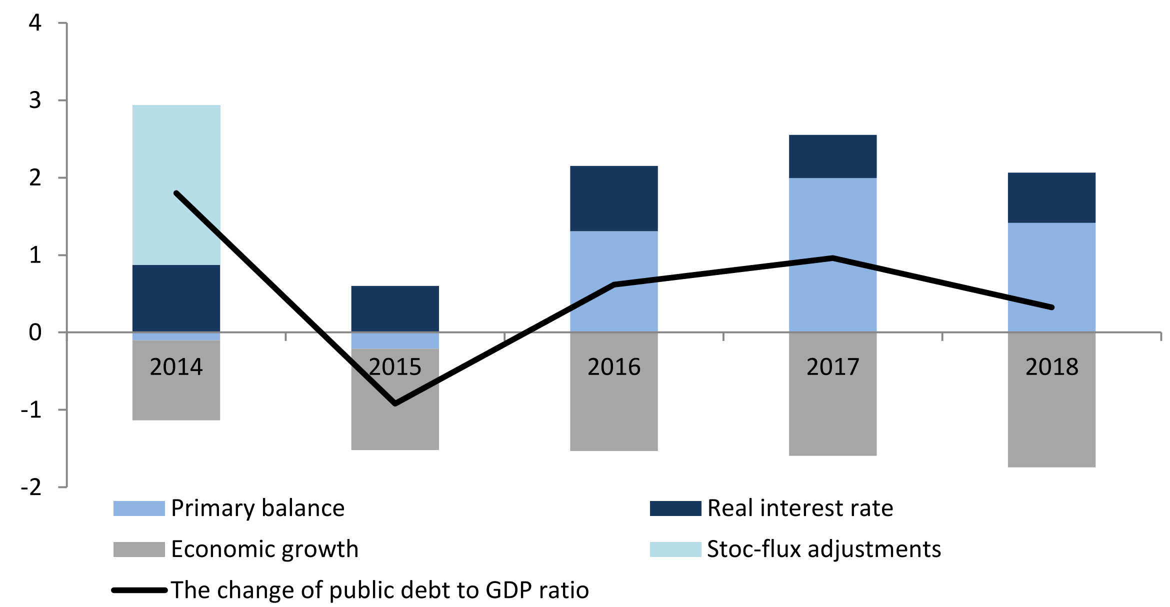
Where d_t is public debt stock at time t, y_t represents nominal GDP at time t, pb_t – is primary deficit at time t, sfa_t - stock-flow adjustments at time t, and

$$1 + \lambda_t = \frac{1 + i_t}{(1 + \pi_t) * (1 + \gamma_t)}$$

Where γ_t - real GDP growth rate during time t, i_t – interest rate at time t and π_t - inflation rate at time t.

The above relationship shows that public debt as share of GDP at time t depends on its weight in the previous period adjusted by the difference between the real interest rate and the economic growth rate, plus the consolidated general budget primary deficit expressed as percentage of GDP. In case of a real economic growth rate higher than the real interest rate for the public debt, the latter, expressed as a percentage of GDP, will have a downward trend even when the primary deficit equals to 0. It is therefore possible to reduce public debt as a percentage of GDP even when the primary balance registers a primary surplus lower than the interest expenditure provided that the real economic growth is higher than the real interest rate of public debt. The coefficient λ_t can be seen as a real interest rate adjusted by the economic growth.

Figure 35: Contributions to changes in public debt as share of GDP in the period 2014 – 2018 (given the implementation of draft revision of the Fiscal Code)



Source: National Commission for Economic Forecasting, Ministry of Public Finance, Fiscal Council's calculations

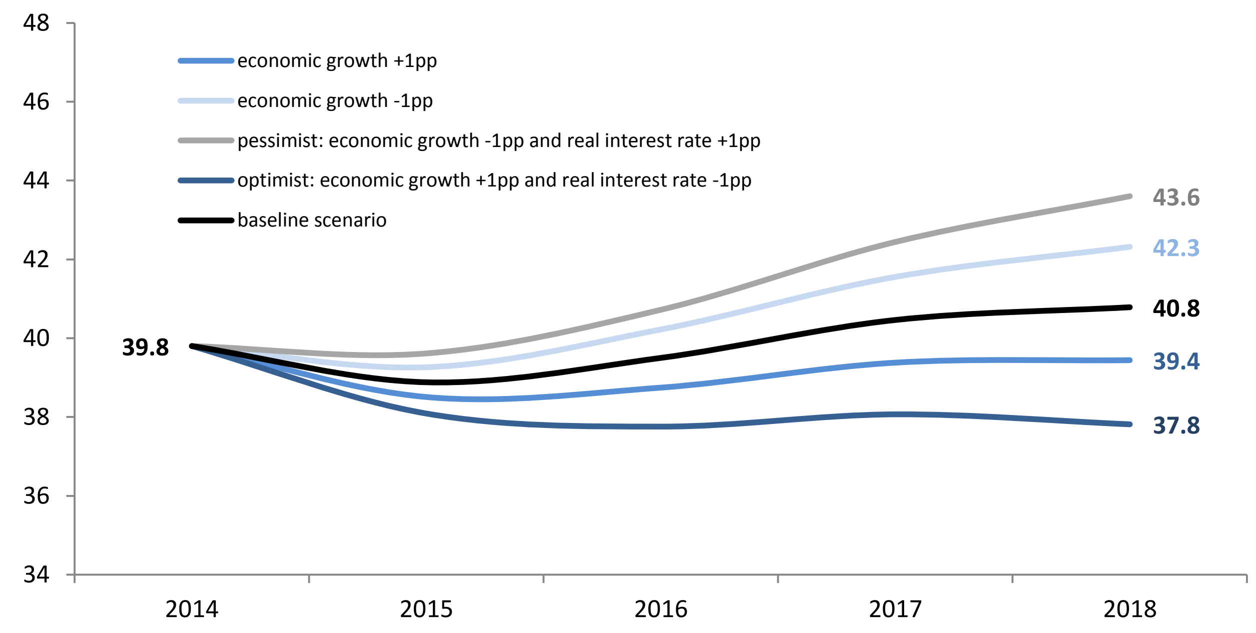
Using Government's official forecasts for the determinants of the trajectory of public debt (respectively the Preliminary Autumn Forecast 2015, which include the additional economic growth generated by the fiscal stimulus), adjusted by the Fiscal Council's projections regarding the headline deficit generated by the new Fiscal Code[41] and the interest rate paid on the public debt, and assuming for the period 2015-2018 a stock-flow adjustment equal to zero, we calculated their contributions to the public debt variation as a share of GDP between 2014 and 2018. Thus, even if the Government considered when submitting the Convergence Programme to the European Commission that the large fiscal loosening will have no impact on the budget deficit, this being fully offset by the additional revenues derived from reducing the tax evasion, the Fiscal Council, in line with the European Commission's approach has chosen to use own estimates for the budget deficit, which further influence the trajectory of the public debt in the next period.

[41] In force from 10th September 2015. The effective headline deficits estimated by the Fiscal Council as a result of implementing the proposed amendments of the new Fiscal Code are: 2.9% of GDP in 2016, 3.5% of GDP in 2017, and respectively, 3% of GDP in 2018.

In 2014 the largest contribution to the increase in the stock of debt was generated by the stock-flow adjustment (2.1% of GDP), exclusively as a result of the decision of Ministry of Public Finances to additionally raise the Treasury reserves, followed by the real interest rate (0.87% of GDP). The economic growth of 2.8% registered in 2014 has contributed to the reduction of the debt-to-GDP ratio by 1.03 % of GDP, being higher than the real interest rate of 2.4% of GDP, involving thus a negative value for the coefficient λ_t. According to the baseline scenario, the share of public debt in GDP in 2015 is projected to be below the level recorded in 2014, the economic growth being the main factor acting in the sense of reducing the public debt. Given the application of the new Fiscal Code, the public debt will stabilize in the period 2016-2018 around the level reached in 2014 and is projected to reach to a level of 40.8% in 2018, compared to a downward trajectory in the absence of the fiscal loosening package. Thus, the main factor that will act to increase the share of public debt to GDP will be the primary deficit, offset by the acceleration of the economic growth. On the other hand, in the absence of changes proposed by the new Fiscal Code, the balance of public debt would have continued its downward trend, reaching a level of 36.2% of GDP in 2018, due to acceleration in the economic growth, but also due to a primary surplus of about 0.5% of GDP.

The above results depend to a large extent on the forecasts used for the real interest rate and for the real GDP growth rate. A higher-than-expected real interest rate would involve additional costs for public debt financing and may lead to an increased public debt as a share of GDP. Furthermore, a lower economic growth rate may cause an increase in the public debt ratio to GDP compared to the initial forecasts. Considering the uncertainty associated to the forecasts, a sensitivity analysis is appropriate in order to assess the impact of changes in the variables used for assessing the development of the public debt.

Figure 36: Scenarios for the evolution of public debt (% of GDP)



Source: National Commission for Economic Forecasting, Ministry of Public Finance, Fiscal Council's calculations

According to the baseline scenario, the public debt will be stable between 2015-2018 at around 40% of GDP, reaching at the end of the period a level of 40.8% of GDP, considering also the implementation of the proposed amendments to the Fiscal Code. In an optimistic scenario, characterized by an economic growth higher than projected by 1 pp and a real interest rate lower by the same amount, a reduction in the public debt up to 37.8% of GDP will be observed in 2018. On the other hand, if considering a pessimistic scenario, according to which the real GDP growth rate decreases by 1 pp, in conjunction with an increased real interest rate by 1 pp, the public debt as a share of GDP will reach a level of 43.6% - a lower level, but relatively close to the threshold of 45%, defined by the Fiscal Responsibility Law no. 69/2010 with subsequent amendments. The aforementioned Law was amended at the end of 2013, one of the changes being represented by the introduction of the public debt thresholds which trigger actions from the Government. Thus, if the public debt exceeds 45% of GDP, the Ministry of Public Finance presents to the Government a report to justify the debt increase and presents proposals to maintain this indicator at a sustainable level; if the public debt exceeds 50% of GDP, the Government shall freeze the total expenditures for the public sector wages and eventually adopts additional measures to reduce the public debt; if the indicator is above 55% of GDP the total social assistance expenditures of the public sector will be automatically frozen. All these new provisions are aimed at preventing the situation in which the public debt would exceed the 60% of GDP threshold, stipulated in the Maastricht Treaty.

The Fiscal Council considers that the next period corresponding with the upturn in the economic cycle should be used to reduce indebtedness, as the current trajectory of the public debt development as share in GDP could lead to an excessive accumulation of vulnerabilities that would become fully visible in a future descending phase of the economic cycle. One relevant example in the sense of the potential for a rapid growth of public debt in the context of adverse cyclical developments simultaneously with high structural deficits is Romania itself, which in 2008 recorded a debt level of only 13.2% of GDP. Other examples of rapid growth of public debt in the context of prolonged recessions are provided by Croatia (38.9% of GDP in 2008, 85% of GDP in 2014) and Finland (32.7% of GDP in 2008, 59.3% of GDP in 2014). In addition, a further increase in the public debt above 40% of GDP could become problematic given the current level of development of the economy and also due the limited capacity of absorption of the local financial markets.

IV. The absorption of EU funds

In the **period 2007-2013**, as it appears from data provided by the Ministry of European Funds (MEF), Romania has been allocated structural and cohesion EU funds amounting to 19.2 billion euro to which is added 13.8 billion euro in the Common Agricultural Policy. Coordinated through the EU cohesion policy, the cohesion and structural funds are financial instruments (Cohesion Fund – CF, European Regional Development Fund – ERDF, European Social Fund - ESF), designed to eliminate economic and social disparities between regions, supporting the convergence of member countries, increasing competitiveness and employment. Considering these aspects, this report examines the absorption of EU funds in Romania considering only the structural and cohesion funds.

Considering the obligation of Member States to contribute to achieving Europe 2020 strategy objectives, each country draws up a National Reform Programme (NRP) which transposes the EU's overall objectives into national targets and which is transmitted together with the Stability and Convergence Programme[42], both programs being integrated into the national budgetary plans for the next three years. Each Member State is faced with different economic circumstances and implements the overall objectives of EU in national targets by national reform programs, a document containing policies and measures in support of smart, sustainable and inclusive growth, high levels of employment and achieving the targets set by the Europe 2020 strategy.

In the 2014 NRP submitted by Romania to the European Commission in April 2014, there are defined the reforms and development priorities for a period of 12 months (from July 2014) and the identified measures and directions for actions to facilitate the access to European funds in the programming period 2014-2020 and increase the absorption capacity of structural and cohesion funds.

The annual assessment prepared by the European Commission (June 2014) regarding the progress projected by the National Reform Programme 2014[43] revealed several factors that

[42] According to the preventive arm of the Stability and Growth Pact, EU Member States must submit to the European Commission (EC) Stability or Convergence Programs each spring. States that have adopted the euro prepare and submit Stability Programs, and those that have not adopted the euro, Convergence Programs.

[43] European Commission (2014), "Assessment of the 2014 National Reform Programme and Convergence Programme for Romania", Commission Staff Working Document, Brussels, 02.06.2014, SWD (2014) 424 final.

contributed to maintaining the lowest rate of absorption[44] of EU funds in Romania, pointing out that they may have a negative impact on the preparations for the new generation of programs and their execution:

- insufficient administrative capacity to manage programs and projects;
- poor coordination between ministries, the factors responsible for sectoral policies and funds management institutions;
- precarity of the management and control systems and practices in public procurement.

In addition to these elements, the EU Council Recommendations of July 8th, 2014 on the National Reform Programme 2014 of Romania were also identified as having a negative impact:

- the strategic planning and priority setting in the government policies, and the lack of multi-annual budgetary planning in ministries with major investment portfolios;
- institutional framework (multiple actors, overlapping responsibilities, etc.);
- corruption and conflict of interest.

It should be noted, however, that in January 2015 compared to January 2014, Romania registered a significant increase in the absorption rate of structural and cohesion funds, respectively from 36.65% to 52.08%, according to data from the Ministry of European Funds. Even in these circumstances, the absorbed funds are just over half of the funds allocated for 2007-2013.

With the highest absorption rate (73.52%) for the Operational Programme Administrative Capacity Development under an initial allocation of only 208 million euros and the lowest rates (45.40% and 45.02%) for the Sectoral Operational Programmes Transport and Environment corresponding to the higher initial allocation (4.42 billion EUR and respectively 4.41 billion EUR), Romania still faces major challenges in terms of the capacity to absorb EU funds.

Although the absorption rate remains modest in Romania, in the last two years progress has been visible. Most of the increased absorption rate was for the Operational Programme Administrative Capacity Development (by 50 pp), but the amount raised is small (147.11 million EUR) considering also the low initial allocations. The Sectoral Operational Programme Economic Competitiveness had an accelerated growth in the last two years, the absorption rate advancing by 37 pp and the money spent amounting to 1,218.19 million EUR. Although the absorption rate for the Sectoral Operational Programme Transport obviously increased (by 36 pp in the last two years, reaching 45.40% in January 2015 compared to only 9% in 2012), it remains still one of the least efficient operational programs, with only 2009.34 million EUR spent by January 2015.

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[44] Although, according to the document mentioned above, between June 2013 (when it was only 18.4%) and December 2013, the absorption rate nearly doubled.

Table 12: Structural funds absorption by operational programs (million EUR)						
	Total allocations 2007-2013 (cumulative)	Payments January 2015			Absorption rate Jan. 2015	Absorption excl. pre-financing Jan. 2015
		Total, out of which:	Pre-financing[45]	Refunds to EU		
Regional Development	3,966.02	2,297.14	560.31	1,736.83	57.92%	43.79%
Environment	4,412.47	1,986.52	731.89	1,254.64	45.02%	28.43%
Transport	4,425.93	2,009.34	-	2,009.34	45.40%	45.40%
Competitiveness	2,554.22	1,462.11	243.93	1,218.19	57.24%	47.69%
Human Resources	3,476.14	2,015.15	624.14	1,391.01	57.97%	40.02%
Administrative Capacity Development	208.00	152.93	5.81	147.11	73.52%	70.73%
Technical Assistance	170.23	83.47	1.41	82.05	49.03%	48.20%
Total	**19,213.03**	**10,006.66**	**2,167.49**	**7,839.17**	**52.08%**	**40.80%**

Source: Ministry of European Funds, Fiscal Council's calculations

It can be observed a significant dynamic in the case of the Operational Programme Technical Assistance, the absorption rate increasing by 30 pp, but the amounts drawn remains low (82.05 million EUR). With 1254.64 million EUR payments, the Sectoral Operational Programme Environment has increased the absorption rate by 27 pp in the past two years.

The Sectoral Operational Programme Human Resources and the Operational Programme Regional Development had a similar pattern, increasing steadily since the beginning, the absorption rate advancing in the past two years by 26 and 23 pp and reached 57.97% and 57.92% in January 2015, these programs still being the best programs in the absorption of structural funds in Romania. Their absorption rate was exceeded in 2014 only by the Operational Programme Administrative Capacity Development which was 73.52%, but the

[45] According to GEO no. 64/2009, prefinancing is the amount transferred to the beneficiaries of structural instruments through direct payments or through indirect payment in the initial stage to support start carrying out projects and/or the implementation thereof, as provided in the agreement/ decision/order financing between a beneficiary and the managing authority/intermediate body responsible/accountable to ensure the proper conduct of the projects financed under the operational programs.

funds raised through this program are modest. Payments including January 2015 for Operational Programme Human Resources Development and the Regional Operational Programme (1391.01, respectively 1736.83 million EUR) were surpassed only by payments for Sectoral Operational Programme Transport (2009.34 million EUR).

Compared to other new EU Member States, according to the data released by the European Commission, the absorption rate in Romania remains the lowest, being only 56.3%[46] in 2014 (58.7% in February 2015) after about eight years of EU membership, not by much than in Slovakia, the penultimate country in this ranking, which recorded a rate of absorption of 60.1% in 2014, and Bulgaria which registered an absorption rate of 65.5%.

Table 13: Absorption of structural funds – comparison with other EU member states

	Total allocations 2007-2013 billion EUR	Payments 2014 billion EUR	Absorption rate 2014 %	Total allocations /inhabitant 2007-2013 EUR	Total payments /inhabitant 2014 for 2007-2013 EUR
Lithuania	6.78	6.35	93.70%	2,279.85	2,136.22
Estonia	3.40	3.14	92.30%	2,578.04	2,379.53
Poland	67.19	57.31	85.30%	1,743.57	1,487.27
Latvia	4.53	3.70	81.70%	2,238.56	1,828.90
Slovenia	4.10	3.35	81.70%	1,991.94	1,627.42
Hungary	24.92	19.01	76.30%	2,515.05	1,918.99
Bulgaria	6.67	4.37	65.50%	916.13	600.07
Czech Republic	26.53	16.76	63.20%	2,522.45	1,594.19
Slovakia	11.50	6.91	60.10%	2,125.06	1,277.16
Romania	19.21	10.82	56.30%	959.69	540.30

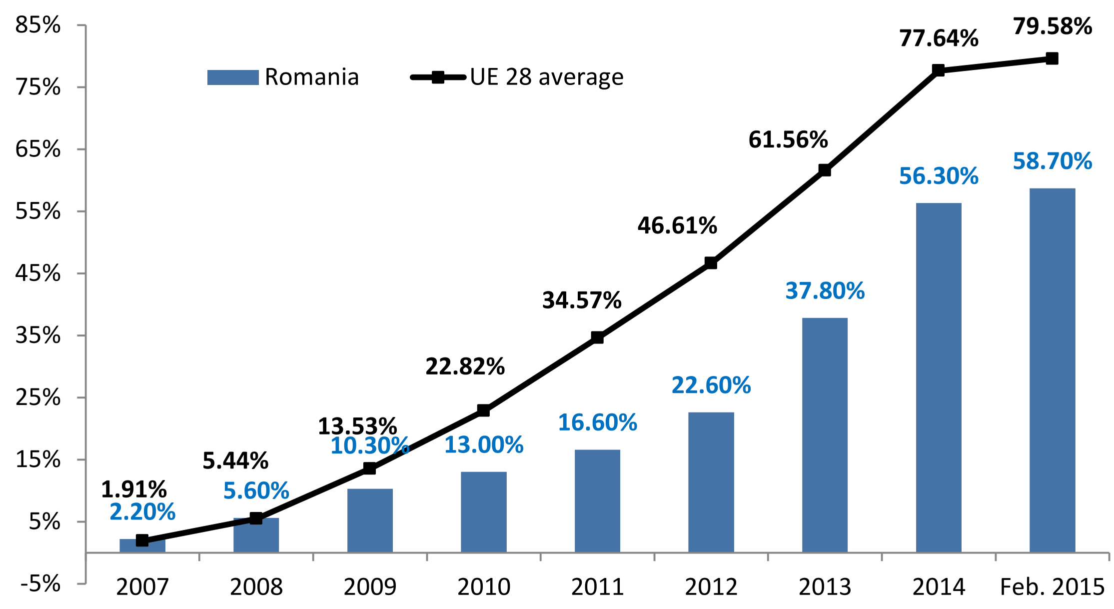
Source: European Commission (structural funds) and Eurostat (population, 2013)
Note: The absorption rate calculated by the European Commission on interim payments and pre-financing.

The low level of absorption is explained also by the blockages occurred in attracting European funds in 2011-2013. To minimize the risk of losing these funds, Romania and Slovakia have received an additional year for drawing European funds for the financial year 2007-2013, until the end of 2015.

[46] The rate of absorption of the European Commission is based on interim payments and pre-financing (it is slightly larger than the absorption rate based on payments to beneficiaries published by MEF).

Considering the EU funds allocated divided by the number of inhabitants, Romania is also ranked on the lowest position between the new Member States of EU, reaching in 2014 540.3 euro/inhabitant compared to 2379.53 euro/inhabitant in Estonia or 600 euro/ inhabitant in Bulgaria.

Figure 37: Evolution of EU funds absorption rate: Romania versus EU 28 average, 2007-February 2015 (financial exercise 2007-2013)



Source: European Commission, Fiscal Council's calculations

Compared to the EU 28 average, EU funds absorption performance in Romania remains low, the level of absorption being by more than 20 pp below the EU 28 average at the end of 2014. Although the absorption rate is slightly higher, the gap persists also in February 2015.

It is true that in the years 2013 and 2014 there have been made progresses in terms of attracting European funds, evidenced by the increase in the absorption rate with 15.10 pp in 2013 compared to the end of 2012 and by 18.5 pp in 2014 compared to the end of 2013, according to data released by the European Commission. However, given the deadline for drawing European funds allocated for the period 2007-2013, respectively December 31st, 2015, there are significant risks for their loss and are required urgent measures to improve the absorption.

For the year 2015 there were announced ambitious targets concerning European funds absorption, namely an absorption rate of 80%[47], which would imply an increase with 23.7 pp compared to 2014. Even in terms of achieving this target, the loss of the amount allocated to Romania for the 2007-2013 programming period would be significant (3.84 billion EUR).

One way to increase the absorption rate, already discussed by the Romanian authorities with the European Commission, is the retroactive financing for public projects financed from public sources (or loans) already completed or nearing completion by 31 December 2015. An example of this is to cover 85% of construction costs (305.7 million EUR) for the section Cernavodă - Constanța of the Sun Highway[48] from European funds, for which was originally used a loan obtained from the European Investment Bank contracted in 2005. This approach was preceded by allocating 262 million EUR from the Cohesion Fund to cover the construction of two sections of motorway (highway Arad-Timișoara opened in 2011 and Constanța beltway opened in 2012), the European contribution for these projects reaching 439 million EUR.

On the other hand, strengthening the monitoring of projects at risk of non-completion by the end of 2015 and phasing of projects[49] in delay (on two stages of implementation), together with reimbursement of amounts spent in the second stage of implementation of these projects funds for 2014-2020, are intended to be measures to accelerate absorption and reduce the loss of amounts allocated for Romania in the period 2007-2013.

For the **financial exercise 2014-2020**, there was a shift in the EU policy orientation towards fulfilling the objectives derived from Europe 2020 strategy, Commission services position paper and Country-specific recommendations. The Partnership Agreement between a Member State and the European Commission which set funding priorities, referred to the management of EU funds programming by: Cohesion Fund, European Regional Development Fund, European Social Fund, European Agricultural Fund for Rural Development (EAFRD) and European Maritime and Fisheries Fund (EMFF). The 11 thematic objectives[50] for the period 2014-2020 are set out in

[47] Ministry of European Funds (2014), "Balance 2014. Structural and Cohesion Funds Absorption" („Bilanț 2014. Absorbția fondurilor structurale si de coeziune”), December 30th, 2014.

[48] Decision taken by the European Commission on January 12th, 2015, for 51.3 km put into service in November 2012.

[49] According MFE, projects’ phasing is provided in European legislation since 2006 and is a common measure applied by Member States. European Commission's Guidelines on phasing methodology was revised at the end of February 2015. The final deadline in which all Member States must fall is September 2015.

[50] " …for smart, sustainable and inclusive growth and to the Fund-specific missions pursuant to their Treaty-based objectives, including economic, social and territorial cohesion ..."

Article 9 of Regulation (EU) No. 1303/2013 of the European Parliament and of the Council of December 17th, 2013:

1. strengthening research, technological development and innovation;
2. enhancing access to, and use and quality of, ICT;
3. enhancing the competitiveness of SMEs, of the agricultural sector (for the EAFRD) and of the fishery and aquaculture sector (for the EMFF);
4. supporting the shift towards a low-carbon economy in all sectors;
5. promoting climate change adaptation, risk prevention and management;
6. preserving and protecting the environment and promoting resource efficiency;
7. promoting sustainable transport and removing bottlenecks in key network infrastructures;
8. promoting sustainable and quality employment and supporting labor mobility;
9. promoting social inclusion, combating poverty and any discrimination;
10. investing in education, training and vocational training for skills and lifelong learning;
11. enhancing institutional capacity of public authorities and stakeholders and efficient public administration.

The total budget for the cohesion policy 2014-2020 was established in December 2013 and amounts to 351.85 billion EUR, in current prices by 1.3% higher than in 2007-2013. More than half of this budget (54.74%, respectively 192.63 billion EUR) is allocated to new EU Member States (Bulgaria, Czech Republic, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Hungary).

In the period 2014-2020, according to data from the Ministry of European Funds, Romania will receive a total allocation of about 22.98 billion EUR in structural and cohesion funds for operational programs, increasing against the 19.2 billion EUR budget for 2007-2013. To these allocations are added other 19.7 billion EUR for Common Agricultural Policy (financed by both financial instruments, EAFRD and the European Agricultural Guarantee Fund - EAGF) and 168 million EUR for the Operational Programme for Fisheries and Maritime Affairs - OPFMA (funded by European Maritime and Fisheries Fund - EMFF).

Under the Partnership Agreement proposed by Romania and approved by the European Commission on August 6th, 2014 for the programming period 2014-2020, starting with February 2014, there will be 6 Operational Programmes on Cohesion Policy, compare to 7 in the period 2007-2013. Sectoral Operational Programme Transport and Sectoral Operational Programme Environment were united and together with the funding for energy sector constitute the Operational Programme Large Infrastructure program with a budget of about 9.41 billion EUR. The Operational Programme Human Resources changed its name in the Operational Programme Human Capital, further comprising a new initiative "Jobs for Youth" and having allocated a total sum of 4.32 billion EUR[51]. There was also added a new program, namely the Operational Programme Helping Disadvantaged People, the first Romanian program for the period 2014-2020 that received the European Commission's approval on November 28th, 2014, a program through which in financial period 2014-2020 Romania will dispose of 441 million EUR. Among the first programs approved by the European Commission are also the Operational Programme for Technical Assistance amounting to 212.76 million EUR approved on December 18th, 2014 and the Operational Programme Competitiveness that has allocated an amount of 1.32 billion EUR, approved on December 19th, 2014. The Operational Programmes Regional Development, Large Infrastructure and Administrative Capacity Development were submitted to the European Commission, with the indicative allocations amounting to 6.7 billion EUR, 9.4 billion EUR, and 553.19 million EUR respectively, being in early March 2015 in negotiations with the European Commission.

At the European Commission level, for the new programming period 2014-2020, in February 2015, 80% of programs were adopted, and 20% still remains to be adopted after the revision of the multiannual financial framework.

In general, the financial allocations for future programs are bigger than those in the period 2007-2013, except for the Sectoral Operational Programme Increase of Economic Competitiveness, which received only 1.32 billion EUR, compared with 2.55 billion EUR in the previous period, the allocations for the period 2014-2020 being halved. The operational Programmes with the highest rates of absorption in the previous financial period (2007-2013) will receive funding higher by more than 65% (the Operational Programme Regional Development - 6.70 billion EUR, compared to 3.96 billion EUR and the Operational Programme Administrative Capacity Development - 553.19 million EUR, compared to 208 million EUR).

[51] The program was approved by the European Commission on February 25th, 2015.

Table 14: Comparison between the allocations in 2007-2013 and 2014-2020 (million EUR)				
Total allocations 2014-2020 according to Operational Programs and Partnership Agreement[52]			Total allocations 2007-2013	
Regional Development	6,700.0	Approved 23 June 2015	**Regional Development**	3,966.02
Large Infrastructure	Total: 9,418.52 FC: 6,934.99 FEDR: 2,483.52	Approved 10 July 2015	**Environment**	4,412.47
			Transport	4,425.93
Competitiveness	1,329.78	Approved 19 Dec. 2014	**Competitiveness**	2,554.22
Human Capital Aut of which "Jobs for Youth":	4,326.83 105.99	Approved 25 Feb. 2015	**Human Resources**	3,476.14
Administrative Capacity Development	553.19	Approved 25 Feb. 2015	**Administrative Capacity Development**	208.00
Technical Assistance	212.76	Approved 18 Dec. 2014	**Technical Assistance**	170.23
Helping Disadvantaged People	441.01	Approved 28 Nov. 2014		
Total	**22,982.12**		**Total**	**19,213.03**

Source: Ministry of European Funds

Since February 2015 when the first Monitoring Committee met, were made the first steps for launching new calls. Thus, according to data released by the Ministry of Finance, in the consolidated general budget for January 2015 the newly introduced type of expenditure in category Transfers: *Projects funded by external grants corresponding to the financial framework 2014-2020* registered a sum with a low value of only 52.75 million lei, which however has reached 480.50 million lei in May.

In addition, for the programming period 2014-2020, it was introduced a simplification for the institutional structure, setting the management authority for only 3 ministries:

- Ministry of European Funds will be managing authority for: Operational Programme Large Infrastructure, Operational Programme Human Capital, Operational Programme Competitiveness, Operational Programme Technical Assistance, and Operational Programme Helping Disadvantaged People;

[52] Is presented information available in late February 2015.

- Ministry of Regional Development and Public Administration will be management authority for: Operational Programme Regional Development, Operational Programme Administrative Capacity, and European Territorial Cooperation Programs;
- Ministry of Agriculture and Rural Development will be the managing authority for: National Programme for Rural Development, Direct Payments in Agriculture, and Operational Programme for Fisheries and Maritime Affairs.

Another novelty announced by the Ministry of European Funds is the fact that for the new 2014-2020 Operational Programmes, the full amount of available funding for a line will be launched from the beginning, thus allowing for continuous projects submitting until budget's depletion.

As of May 26th, 2015 came into effect the Emergency Ordinance no. 13/2015 on the establishment, organization and functioning of the National Agency for Public Procurement which was required as an obligation of Romanian Government to meet *ex-ante* the horizontal conditionality on public procurement reform in Romania's partnership agreement for financial programming period 2014-2020 approved by European Commission by the Decision no. C (2014) 5515 of August 6th, 2014 concerning the adoption of legislative measures that would ensure effective work in this area. The Public Procurement Agency is a public institution with legal personality, under the Ministry of Finance, through taking attributions, activity, positions and personnel from the National Authority for Regulating and Monitoring Public Procurement, the Unit for Coordination and Verification of Public Procurement and from public procurement verification compartments of the regional general directorates for public finance. The main objectives of the National Agency for Public Procurement are formulated at the level of design, promotion and implementation of public procurement policy, establishing and implementing a system of verification and control for uniform application of laws and procedures in public procurement and monitoring the efficient operation of the public procurement system.

Romania, like other new Member States, has received for the period 2014-2020 a higher allocation for the structural and cohesion funds, compared with the previous financial period (22.99 billion EUR compared 19.21 billion euro), exception to this rule, being the Czech Republic (21.98 billion EUR compared to 26.53 billion EUR), Slovenia (3.07 billion EUR compared to 4.10 billion EUR), and Latvia, which received almost the same amount for the next period (namely 4.51 billion EUR, compared to 4,53 billion EUR).

With regard to allocations for 2014-2020 relative to the number of inhabitants, Romania is still on the second lowest position with 1,148.53 EUR/inhabitant, exceeding only Bulgaria (1,041.71 EUR/inhabitant). It can be seen that the Baltic countries have among the highest allocations per inhabitant for the next period, respectively 2,719.33 EUR in Estonia, 2,229.34 EUR in Latvia, and 2,295.86 EUR in Lithuania. Allocations relative to population increased significantly in the case of Slovakia (from 2,125.06 EUR compare to 2585.86 EUR) and Poland (from 1,743.57 EUR to 2,012.98 EUR) and decreased in the case of Czech Republic (from 2,522.45 to 2,090.39 EUR), Slovenia (from 1,991.94 EUR to 1,493 EUR) and Hungary (from 2,515.05 EUR to 2,210.75 EUR).

Table 15: Situation of the allocations of the European funds: 2014 - 2020 compared to 2007 - 2013 - comparison with other EU countries

	Total allocations for EU Cohesion Policy 2014-2020 billion EUR	Total allocations/ inhabitant 2014-2020 EUR	Total allocations 2007-2013 billion EUR	Total allocations/ inhabitant 2007-2013 EUR
Poland	77.56	2,012.98	67.71	1,743.57
Romania	22.99	1,148.53	19.21	959.69
Czech Republic	21.98	2,090.39	26.53	2,522.45
Hungary	21.90	2,210.75	24.92	2,515.05
Slovakia	13.99	2,585.86	11.50	2,125.06
Bulgaria	7.58	1,041.71	6.67	916.13
Lithuania	6.82	2,295.86	6.78	2,279.85
Latvia	4.51	2,229.34	4.53	2,238.56
Estonia	3.59	2,719.33	3.40	2,578.04
Slovenia	3.07	1,493.47	4.10	1,991.94

Source: European Commission (European funds) and Eurostat (population, 2013)

Note: The amounts allocated to each Member State include, in addition to structural and cohesion funds, represent the performance reserve and cross-border and transnational cooperation funding, according to the data available on the European Commission website.

Given that during 2014-2015 two financial exercises are overlapping (2007-2013 and respectively 2014-2020), Romania has an additional opportunity to implement more EU funded projects, this imposing decisive actions for the start of fundraising procedures under the new financial period along with measures to reduce the risk of allocations' loss for 2007-2013 period. For a better implementation of programs for the period 2014-2020, it is imperative that the issues identified in the previous financial period to be settled before launching new calls.

The absorption of EU funds remains a national interest objective and a solution to stimulate the economy, especially in the context of the constraints imposed by the new fiscal pact. For the 2007-2013 programming period, even if the proposed target for the absorption rate of 80% is achieved, the revenue loss would be significant, respectively around 3.84 billion EUR. Given the present huge gap relative to the proposed target, the Fiscal Council considers that this seems optimistic, existing a substantial risk that the loss of revenue to be significantly higher.

V. The Sustainability of Public Finance

V.1 State owned companies – arrears, efficiency and fiscal impact

A potential risk for the fiscal sustainability on the medium term is represented by the accumulation of losses and arrears in companies where the state is the major shareholder (SOEs), because if these companies fail to streamline their activity, the Government will eventually be forced to intervene with public resources, which may lead to a deterioration of public finances, respectively by increasing the budget deficit.

According to the Ministry of Public Finance, the arrears of state owned companies represent delayed payments by more than 30 days compared to contractual or legal terms that generate payment obligations to banks, state budget, social security budget, suppliers and other creditors. It is worth noting that since 2000, reducing the arrears of the state owned companies has been a constant concern of the Government, the SOEs being closely monitored, inclusively under the agreements with international financial institutions (IFIs). However the pace of their decline was a slow one, the undertaken targets being missed on several occasions.

At the end of 2014, there were 1,155 SOEs that reported financial statements to the Ministry of Public Finance, most of them being organized as companies and autonomous administrations, with an aggregate turnover of nearly 44.5 billion lei. Although the contribution of these companies to the overall economy turnover was only 4% in 2014, the accumulated outstanding payments represented 20.7% of the arrears registered in the economy, both indicators continuing the downward trend compared to the peak reached in 2009 (6% for the contribution of SOEs to the overall economy turnover and 35.5% for the accumulated outstanding payments by the SOEs of the total arrears registered in the economy). The stock of arrears for the 1,155 SOEs represented 3.7% of GDP, following the same downward trend as the above-mentioned indicators (6.7% of GDP, peak reached in 2009). The data show that although the share of SOEs arrears remains important, their contribution to gross value added for the total economy is still modest (9.9%), close to the previous minimum recorded in 2013 (10.5%).

The number of employees in state owned companies continued to decline from the maximum level recorded in 2007 (406 thousand of persons), reaching 297 thousand of persons in 2014, representing 7.6% of total employees in the economy, and the gross profit of state owned companies was negative in 4 of the 8 years analyzed, 2014, however, recording the best performance in the period under review (i.e. a 3,568 million lei gross profit). However, the favorable last year's evolution is mostly attributable to the increase in the profitability of a very small number of state owned companies. Therefore, if we remove the influence of the best performing five state owned companies in terms of profit (Top 5 from now on - they can be found in Table 18) we can notice a deepening of the aggregate negative result from -387 million lei to -957 million lei. Moreover, throughout the analyzed period the aggregate gross profit of the state owned companies, excluding Top 5 remained in a negative territory, the 2008-2012 period being characterized by high losses, which declined considerably in the last two years, even in the context of the worsening displayed in 2014. Instead, the Top 5 state owned companies have constantly recorded large profits, in the past two years taking place almost a doubling of their gross profit compared to 2012 (i.e. from 2.465 million lei to 4.525 million lei at the end of 2014). Thus, there can be noticed a decisive influence of the Top 5 in terms of the state owned companies' aggregate performance and in this context, for a more closely analysis of the financial performance evolution of the state owned companies' whole sector, the specific indicators in the current report will be presented both for the aggregate level and eliminating the influence of the Top 5.

Table 16: The evolution of the number of SOEs that report financial statements by components								
	2007	2008	2009	2010	2011	2012	2013	2014
Autonomous administrations	128	117	150	152	173	180	184	193
Companies owned 100% by the state	385	358	333	389	437	431	456	479
National companies and societies	50	41	45	50	61	48	41	46
Other companies entirely owned by state or where the state is the major shareholder	62	51	51	57	130	132	148	154
State-owned companies, local and foreign state capital (state capital >= 50%)	13	5	25	9	44	40	55	54
State-owned companies, local and foreign private capital (state capital >= 50%)	21	7	20	9	16	18	19	28
State-owned companies and with local private capital (state capital >=50%)	105	85	87	82	98	85	93	102
State-owned companies and with foreign private capital (state capital >=50%)	5	4	11	12	15	12	18	22
State-owned companies, privatized in the reporting year	50	50	52	31	74	60	72	77
Total number of SOEs	819	718	774	791	1,048	1,006	1,086	1,155

Table 17: The evol. of certain fin. indicators of Romanian companies that report financial statements considering the form of ownership									
		2007	2008	2009	2010	2011	2012	2013	2014
Companies number	Total companies excluding financial sector	617,272	663,860	602,190	613,080	644,379	630,066	627,545	643,644
	Share of SOEs in total	0.1%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	0.2%
Total income, mn lei	SOEs	51,953	56,660	50,756	55,022	58,511	49,853	46,906	44,487
	Total companies excluding financial sector	779,968	977,619	845,396	920,600	1,056,190	1,072,777	1,061,016	1,113,445
	Share of SOEs in total	6.7%	5.8%	6.0%	6.0%	5.5%	4.6%	4.4%	4.0%
Gross value added, mn lei	SOEs	19,048	21,744	20,454	22,881	24,202	22,339	23,805	25,220
	Total companies excluding financial sector	166,722	203,875	189,633	195,849	196,151	197,392	227,615	255,957
	Share of SOEs in total	11.4%	10.7%	10.8%	11.7%	12.3%	11.3%	10.5%	9.9%
Employees number, thous. of persons	SOEs	406	390	364	364	343	327	294	297
	Total companies excluding financial sector	4,620	4,618	4,019	3,962	4,040	3,898	3,836	3,882
	Share of SOEs in total	8.8%	8.4%	9.1%	9.2%	8.5%	8.4%	7.7%	7.6%
Gross profit, mn lei	SOEs	1,400	(1,026)	(2,777)	(2,101)	1,372	(561)	3,093	3,568
	SOEs, excluding best performing 5 comp.	-563.01	-3,926.82	-4,329.11	-4,201.71	-2,449.37	-3,026.17	-386.80	-957.37
	Private companies	43,008	23,513	19,914	27,934	10,421	15,623	23,856	27,479
Arrears, mn lei	SOEs	13,690	17,294	34,405	28,012	26,251	25,363	26,187	24,369
	Private companies	44,050	53,127	62,406	69,193	88,882	91,536	90,358	93,508
	Total companies excluding financial sector	57,740	70,422	96,811	97,205	115,133	116,899	116,545	117,878
	Share of SOEs in total	23.7%	24.6%	35.5%	28.8%	22.8%	21.7%	22.5%	20.7%
Arrears, % of GDP	SOEs	3.3%	3.3%	6.7%	5.2%	4.6%	4.3%	4.1%	3.7%
	Private companies	10.5%	10.1%	12.2%	13.0%	15.7%	15.3%	14.2%	14.0%
	Total companies excluding financial sector	13.8%	13.4%	19.0%	18.2%	20.4%	19.6%	18.3%	17.7%

Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

Table 18: Top 5 SOE's net profit

Top 5 net profit in 2014

	Company name	Net profit (mil.lei)
1	S.N.G.N. ROMGAZ S.A.	1,409.88
2	S.P.E.E.H. HIDROELECTRICA S.A.	941.54
3	S.N.T.G.N. TRANSGAZ S.A. MEDIAŞ	502.52
4	SOCIETATEA UZINA MECANICĂ CUGIR S.A.	442.01
5	C.N.A.D.N.R. S.A.	428.61
	Total	**3,724.56**

Top 5 net profit in 2013

	Company name	Net profit (mil.lei)
1	S.N.G.N. ROMGAZ S.A.	995.55
2	S.P.E.E.H. HIDROELECTRICA S.A.	718.83
3	S.N. NUCLEARELECTRICA S.A.	423.39
4	S.N.T.G.N. TRANSGAZ S.A. MEDIAŞ	334.49
5	C.N.A.D.N.R. S.A.	253.19
	Total	**2,725.46**

Top 5 net profit in 2012

	Company name	Net profit (mil.lei)
1	S.N.G.N. ROMGAZ S.A	1,244.05
2	S.N.T.G.N. TRANSGAZ S.A. MEDIAŞ	329.31
3	C.N.A.D.N.R. S.A.	174.14
4	COMPANIA NATIONALĂ DE CĂI FERATE CFR S.A.	144.65
5	COMPLEXUL ENERGETIC OLTENIA S.A.	118.33
	Total	**2,010.47**

Top 5 net profit in 2011

	Company name	Net profit (mil.lei)
1	TERMOELECTRICA S.A.	1,597.22
2	S.N.G.N.ROMGAZ S.A.	1,031.75
3	S.N.T.G.N. TRANSGAZ S.A.	379.57
4	C.N.A.D.N.R. S.A.	246.29
5	S.C. ELECTROCENTRALE BUCUREŞTI S.A.	106.85
	Total	**3,361.69**

Top 5 net profit in 2010

	Company name	Net profit (mil.lei)
1	S.N.G.N. ROMGAZ S.A.	651.21
2	S.N.T.G.N. TRANSGAZ S.A.	376.35
3	S.C. HIDROELECTRICA S.A.	292.37
4	S.C. ELECTROCENTRALE BUCUREŞTI S.A.	166.97
5	COMPANIA NATIONALĂ LOTERIA ROMÂNĂ S.A.	121.15
	Total	**1,608.05**

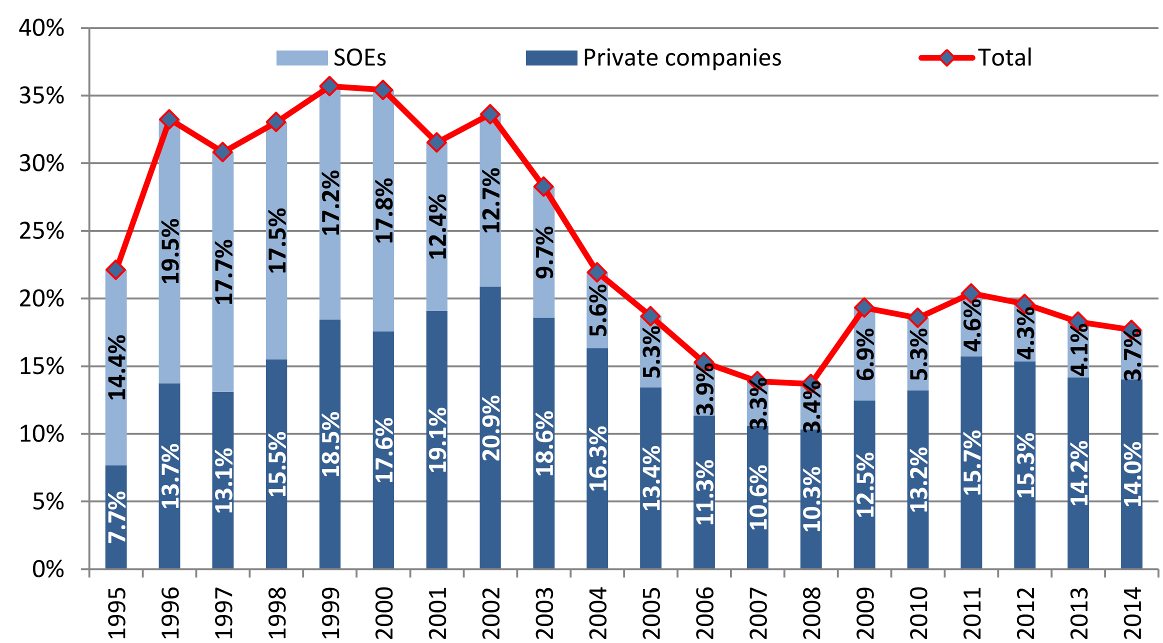
Top 5 net profit in 2009

	Company name	Net profit (mil.lei)
1	S.N.G.N. ROMGAZ S.A.	572.46
2	S.N.T.G.N. TRANSGAZ S.A.	298.63
3	COMPANIA NATIONALĂ LOTERIA ROMÂNĂ S.A.	150.59
4	COMPANIA NAŢIONALĂ AEROPORTUL INTERNAŢIONAL HENRI COANDĂ	59.47
5	S.N. NUCLEARELECTRICA S.A.	49.36
	Total	**1,130.51**

Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

Since 2000, the share of the accumulated outstanding payments in the economy has considerably declined, from 35.4% of GDP in 2000 to 13.7% of GDP in 2008 (i.e. a reduction in nominal value amounting to 41.7 billion lei), but the financial crisis that started in 2008 led their increase to a maximum of 20.7% of GDP in 2011, but without reaching the very high values from the early 2000s. The SOEs' and private companies' arrears as a percentage of GDP have declined starting with 2012 (19.9% of GDP), reaching a level of 17.7% of GDP in 2014. The state owned companies' arrears as a percentage of GDP have declined starting with 2009, respectively from 6.9% of GDP to 3.7% of GDP in 2014 under the measures agreed in the context of the balance of payments agreements with the international financial institutions (European Commission, IMF, World Bank), established in 2011-2015. These measures aimed at framing the arrears in the quarterly indicative targets and included budget transfers, placing SOEs into voluntary liquidation or insolvency or arrears' conversion into shares.

Figure 38: The evolution of SOEs' and private companies' arrears (% of GDP)



Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector[53]

[53] The values for 2013 presented in Graphs 38, 39, 40 and 41 and Tables 19 and 20 and partly in Table 17 differ from those presented in the Fiscal Council's Report for 2013 because the arrears of state owned companies: RADET Bucharest, CFR Marfă and CFR Călători, unavailable at the time of writing the previous Annual Report, were now included in the calculus.

In the private sector the share of arrears had also an upward trend in the 2009-2011 period (from 12.5% of GDP to 15.7% of GDP), since 2012 the share of arrears declining to a level of 14% of GDP at the end of 2014.

Figure 39: Arrears (% of turnover)

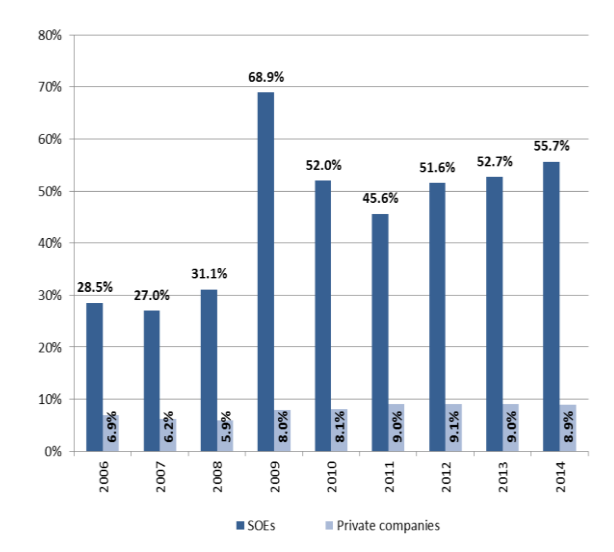
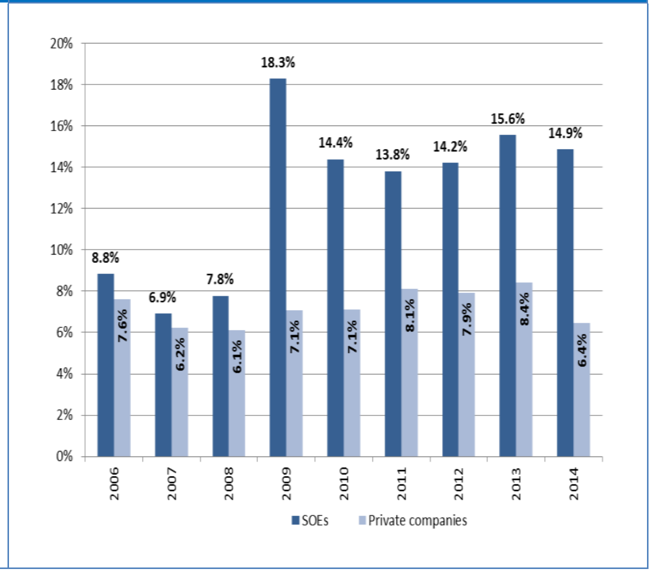


Figure 40: Arrears (% of total assets)



Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

With the onset of the financial crisis, the share of arrears in the turnover reached a peak in 2009, when the share of SOEs' arrears in the turnover recorded a significant jump compared to the previous year of over 100% (from 31.1% to 68.9%), while the share of private companies' arrears in the turnover recorded a lower jump (from 5.9% to 8% of the turnover). Since 2012, the private companies are on a downward trend in the share of arrears in the turnover, in contrast with the state owned companies which, although have recorded in 2009-2011 a significant reduction, of 23.3 pp, are on an upward trend since 2012, this ratio reaching a level of 55.7% at the end of 2014 (compared to 45.6% in 2011). Note that the increasing share of arrears in the turnover for the state owned companies in 2014 compared to the previous year can be explained by a more rapid decline in the turnover (-12%) compared with the value of arrears (-7%). In nominal terms, in 2014, unlike the state owned companies that have managed to reduce arrears by 7%, the private companies' arrears increased by 3.5% to the previous year, but as the dynamic of private companies' turnover exceeded by 1.9 pp (+5.4%) the dynamic of outstanding payments, they reduced the share of arrears in the turnover.

In addition, most of the state owned companies' arrears are directed towards the general consolidated budget (42% of total arrears), and in particular towards the social security budget, unlike private companies that have arrears mostly to suppliers (50% of total arrears). The total state owned companies' outstanding debts towards the general consolidated budget amounted 10.17 billion lei (1.5% of GDP) in December 2014, of which 5.7 billion lei were towards the social security budgets (0.8% of GDP). In general, the state owned companies do not pay on time their debts to the general consolidated budget (especially to the social security budgets) and to other state owned companies. The suppliers rank second among creditors of SOEs in 2014, the amount due by them being 8.9 billion lei (1.3% of GDP and 37.3% of total arrears). Compared to the previous year, in 2014 the share of SOEs' arrears to the suppliers and to the general consolidated budget declined with 8% and 10%.

Figure 41: Structure of arrears - SOEs (million lei)

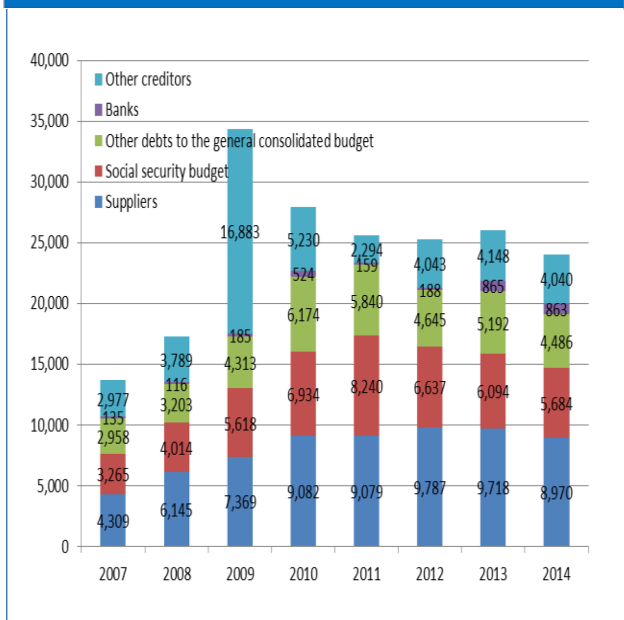
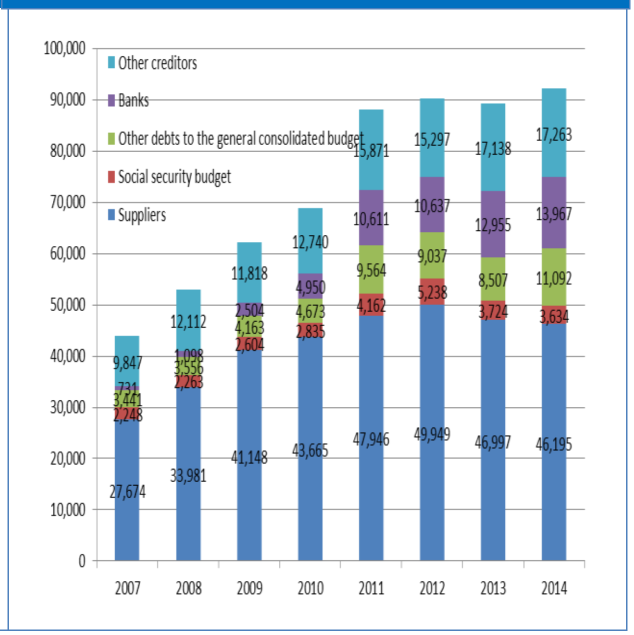


Figure 42: Structure of arrears – private companies (million lei)



Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

Besides direct fiscal consequences generated by SOE's arrears – revenue shortfalls to the general consolidated budget - the accumulation of outstanding payments towards the private sector is likely to create liquidity problems and to hamper the economic recovery. The top 10 companies in terms of outstanding payments account for over 60% of the total arrears of SOEs, the arrears being particularly high in the railway, mining and chemical sectors.

Table 19: Top 10 SOE's arrears

Top 10 arrears in Dec 2014

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI S.A. ÎN LICHIDARE	4,865.05
2	S.C. OLTCHIM S.A.	3,397.19
3	RADET BUCUREȘTI	3,157.86
4	REGIA AUTONOMĂ PENTRU ACTIVITĂȚI NUCLEARE R.A.	1,097.06
5	COMPANIA NAȚIONALĂ A METALELOR PRETIOASE ȘI NEFERO	570.30
6	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	553.10
7	CENTRALA ELECTRICĂ DE TERMOFICARE IAȘI (C.E.T.) S.A	545.38
8	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI S.A.	518.77
9	FORTUS S.A.	405.21
10	CENTRALA ELECTRICĂ DE TERMOFICARE BRAȘOV S.A.	394.55
	% total	**63.62%**

Top 10 arrears in Dec 2013

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI SA ÎN LICHIDARE	4,978.38
2	S.C. OLTCHIM S.A.	3,372.78
3	RADET BUCUREȘTI	2,763.46
4	CNCF CFR S.A.	1,051.87
5	S.N.T.F.C. CFR CĂLĂTORI S.A.	914.44
6	REGIA AUTONOMĂ PENTRU ACTIVITĂȚI NUCLEARE	651.71
7	C.N.A.D.N.R. S.A.	592.86
8	C.N.M.P.N REMIN S.A.	580.95
9	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	547.76
10	S.C. CET IAȘI S.A.	525.63
	% total	**68.31%**

Top 10 arrears in Dec 2012

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI S.A.	4, 904.60
2	SC OLTCHIM S.A.	2,505.96
3	RADET BUCUREȘTI	2,412.76
4	SNTFM CFR MARFĂ S.A.	1,572.26
5	CNCF CFR S.A.	1,491.56
6	S.C. P.E.E.H. HIDROELECTRICA S.A.	1.058.58
7	S.N.T.F.C. CFR CĂLĂTORI S.A.	762.28
8	C.N.M.P.N REMIN S.A.	576.51
9	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI S.A. PLOIEȘTI	516.86
10	S.C.UZINA MECANICĂ CUGIR S.A.	457.00
	% total	**64.10%**

Top 10 arrears to consolidated general budget in Dec 2014

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI S.A. ÎN LICHIDARE	4,851.92
2	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI S.A.	505.66
3	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	454.51
4	CENTRALA ELECTRICĂ DE TERMOFICARE IAȘI (C.E.T.) S.A.	407.93
5	SC COMPLEXUL ENERGETIC HUNEDOARA S.A.	293.48
6	MOLDOMIN S.A.	260.77
7	SOCIETATEA NAȚIONALĂ A CĂILOR FERATE ROMÂNE R.A.	241.74
8	SC ELECTROCENTRALE CONSTANȚA	185.97
9	REGIA AUTONOMĂ PENTRU ACTIVITĂȚI NUCLEARE RA	175.80
10	INTERVENȚII FEROVIARE S.A.	175.01
	% total	**74.27%**

Top 10 arrears to consolidated general budget in Dec 2013

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI SA ÎN LICHIDARE	4,968.50
2	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI SA PLOIEȘTI	505.37
3	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	501.87
4	UZINA MECANICĂ CUGIR S.A.	453.54
5	S.C. ELECTROCENTRALE BUCUREȘTI S.A.	421.53
6	S.C. CET IAȘI S.A.	388.18
7	SNCFR R.A.	267.51
8	S.C.MOLDOMIN S.A.	263.03
9	S. U.M.SADU S.A.	183.17
10	S.C. INTERVENȚII FEROVIARE S.A.	168.99
	% total	**72.14%**

Top 10 arrears to consolidated general budget in Dec 2012

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI S.A.	4,865.40
2	SNTFM CFR MARFĂ S.A.	876.92
3	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI S.A. PLOIEȘTI	505.30
4	C.N.M.P.N REMIN S.A.	501.09
5	S.C.UZINA MECANICĂ CUGIR S.A.	449.80
6	CNCF CFR S.A.	304.98
7	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	273.70
8	SNCFR R.A.	267.55
9	S.C.FORTUS S.A. IAȘI	252.38
10	S.C. ELECTROCENTRALE BUCUREȘTI S.A.	220.80
	% total	**75.50%**

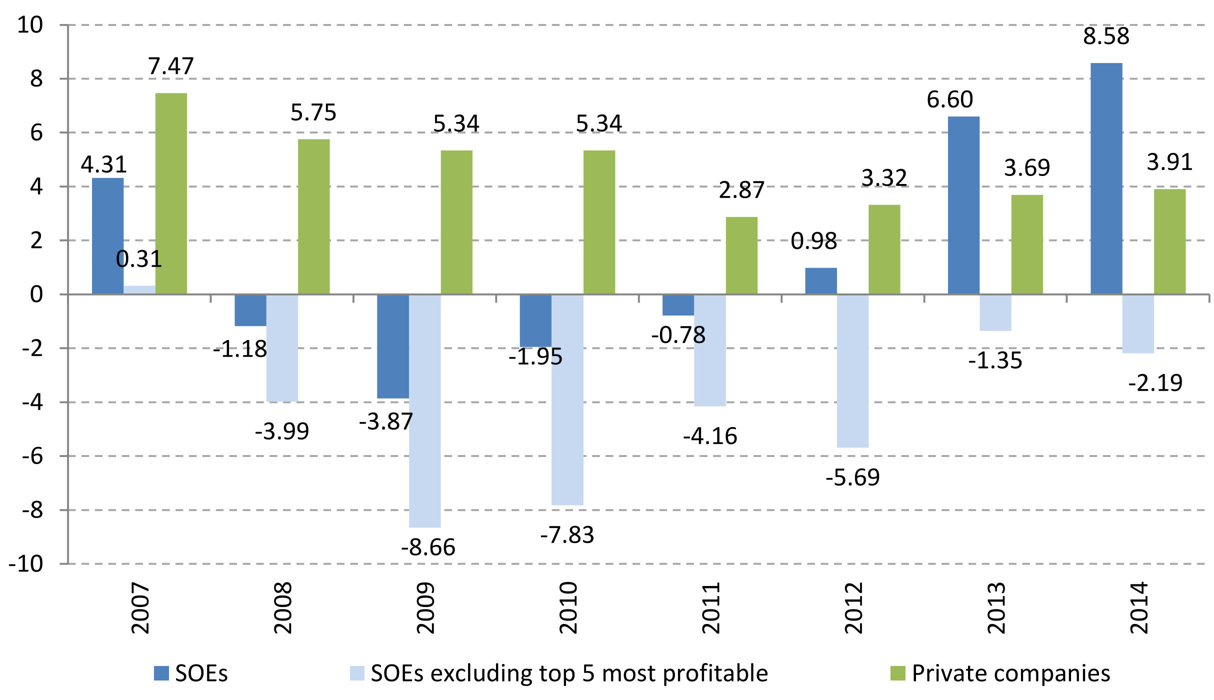
Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

Table 20: SOEs arrears evolution by type of company								
Total arrears (million lei)	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Autonomous administrations	960.09	1,130.70	1,411.14	2,019.32	3,153.75	3,662.52	4,539.81	5,515.00
Companies owned 100% by the state	5876.08	6,802.97	8,102.41	9,648.19	7,670.87	5,605.94	6,325.26	5,378.51
National companies and societies	5511.38	7,945.22	23,710.69	15,032.90	12,773.24	10,350.17	8,657.59	7,300.42
Other state – owned companies or majority-state – owned companies	74.93	77.60	184.32	298.81	769.32	879.87	1,484.01	1,187.36
State – owned companies, local and foreign state capital (state capital >= 50%)	4.65	5.52	1.05	0.26	46.28	3.27	1.35	1.76
State –owned companies, local and foreign private capital (state capital >=50%)	529.42	717.28	35.38	78.59	330.44	2,551.90	3,412.91	3,423.14
State –owned companies and with local private capital (state capital >=50%)	552.79	609.37	957.00	932.08	1,504.96	2,308.42	1,764.89	1,560.32
State –owned companies and with foreign private capital (state capital >=50%)	2.11	0.86	1.66	0.37	0.47	0.43	0.77	1.17
State –owned companies, privatized in the reporting year	178.37	4.81	1.38	1.79	2.06	0.62	0.51	1.80
TOTAL arrears	**13689.81**	**17,294.33**	**34,405.02**	**28,012.31**	**26,251.39**	**25,363.13**	**26,187.10**	**24,369.48**

Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

The year 2014 witnessed a favorable development of the aggregate financial performance of the state owned companies, as they registered a higher efficiency of their activities, which has begun in 2013. Thus, the rate of operating surplus increased compared to 2013 by about 1.98 percentage points, up to a level of 8.58%, even higher than that recorded by private companies (3.9%). However, the operating surplus has recorded negative values throughout the period analyzed when the best performing five state owned companies in terms of profit are excluded. Nevertheless, we can notice a significant improvement trend at the level of this indicator until 2013, when it has recorded a level of -1.35% compared to -5.69% in 2012, deteriorating in 2014 to -2.19%. The operating surplus worsened, however, in 2014 by 0.84 pp from the previous year, reaching -2.19%. The gap recorded when we exclude the best performing five state owned companies is significantly, suggesting the high impact of these five companies on the aggregate level. In addition, the Top 5 manage to record a performance which counterbalance the underperformance of the other state owned companies, positively adjusting the average of the whole sector of state owned companies.

Figure 43: Operating surplus ratio (%)

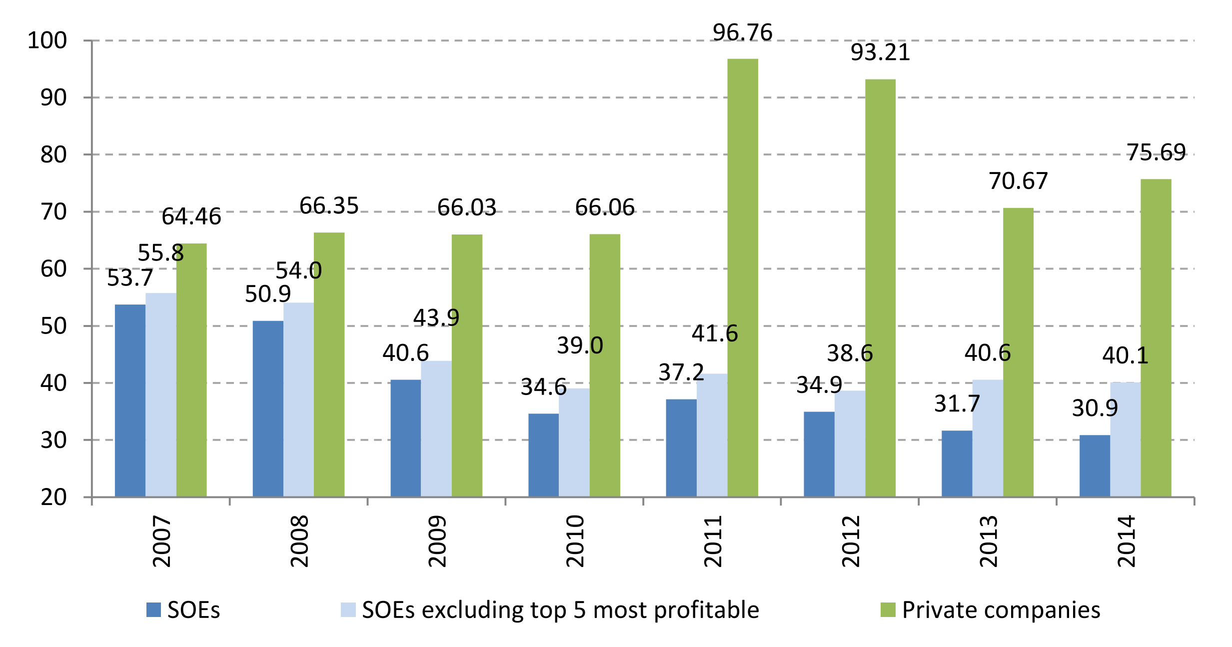


Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

*Note: Operating surplus (%)=Operating surplus/ Total income * 100*

Regarding state companies' ability to cover their debts with the available assets, reflected by the degree of solvency, there has been a favorable development, the share of debt in total assets droped to 30.9% from 31.7% due to lower total debt, the level being significantly lower than the 75.7% recorded by the private companies. Furthermore, the latter increased their debt ratio in the past year, unlike state companies, investments being also carried out from external sources. This result is influenced, however, by the uneven distribution of indebtedness of state companies, among which are found very large companies with a very low degree of debt. Thus, excluding the top five best performing companies, the solvency ratio is reduced from 40.6% to 40.1% due to a higher growth of the assets relative to debt. Note, however, that excluding the top five companies, the remaining state companies are obviously more indebted and the reduction of the solvency ratio at the aggregate level is mainly due to the best performing companies.

Figure 44: Solvency ratio (%)

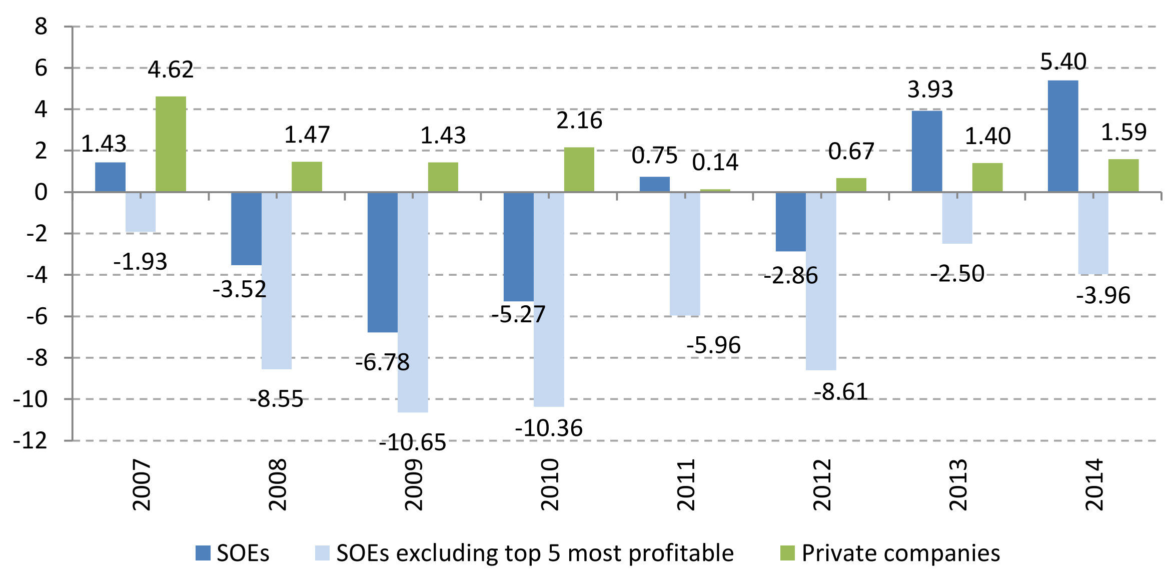


Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

*Solvency ratio (%)=Total debt / Total assets * 100*

The improvement of SOEs' operational performance was visible in the level of the profit margin which increased to 5.4% in 2014 from 3.93% in the previous year, given that in 2008-2012 this indicator registered negative values. Furthermore, the profit margin for state owned companies is higher than the one for private companies (1.59% in 2014, up by 0.19 percentage points compared to previous year), an outcome explained by the positive trend of the top five best performing SOEs. Thus, when excluding the Top five companies, the profit margin recorded negative values throughout the analyzed period, reaching -3.96% in 2014, respectively a deterioration of 1.44 percentage points compared to the previous year, but an improvement of 4.65 pp compared to 2012. The differences between the operating surplus and the profit margin are explained by the fact that the latter takes into account the financial and the extraordinary result. Thus, due to the negative impact of interest expenses on net profit during the whole period, the profit margin has lower values compared to the operating surplus.

Figure 45: Profit margin (%)

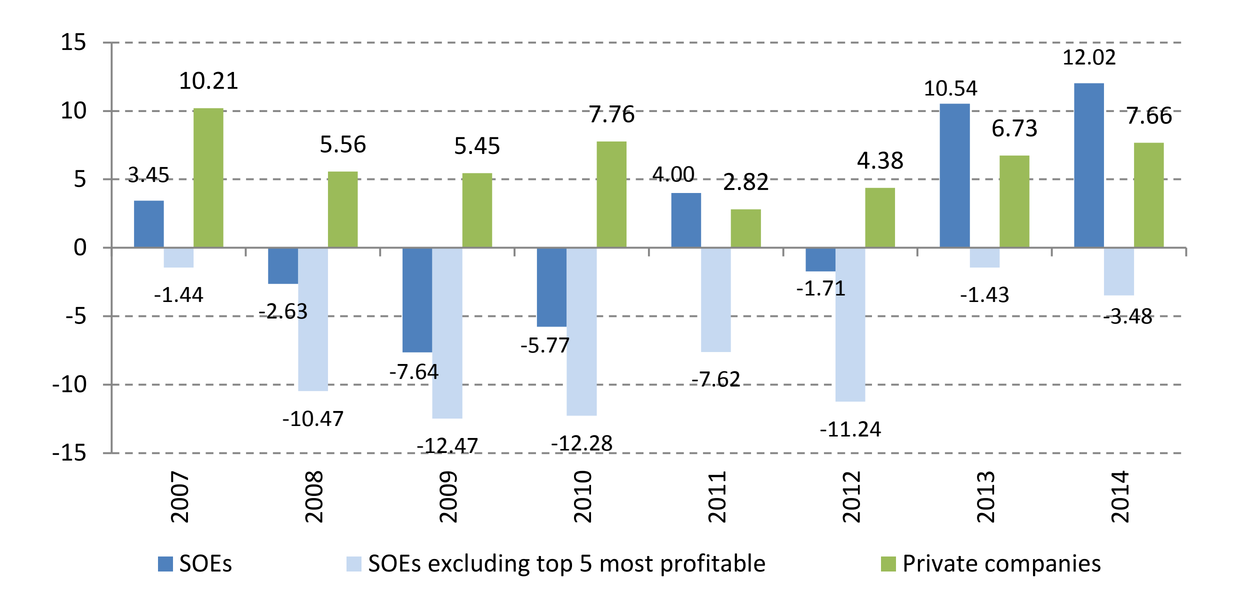


Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

*Note: Profit margin (%)=Net result/Total income*100*

The results of SOEs' profitability compared to private companies are confirmed also by the indicator: gross profit per 1000 employees which experienced a very good evolution in the period 2013-2014 for SOEs, its level being about 57% higher than in the private sector in 2014. Once again, the positive trend in the evolution of public companies is due to the top five best performing companies, given that in 2014 they recorded a gross profit of 4,525 million lei while the other state companies recorded losses of 957.37 million lei. Therefore, the spread between the gross profit of the top five and of the others is considerable, significantly influencing the global assessment of the SOEs' profitability.

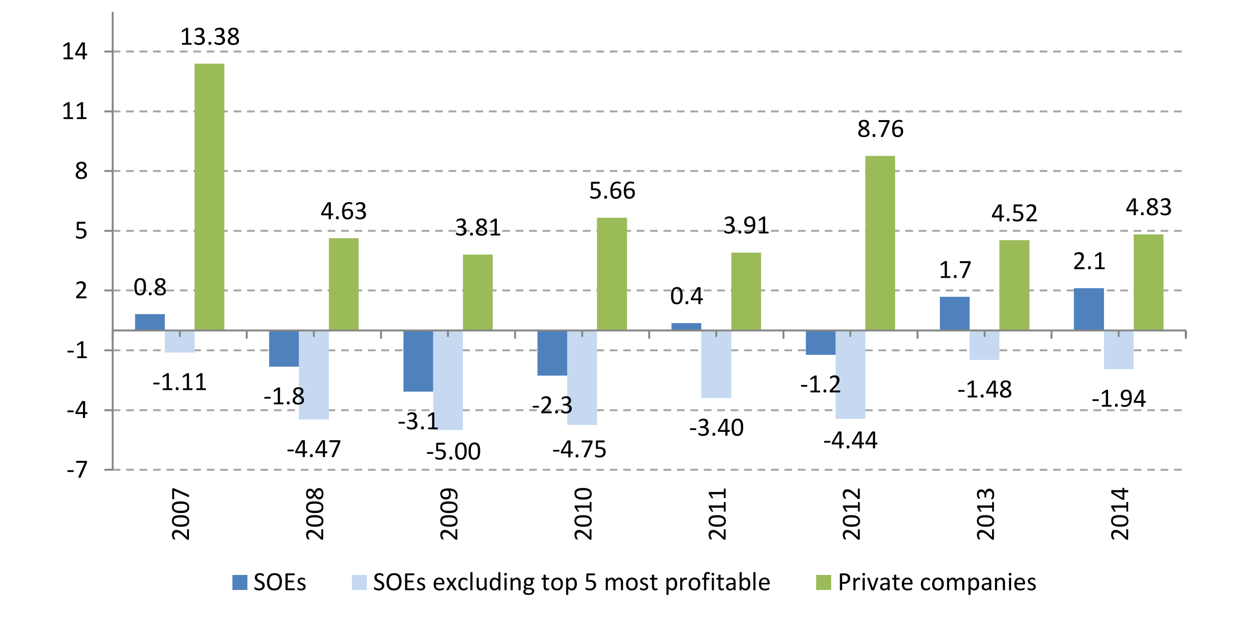
Figure 46: Gross profit per 1000 employees (thousands lei)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

The 2013 upward trend of the return on equity (ROE) and the return on assets (ROA) also continued in 2014 due to a favorable dynamic of the net profit. Return on equity has reached a level of 2.1%, while return on assets was 1.46%. This favorable evolution is also explained by the positive trend of the top five best performing state companies. If we do not take them into consideration, the evolution of the two indicators worsened in 2014 compared to the previous year, registering ROE -1.9% compared to -1.5% in 2013 and ROA -1.2% compared to -0.9%, the level registered in the previous year. However, at the aggregate level, it is worth noting that all profitability indicators are higher in the public sector, except return on equity, as a result of higher capitalization of SOEs compared to private enterprises.

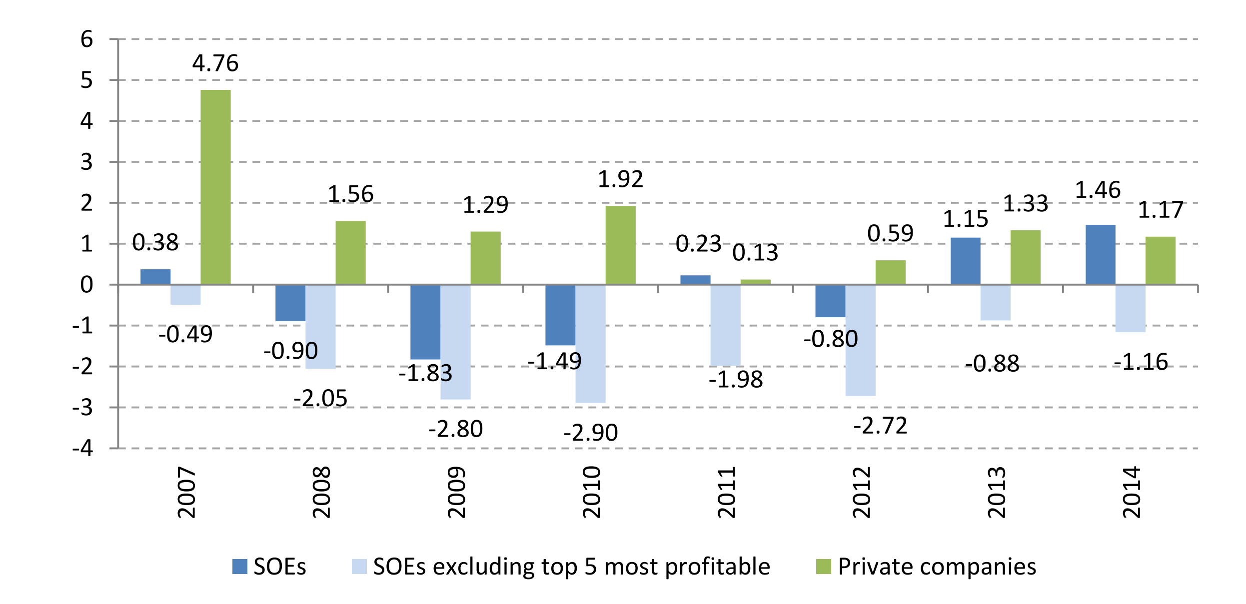
Figure 47: ROE (%)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

Note: ROE(%) = Net Profit / Equity

Figure 48: ROA (%)

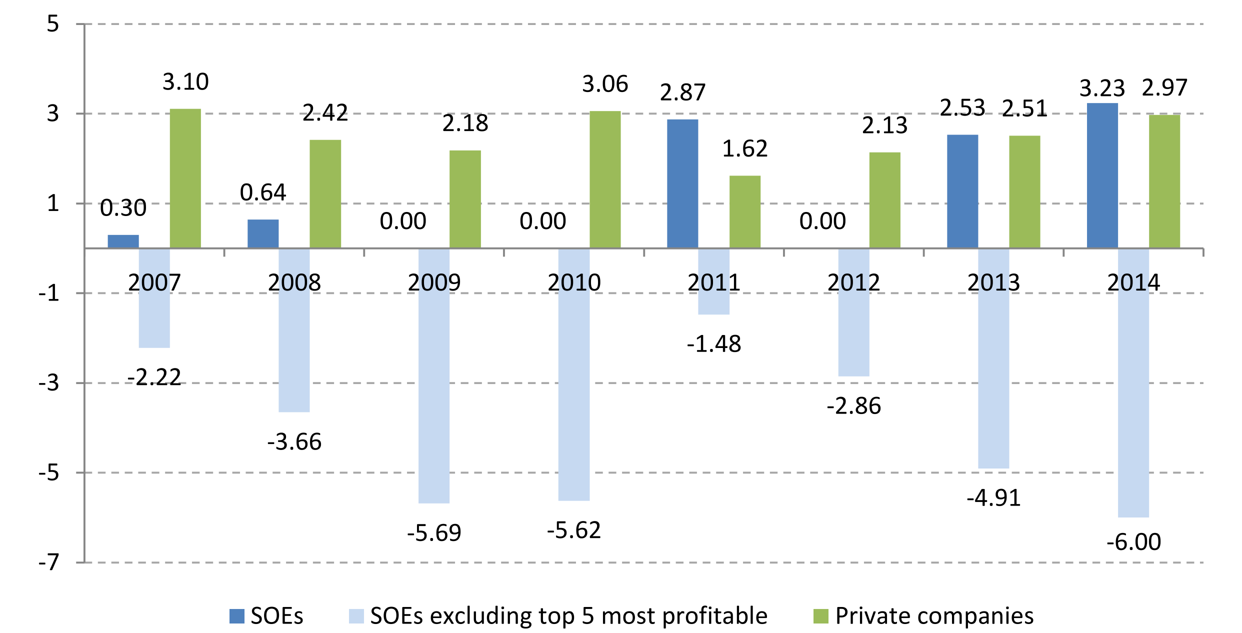


Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

Note: ROA(%)=Net income / Total assets

The state-owned companies' position continued to improve also due to their ability to pay interest costs, reflecting a better ability of state owned companies to service their debts. Thus, in 2014, the interest coverage ratio was 3.2, slightly higher than the one for private companies, while in 2009, 2010 or 2012 this indicator had very low values. The improvement of this indicator can be explained by both the fall in debt ratio and the rise of SOEs' profitability. But if we do not take into consideration the Top 5 best performing state owned companies, its value is negative due to recording losses, which obviously makes debt repayment more difficult and even deteriorating.

Figure 49: Interest coverage ratio

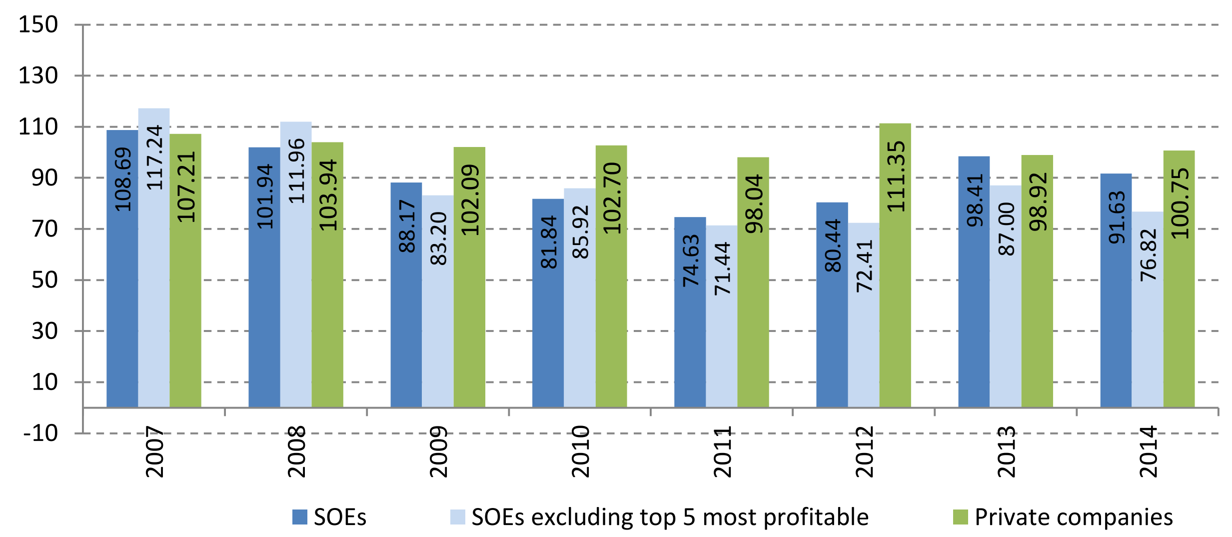


Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

Note: Interest coverage ratio = (Profit or current loss + interest expenses – interest incomes)/interest expenses

In terms of liquidity, state companies were significantly affected by the financial crisis, in 2009-2012 their liquidity rate being significantly lower than in the private sector, indicating a significant deficit of current assets versus current liabilities; in 2013 this gap was reduced, the liquidity ratio in the two sectors being approximately equal (98.4% and 98.8%). Instead, the liquidity ratio of state owned companies for 2014 decreased, but remained at a higher level than in 2008-2012, while the liquidity ratio of the private companies has increased, however both categories of companies recorded a level of this ratio that can be assessed as adequate. If we do not take into consideration the top five best performing companies, the liquidity ratio recorded in 2014 compared to 2013 a decline of 3.4 pp, higher than the one from the aggregate level, an otherwise anticipated outcome judging by the similar development of the other performance indicators analyzed.

Figure 50: Liquidity ratio (%)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

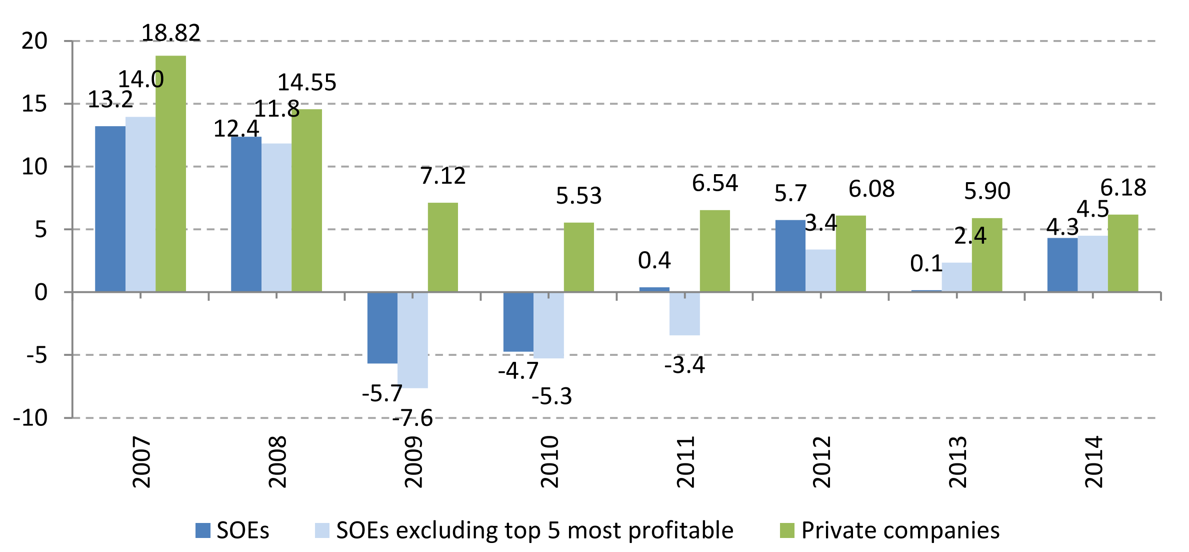
*Note: Liquidity ratio (%) = current assets / short term debts *100*

As a result of improved financial performance, the ability of state-owned companies to make new investments has increased compared to 2013. As we can see in the next figure, the share of new investments in total assets increased, but their value remains lower than the ones made by the private companies. In addition, unlike the performance indicators analyzed above,in the case of exclusion of the Top five companies, one can notice a share of 0.2 pp higher than that recorded at the aggregate level.

Even though the gap narrowed, the need for investment is more pronounced at SOEs than for private companies. Considering the deleveraging of SOEs, it can be appreciated that the new investments were mainly self-financed.

The improvement of SOEs' performance was also supported by the legislative reforms embodied by the enforcement of the Emergency Ordinance no. 109/2011 regarding corporate governance of public enterprises. This represented a major step in the implementation of good corporate governance practices and aimed at depoliticizing and professionalizing the management of SOEs, both regarding the selection, appointment and functioning of the Board of Directors and managers, and in terms of increasing transparency and providing information in order to make the public companies more responsible. The overall performance of SOEs has improved also due to the entry in liquidation procedure of the National Coal Company and Termoelectrica. However, it is important to say that the level of financial performance is not evenly distributed among SOEs, there are some companies highly profitable and had a positive development in recent years, but also many companies have problems both in terms of arrears and profitability. In this context, the reform of SOEs should continue and a special emphasis should fall on identifying companies with problems and propose consistent recovery measures.

Figure 51: New investments (% of total assets)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

The impact of state companies on the budget deficit in European standards based on commitments (ESA10) may be an additional pressure on the budget deficit targets undertaken by the government in accordance with the Maastricht criteria (below 3% of GDP in ESA10 terms) and the Fiscal Compact (structural deficit below 1% of GDP). The impact on the budget deficit in ESA10 standards manifests (i) by the issuance of state guarantees (also subject to EU rules on state aid) and especially (ii) by the reclassification of state enterprises within the public administration.

According to the Eurostat methodology for accrual accounting (ESA10), several SOEs have been reclassified in the government sector. The 145 SOEs consolidated in central government sector had a positive influence on the general consolidated budget deficit in ESA10 standards in 2011-2014, except the year 2012. The table below shows the contribution to consolidated budget deficit of the first 25 state owned companies included in the central government according to the influence they have on the consolidated deficit in ESA10 standards. Regarding state owned companies consolidated in the local government, they had a slightly negative contribution to the consolidated deficit in ESA10 standards in 2011-2014, except the year 2011.

Table 21: Contribution of state companies included in the public sector to the consolidated budget deficit (mn. lei), ESA 2010 standards

	2011	2012	2013	2014
1. Total central companies	**1,236.8**	**-382.7**	**2,475.3**	**3,198.2**
Compania Naţională de Autostrăzi şi Drumuri Naţionale	1,100.5	-1,435.0	2,171.6	2,274.3
CN de Căi Ferate CFR SA	181.5	1,532.8	225.5	494.6
CFR Călători SA	62.6	-186.3	95.5	472.0
Metrorex	-18.1	-6.1	76.8	28.6
SC DANUBIANA SA	11.5	-1.5	1.2	4.4
Societatea Natională Aeroportul Internațional Mihail Kogălniceanu	-0.4	-0.1	0.3	2.6
CN ROMARM SA- Filiala Uzina Mecanică București	0.0	-11.3	-9.8	2.5
Administraţia fluvială Dunărea de Jos Galaţi	-0.6	-20.6	25.6	1.5
SC AVERSA SA	0.0	-18.2	-11.1	0.1
CN de Radiocomunicaţii Constanţa	0.2	-0.2	0.2	0.1
Fondul Proprietatea	192.3	-6.6	0.0	0.0
SC Electrificarea SA (SC Electrification SA)	-24.1	-9.2	0.0	0.0
SC CN Romarm SA Buc - Filiala SC Uzina Mecanica Cugir SA	4.0	-37.3	0.0	0.0
SC CIPROM SA	-14.8	3.6	0.0	-0.2
SN a Cărbunelui	-0.2	-0.4	1.3	-0.3
CN Administratia Canalelor Navigabile Constanţa SA	-1.7	4.9	13.2	-0.6
SC Sanevit 2003 SA	-0.8	-1.4	-0.7	-1.8
SC Avioane Craiova SA	-5.9	-2.1	-5.3	-2.6

	2011	2012	2013	2014
SC Intervenţii feroviare SA	-4.5	-8.3	-4.4	-3.0
SC Uzina AutoMecanică SA Moreni	-4.0	-2.0	-2.8	-4.9
SC Construcții Aeronautice SA	-0.8	-0.9	-1.8	-5.5
SC Uzina Mecanică Orăștie	-9.9	-9.4	-8.3	-6.1
SC Termoelectrica SA	-24.5	-89.0	-60.0	-15.4
CN a Huilei Petroşani	-205.5	-57.9	-35.8	-19.4
SC Uzina Mecanică Sadu	0.0	-20.2	4.1	-22.7
2. Total local companies	**40.6**	**-180.7**	**-250.4**	**-19.6**
Aeroporturi locale	14.5	-15.4	-14.4	-20.4
Centrale Termice de subordonare locală	-64.2	-24.0	-47.6	-0.9
Alte unităţi locale	90.3	-141.3	-188.4	1.7
3. Total SOEs	**1,277.4**	**-563.4**	**2,224.9**	**3,178.6**
% of GDP	**0.23%**	**-0.09%**	**0.35%**	**0.48%**

Source: NIS

The financial performance of SOEs experienced a significant improvement in 2014 in terms of profitability, solvency and liquidity indicators, their dynamics being superior to the ones from the private sector, but there is still an imbalance between the contribution of these companies to the turnover of the total economy and the share in total arrears of the outstanding payments or of the number of employees in total employment of the economy. Moreover, the profitability of the state companies is decisively influenced by the high profit levels achieved by top performing five companies, removing their contribution points out losses across all other state companies during the entire analysis. Thus, the latter are characterized by low efficiency and even if there have been made important steps in terms of their profitability, there are still required additional efforts to strengthen sustainable progress. Fiscal Council advocates a comprehensive analysis of SOEs, reflecting their real situation at the aggregate level beyond the strong financial performance of few companies. The focus can be laid on transposition of corporate governance principles and strengthening of private management for these companies on performance basis.

V.2. Arrears of the general consolidated budget

In 2014, the general consolidated budget arrears[54] to the private sector were situated approximately at the same level compared to the previous year, reaching a value of about 126 million lei at the end of the fourth quarter of 2014 compared to 216 million lei recorded a year

[54] According to the Public Finance Law no. 500/2002 with subsequent amendments and supplements are considered arrears overdue payments older than 90 days, calculated from the due date.

ago. Practically the notable improvement recorded in 2013, due partly to the exclusion of a part of the outstanding payments from the statistics, based on the inspections conducted by the NAFA who challenged the legality of such expenditure[55], continued in 2014 even if during the year there were some small scale oscillations. It should be noted that these amounts in litigation can generate future payment obligations for the general consolidated budget and their simple disposal of records is not equivalent with the final extinction of debt.

Table 22: Quarterly evolution of GCB arrears in 2014 (million lei)

	QIV 2013	QI 2014	QII 2014	QIII 2014	QIV 2014
State budget	**180.2**	**158.9**	**132.8**	**157.1**	**119.5**
Under 90 days	160.3	123.1	96.6	114.6	113.8
Over 90 days	5.0	9.5	11.5	7.2	2.8
Over 120 days	12.7	22.9	19.9	29.2	1.5
Over 360 days	2.3	3.4	4.8	6.1	1.2
Local authorities	**1,011.2**	**946.2**	**927.8**	**1,078.6**	**775.6**
Under 90 days	815.0	650.8	721.7	870.5	654.9
Over 90 days	69.1	128.5	47.5	75.9	80.9
Over 120 days	7.1	73.3	84.5	62.2	24.6
Over 360 days	120.0	93.7	74.0	70.0	15.2
Social security budget	**717.1**	**651.5**	**150.0**	**118.9**	**72.6**
Under 90 days	717.1	651.4	149.9	118.9	72.6
Between 90 şi 360 days	0.1	0.1	0.1	0.0	0.0
Total	**1,908.7**	**1,756.6**	**1,210.5**	**1,354.6**	**967.7**
Under 90 days	1,692.3	1,425.4	968.3	1,104	841.3
Over 90 days	74.1	138.0	59.0	83.1	83.8
Over 120 days	69.8	96.2	104.5	91.4	26.1
Over 360 days	72.4	97.1	78.8	76.2	16.5
Total arrears (90-360 days)	**216.3**	**331.3**	**242.3**	**250.7**	**126.4**

Source: Ministry of Public Finance

[55] The amounts were contested for one of the following reasons: infringements of the provisions or relevant regulations laws, billing or inadequate purchasing or lack of the records regarding the execution of the invoiced works.

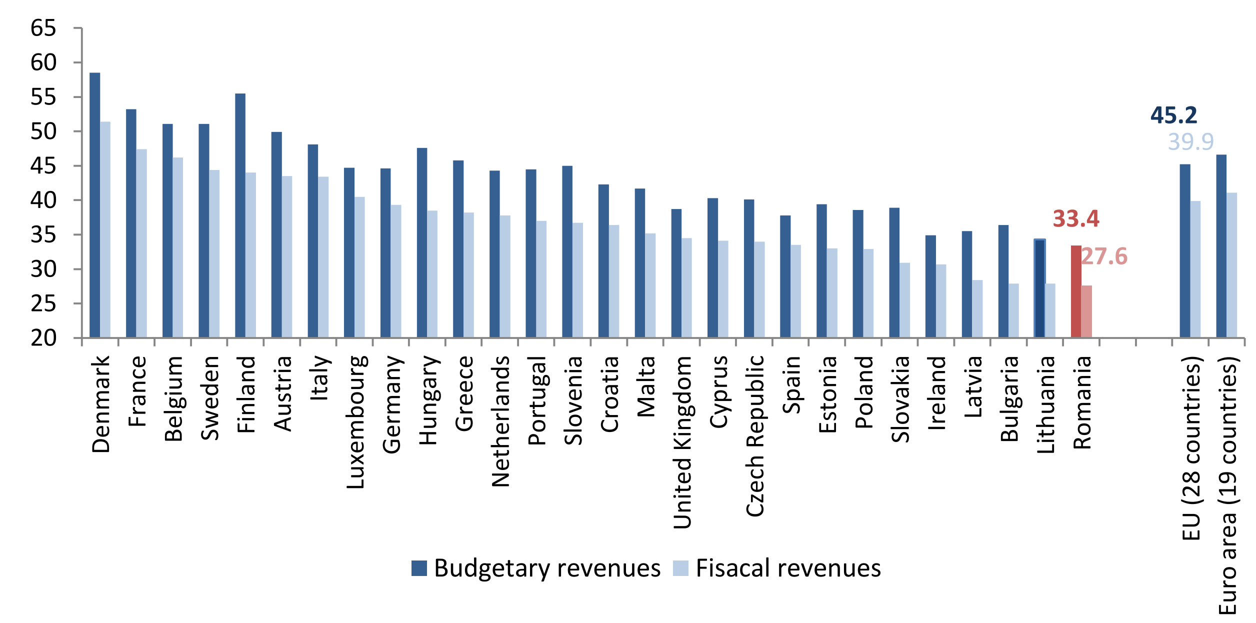
Continuing the legislative efforts initiated in 2013, a series of measures were also adopted in 2014 in order to reduce the stock of the outstanding payments registered at the local authorities level: restraining the possibility of the local authorities to contract new loans strictly to loans for extinction of arrears and limiting the hiring of personnel to ensure budgetary space required for the extinction of the arrears.

Regarding the outstanding payments with a delay of less than 90 days which do not fit into the category of arrears, according to the Public Finance Law no. 500/2002, they are still relevant being at a level of about 970 million lei at the end of 2014, but recorded a significant decline of 40% from the 1.9 billion lei reached a year ago. The decrease was mainly located in the arrears to the social security budget, these registering a decrease of 89% or 644.5 million lei. The favorable evolution of outstanding payments of the general consolidated budget in the last two years is explained primarily by the implementation of the Directive 2011/7/EU on combating late payment in commercial transactions.

V.3 Tax collection in Romania – international comparisons

Compared to EU member states, Romania recorded in 2014 the lowest shares of government revenues to GDP (tax and non-tax revenue), these representing only 33.4% of GDP, 11.8 pp lower than the EU average (45.2% of GDP). The level of tax revenues to GDP (taxes and social contributions) in Romania reached 27.6% of GDP in 2014, being also in the last place with a difference of 12 pp compared to the EU average which is 39.9% of GDP. Analyzing the data according to ESA 2010 methodology, the gap between Romania and the EU average decreased by 0.6 pp of GDP while in the case of tax revenues it decreased marginally by 0.1 pp of GDP. The share of tax revenue to GDP is significantly lower than in similar economies like Hungary (38.5%), Slovenia (36.7%), Czech Republic (34.0%) and Poland (32.9%).

Figure 52: Budgetary revenues and fiscal revenues in 2014 (% of GDP, ESA 2010)



Source: Eurostat; Tax revenues include social contributions.

The structure of tax revenue in Romania, relatively unchanged from 2013, reveals a high share of revenues from indirect taxes, respectively 46.4% of total tax revenue compared to the EU28 average of 33.8%, while the share of revenue from social security contributions was 31.2% (2.6 pp below the average EU28) and from direct taxes - only 22.5% (9.8 pp below the average EU28). The indirect taxes are the main component of tax revenues, their weight being significantly above the EU average (by 12.6 pp), given that the fiscal consolidation initiated in 2010 included on the revenue side of the budget an increase in indirect taxes that led to a widening gap between Romania and EU average in this respect.

From the perspective of tax revenue collection, it can be appreciated that the tax system in Romania is characterized by low efficiency, the weak tax collection being largely due to an inefficient administration, a complicated methodology combined with a lack of predictability but also to a small tax base, to many legal exemptions and deductions and increased tax evasion (*Chapter V.5 Tax evasion*). However, it has to be pointed out that over the past years several measures were initiated in order to improve this situation and the effects of the tax administration reform initiated in 2013 may in time lead to the realization of the objectives regarding the simplification of the tax system, the reduction of the tax evasion and the increase of the tax collection.

The simplification of the tax system and the reduction of the bureaucracy occur gradually, the progresses are evidenced by the World Bank report – “Paying Taxes 2015”, according to which, in the ranking of the ease of paying taxes by a firm of medium size, in 2013[56] Romania has registered a notable progress (of 82 positions) compared to the previous year's edition reaching on the 52nd rank from 189 economies around the world compared to 134th rank occupied in 2012[57]. This remarkable improvement was determined by measures taken by the tax authorities in 2010-2013 to facilitate electronic payments and online submission of declarations, but should be also considered the changing of the calculation methodology which results in making the hierarchy compared to the previous year (see *Box 1*). In 2014, according to World Bank report – Doing Business 2016, Romania reached on the 55th rank, compared to the 52nd rank of 2013.

Box 1: Calculation methodology used by the PricewaterhouseCoopers and the World Bank in the *Paying Taxes* report

Paying Taxes report realized by the PricewaterhouseCoopers (PwC) and the World Bank (WB) analyzes the ease of paying taxes in 189 economies worldwide by examining three indicators at the level of medium-sized companies: the total tax rate (the share of taxes and contributions paid by a firm as a percentage of profit), the time required to comply with tax laws (number of hours allocated by a company to fulfill its reporting obligations and payment of taxes imposed), and number of payments that a company must make to fulfill tax obligations.

Paying Taxes report considers the all taxes and social security contributions that a medium-sized company has to pay to the State during the year. Taxes and social security contributions taken into account include: corporate income tax, social contributions and labor taxes paid by the employer, property taxes, property transfer taxes, dividend tax, capital gains tax, financial transactions tax, waste collection fees, taxes on vehicles, road tax and other taxes.

Although the three indicators considered have not changed, compared to previous editions, this year the methodology used to rank countries is totally different. Thus, it is no longer based on the comparison of the three indicators between countries, but it considers the so-called measure distance to the frontier (DTF). The frontier is practically the best performance observed at the level of the each analyzed indicators in all economies from the sample. The distance to the frontier of an economy is reflected on a scale of 0 to 100, where 0 represents the lowest performance and 100 is the frontier and the score is a measure of how far is an economy from the best performance at that time. With DTF is assessed the level of the performance recorded regarding the environment of the tax legislation and how it improves

[56] Paying Taxes 2015 report uses 2013 as a reference.

[57] According to Paying Taxes 2014.

over time. Thus, the difference between the score regarding the DTF for a country in any year and score recorded this year illustrates the extent to which this has reduced the difference to the frontier in time, respectively the relative advance to the best practices and not compared to the average of the other countries as was shown in reports from the previous years. The general score is calculated as a simple average of the DTF scores for each sub-indicators (number of payments, time and total tax rate). Regarding the time required for the payment of taxes, the frontier is defined as the lowest recorded time taking into account all the economies that perceive the three major taxes: income tax, employment taxes and mandatory contributions and other taxes (that include VAT). For the total tax rate, the frontier is the greatest value for the quantile of 15% from the total tax rates distribution for all countries in the years included in the analysis (for 2013 the threshold is 26.1%).

Compared to the data published last year, Paying Taxes 2015 report notes for Romania that in 2013 compared with 2012, the number of hours required to pay taxes decreased significantly, i.e. from 200 to 159 hours, the number of annual payments that a company should carry out for paying taxes also decreased considerably, from 39 to 14 payments and the share of taxes in the total profit slightly increased from 42.9% to 43.2%. According to the report, in 2013 a medium-sized company from Romania has carried out during one year a number of 14 tax payments (compared to a European average of 12.3 annual payments and a global average of 25.9 annual payments) and consumes for the calculation, the completion and the submission 159 hours of work (below the European average of 176 hours, respectively, well below the global average of 264 hours). In terms of the size of the overall rate of taxation (the share of taxes and social contributions in profit), Romania is placed above the European average of 41%, with a rate of 43.2%, placing themselves as well above the rate of 40.9% recorded globally.

Moreover, according to the Doing Business 2016 report, in 2014 both the number of hours required to pay taxes and the number of annual payments that a company should carry out for paying taxes remain constant, respectively at 159 hours and 14 payments. The total tax rate imporved in 2014, decreasing to 42% from 43.2%.

In 2013, Romania has achieved a notable progress regarding the streamlining of the payment of taxes, being one of the top ranked countries in Central and Eastern Europe, ahead of Poland (87), Hungary (88), Bulgaria (89), Slovakia (100) and the Czech Republic (119), but after Latvia (24), Estonia (28), Croatia (36), Slovenia (42) and Lithuania (44). In 2014, although Romania dropped three positions, it remains one of the top ranked countries in Central and Eastern Europe.

Table 23: Efficiency of tax administration										
	Estonia	Latvia	Slovenia	Lithuania	Bulgaria	Slovakia	Poland	Czech R.	Hungary	Romania
Year	**Ease of paying taxes (rank)**									
2011	50	52	63	60	91	100	114	120	118	**136**
2012	32	49	54	56	81	102	113	122	124	**134**
2013	28	40	42	20	89	100	87	119	88	**52**
2014	30	27	35	49	88	73	58	122	95	**55**
	Number of payments per year for the fulfillment of tax obligations*									
2011	8	7	11	11	15	20	18	8	12	**41**
2012	7	7	11	11	13	20	18	8	12	**39**
2013	7	7	11	11	13	20	18	8	11	**14**
2014	8	7	10	11	14	10	7	8	11	**14**
	Number of hours per year for the fulfillment of tax obligations**									
2011	85	264	260	175	454	207	286	413	277	**216**
2012	81	264	286	175	454	207	286	413	277	**200**
2013	81	193	260	175	454	207	286	413	277	**159**
2014	81	193	245	171	423	188	271	405	277	**159**
	The total tax rate***									
2011	67.3	36.6	34.7	43.7	28.7	47.9	43.8	49.2	50.3	**44.2**
2012	49.4	35.9	32.5	43.1	27.7	47.2	41.6	48.1	49.7	**42.9**
2013	49.3	35.0	32.0	42.6	27.0	48.6	38.7	48.5	48.0	**43.2**
2014	49.4	35.9	31.0	42.6	27.0	51.2	40.3	50.4	48.4	**42.0**

Source: World Bank

* This index shows the total number of taxes and contributions paid, payment method, payment frequency, frequency of completing tax returns and the number of agencies involved in the tax collection process for companies in the second year of operation. Where payment is made electronically, regardless of the frequency of payments, there is only one payment.

** This index shows the time to comply for preparing, filing and payment of main tax obligations: corporate income tax, social security contributions, labor taxes, and other taxes.

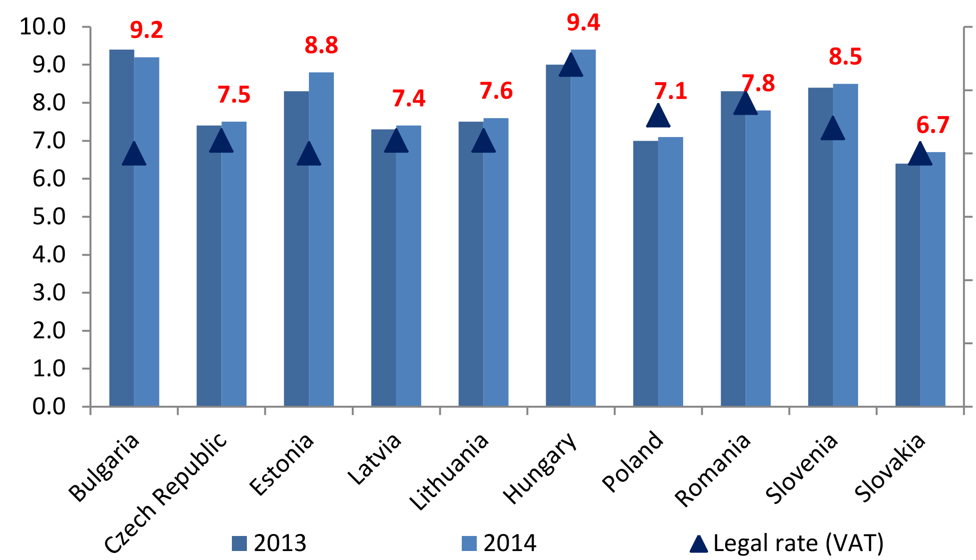
*** Indicator reflecting the share in the commercial profit of the amounts of taxes and compulsory social contributions paid by a company from the second year of activity.

Compared with similar economies, Romania is facing with a poor tax collection from taxes and social contributions. For example, although the legal VAT rate is the second largest of the new EU Member States, in 2014 Romania collected VAT revenue of only 7.8%[58] of GDP, which is below countries with lower statutory rate, as well as Estonia (legal VAT rate of 20%), Slovenia (standard VAT rate of 22%). Moreover, Bulgaria, having a structure of the economy similar to

[58] The level is lower by 0.5 pp compared to 2013 when they collected 8.3% of GDP.

that of Romania and a legal VAT rate of only 20%, collected revenue from VAT of 9.2% of GDP in 2014.

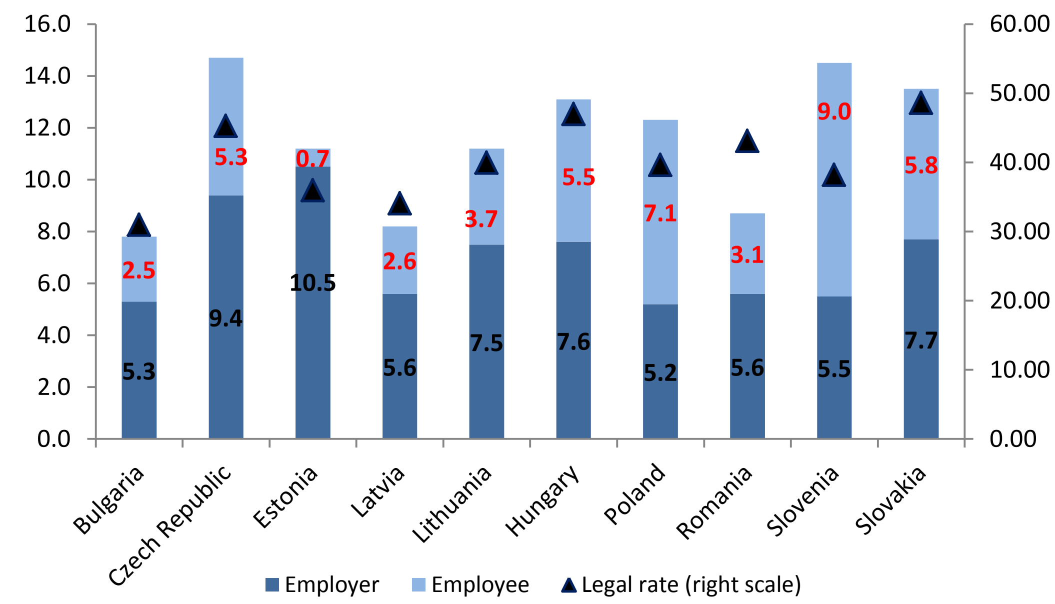
Figure 53: VAT revenues in 2014 (% of GDP)



Source: European Commission, Eurostat

Comparing with the other selected countries regarding the share in GDP of the revenues from social security contributions paid by employees and employers relative to the legal quota of social contributions, for Romania it is highlighted the low level of the collection (see *Figure 54*). Thus, the revenues from the contributions collected by Romania in 2014 were 8.7% of GDP (on a legal rate of social security contributions of 43.1%), being one of the smallest shares, surpassing only Bulgaria (which has legal rates of social security contributions much lower of about 31%) and Latvia (with a legal rate of 34.1%). Slovenia (14.5% of GDP), Poland (12.3% of GDP), Estonia and Lithuania (each with 11.2% of GDP) recorded budget revenues related to this category higher than in Romania, given that the legal rates are significantly lower for social contributions. Compared to the Czech Republic that collected from social contributions 14.7% of GDP, the legal quota in Romania is by only 2 pp lower.

Figure 54: Social contributions revenues in 2014 (% of GDP)



Source: European Commission, Eurostat

In April 2013, Romania has initiated a comprehensive reform of the tax collection system by launching the project regarding "Revenue Administration Modernization in Romania", managed by the NAFA, in partnership with the World Bank, aimed at increasing the efficiency and effectiveness in collection of taxes and social contributions, increasing the compliance and reducing the administrative burdens for taxpayers, which should materialize in the long term by significantly increasing the collected revenue and decreasing the administrative costs.

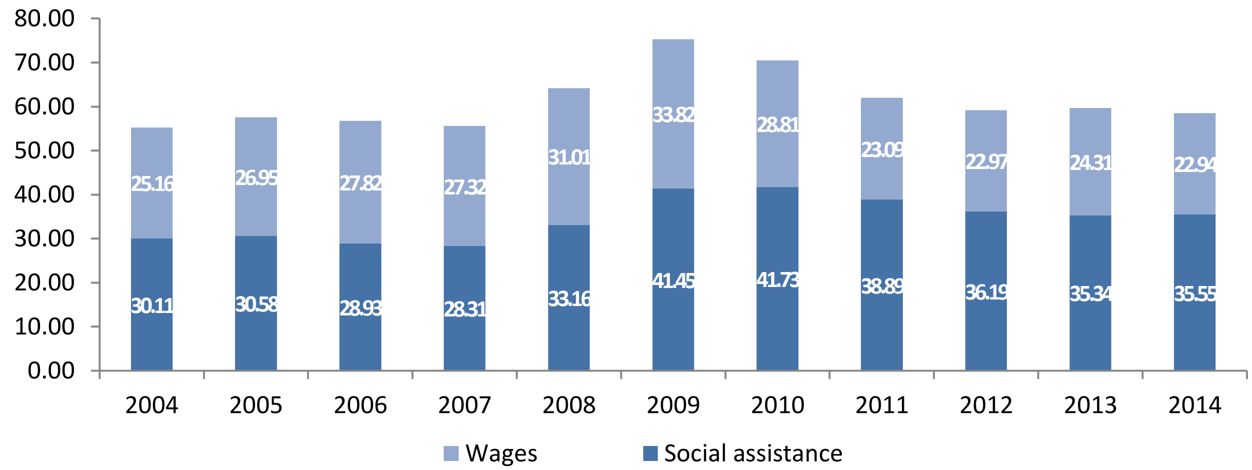
Although there has been a simplification of the bureaucracy, the results in terms of improving the collection efficiency did not occurred in 2014 giving that tax revenues (taxes and social contributions) were below the original budget provisions, despite the advance of the economy being significantly higher than the one considered in drafting the 2014 budget. The Fiscal Council admits that this reform process could take time to produce results, having the potential for generating fiscal space in the medium term. However, given the recent developments, the Fiscal Council draws the attention once again that the adoption of decisions regarding new tax cuts or increases of some expenses based on the potential efficiency gains should take place only *ex post*, after the reform proves irreversible and it is able to generate positive results in the long term.

V.4. Public expenditure – structure and sustainability

In Romania, the structure of the budgetary expenditures is characterized by the dominance of personnel and social assistance expenditure (pensions, social aids), but their relative importance has declined significantly in 2011 – 2014 as a result of the fiscal consolidation (*Figure 55*), i.e. up to 58.5% compared with an average of 70% in 2008-2010. After a relatively stable evolution of these items of expenditure, as a share of the budgetary revenues, before 2007, the personnel and pension expenditure strongly increased during 2008 and 2009, to a level much higher than the EU28 average, then diminishing below the level recorded in the CEE countries, with the exception of Hungary in 2013 and 2014. If the share of personnel expenditure in total budgetary revenues in 2014 is lower than during 2004-2007, social assistance expenditure represents a significant share of government revenue, much higher than in 2004-2007, even in the context of the adjustments made in recent years. Compared to the previous year, the share of social expenditure in the total budgetary revenues increased slightly by 0.21 pp, as the total revenues increased more slowly than this category of expenditure, while the wage bill decreased its share in total revenues with 1.37 pp[59]. Basically, at the end of last year the share of social assistance expenditures and of the expenditures with salaries in total budget revenues is close to that recorded in 2004-2007, except that the relative importance of the first category is currently higher to the detriment of the second.

[59] Although the budget execution in the cash standard indicates stronger advance of the personnel spending compared to that of the budgetary revenues, budget execution in the ESA 2010 standards shows a contrary evolution, and this is explained by the fact that payments for the executory titles relating the obligations of the State to certain categories of employees have already been recorded in the implementation of the budget according to European standards since 2011, currently affecting only the cash budget execution.

Figure 55: Social assistance and personnel expenditure as share of total budget revenues (%)

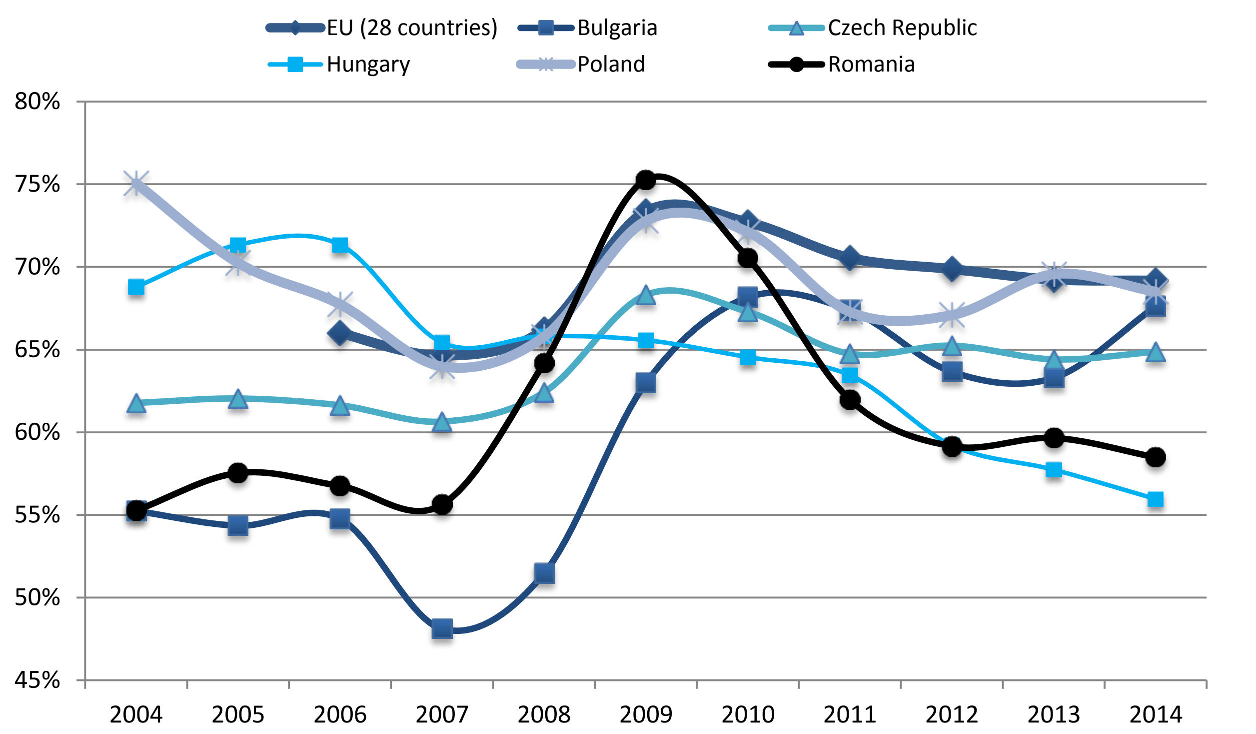


Source: Eurostat

Note: Data according to ESA 2010 - differences from the figures of the previous reports is due to the transition from ESA 95 methodology to ESA 2010.

The precarious state of the public pension system is an important vulnerability of the public finances position and the share of this expenditure category in total revenues is still too high, but applying the new pension law should support the objective of reducing the share of this expenditure category in total budgetary revenues in the medium-term. This objective, however, is currently jeopardized by the manifestation of some reversing pressures of the pension system reform initiated in 2010, with initiatives to restore some of the special pension disbanded by it. In terms of medium and long-term sustainability, it is important that any increases of wages in the public sector in the following years to be done only in line with the evolution of economic activity and, especially, with productivity gains.

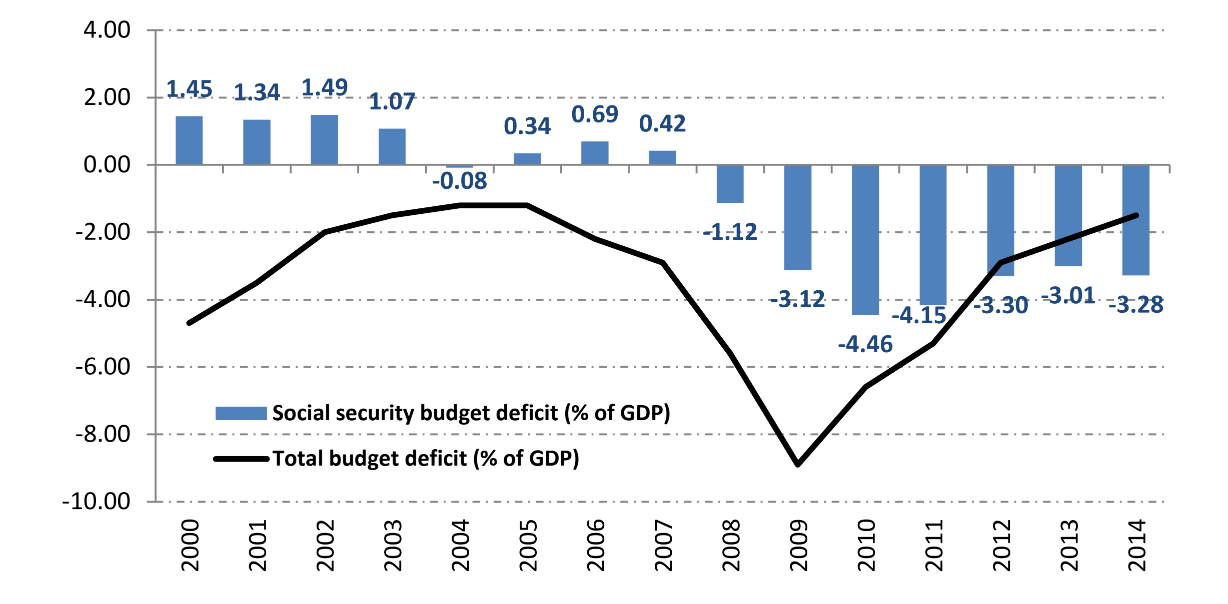
Figure 56: Social assistance and personnel expenditure (including pensions) in total budgetary revenues in EU 28 and CEE during 2004-2014



Sursa: Eurostat

If in 2000 – 2007, social security budgets (pensions, unemployment and health) were characterized by a relatively equilibrated or even positive balance, after 2008 the deficits have represented an important component of the general consolidated budget deficit, respectively between 67.5% and 218.7% in the period 2010 – 2014. Basically, in the latter year, Romania would have had a budgetary surplus if the social security budget had been in equilibrium. In particular, the deficit recorded in the public pension system (-1.9% of GDP) significantly affects the public finance position, representing a relevant risk to the sustainability of fiscal policy in the medium and long-run.

Figure 57: Social security budget deficit (pensions, unemployment and health) and total budget deficit – ESA 2010 (% of GDP)

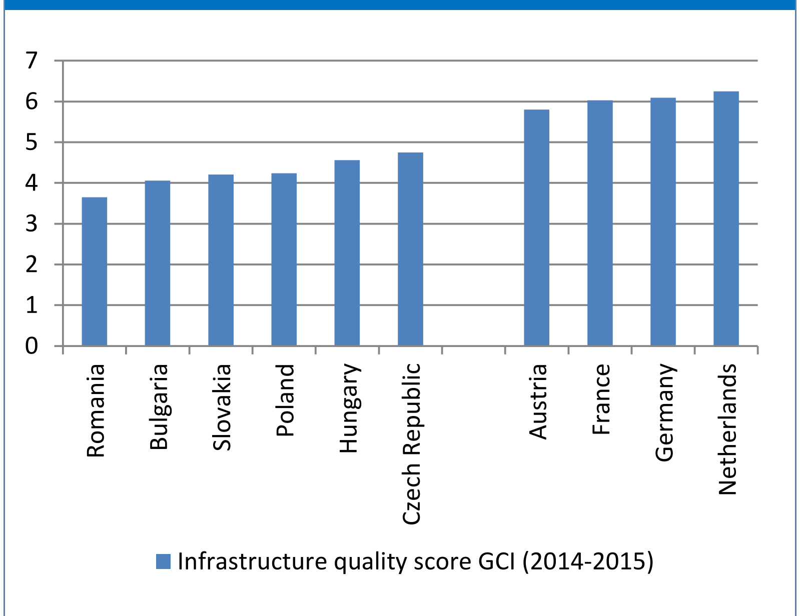


Source: Eurostat

Note: Data according to ESA 2010 - differences from the figures of the previous reports is due to the transition from ESA 95 methodology to ESA 2010.

The efficiency reserves on the side of budgetary expenditure are very high. For instance, Romania had the largest allocation for investment expenditure as a share of GDP (and also as share of total budgetary revenues) of all European countries during 2006 – 2014; however, the results were modest, as Romania is still characterized by the poorest infrastructure in the EU. This example clearly shows that the resources were spent inefficiently. Among the mitigating circumstances can be listed: the low level of GDP and initial quality of infrastructure.

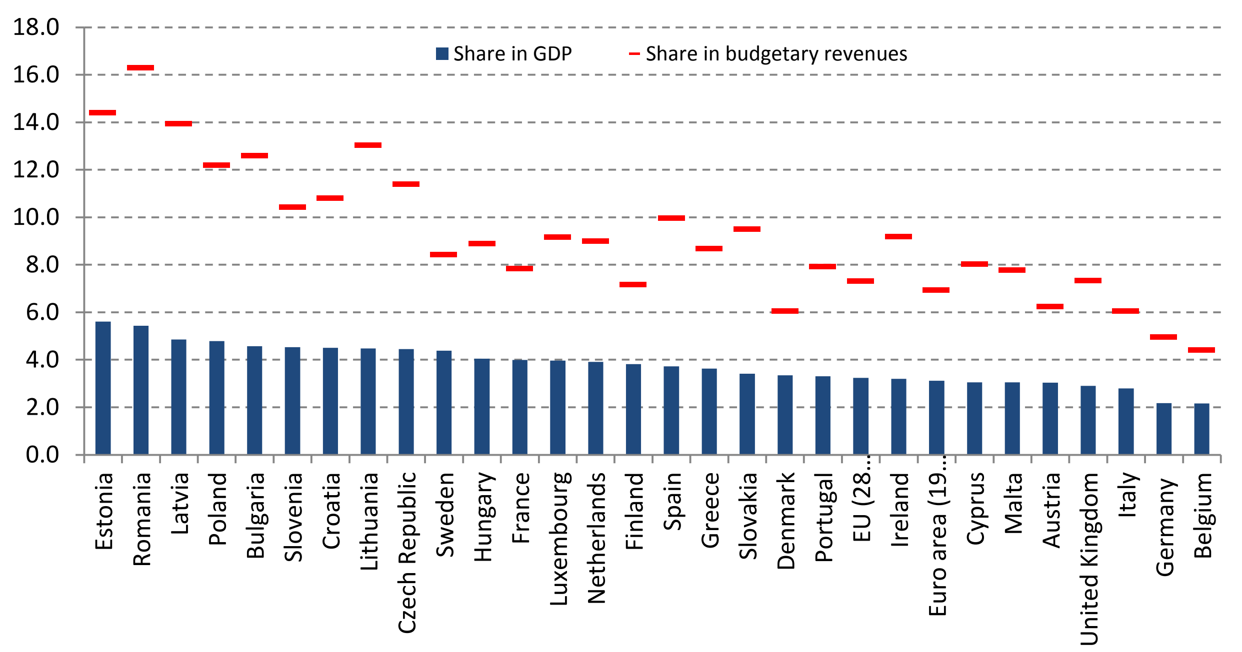
Figure 58: Infrastructure quality



Source: World Economic Forum, The Global Competitiveness Report 2014-2015

However, it should be mentioned that in the past three years, the share of public investment expenditures decreased significantly, this practice being used as a way of achieving fiscal targets. The Fiscal Council considers that the emphasis should fall on increasing the efficiency of money spent for this purpose and on a better prioritization of projects, Romania making steps in this direction as shown above.

Figure 59: The share of investment expenditure in GDP and in total budgetary revenues (average 2006-2014)



Source: Eurostat

VI. Fiscal Transparency

The fiscal transparency is a key point in setting the fiscal policy decisions, the overall trend being to strengthen fiscal surveillance worldwide, due to the financial and economic crisis. This allows a reduction in the information asymmetry, providing both policy makers and the general public clear information about the conduct of the fiscal policy. Moreover, the fiscal transparency highlights the fiscal risks and a high degree of fiscal transparency can improve a country's fiscal credibility, leading to the creation of a stable economic environment.

The literature review shows that fiscal transparency has a significant impact on the investor perception, especially in times of economic uncertainty. For example, in *Fiscal Transparency and Sustainability of Public Debt in Times of Crisis: How to Strengthen Investor Confidence?* (Tilly J., 2012), the relationship between fiscal transparency (measured by Open Budget Index proposed by International Budget Partnership) and the perception of financial markets (measured by 5 years CDS spreads[60]) is analyzed. This index is the arithmetic mean of the scores obtained for the 90 questions contained in a questionnaire on fiscal transparency, questionnaire carried out by the International Budget Partnership every two years. In addition, the fiscal transparency components (data availability, a medium term budgetary framework, budget execution and fiscal risks) in relation with the investor perceptions are also analyzed in the same study and from all the elements, the budget execution is the one with the greatest impact on the investor perception in times of economic uncertainty.

Moreover, the research in this area emphasizes not only the effects of fiscal transparency, but also its determinants. Thus, according to the *Citizens, Legislators and Executive Disclosure: The Political Determinants of Fiscal Transparency* study (Wehner and Renzio, 2013), the domestic political factors play an essential role in determining the level of fiscal transparency. According to them, free and fair elections have a significant positive impact on budget transparency, while democratic maturity does not necessarily mean offering more and better tax information. Furthermore, the hypothesis that countries rich in oil and natural gas have a limited fiscal transparency is tested and confirmed. The same authors complete the study named *The Causes of Fiscal Transparency: Evidence from US States* (Alt et al., 2006), confirming that the main cause of fiscal transparency is given by the political competition, so that partisan fragmentation in the legislature is associated with a higher level of budgetary disclosure.

In Romania, according to FRL, six principles based on which the government defines and develops its fiscal policy are defined and the transparency principle regarding the setting of fiscal objectives is the first. According to the transparency principle "the Government and the

[60] Instrument for credit risk transfers (Credit Default Swaps).

local authorities have the obligation to make public and maintain in public debate, for a reasonable period of time, all 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". In addition, FRL includes a whole chapter dedicated to the fiscal transparency, that consists of requirements regarding the disclosure of fiscal data – publishing on the web-site the quarterly financial programming, state budget expenses, state social insurance budget – but also the elaboration of a detailed analysis on the results of the fiscal policy – the half-year report regarding the economic and budgetary situation, the report regarding the final budget execution.

In order to promote fiscal transparency in general and to establish a uniform framework for assessing it in particular, the IMF has developed in 1998 the "Code of Good Practices on Fiscal Transparency", code that was revised in 2007 and then in 2014 in order to increase the effectiveness of the fiscal management and supervision, as a result of the lessons learned from the 2008-2009 global financial crisis. The New Code reflects a massive concentration in the fiscal risks management, in the context of the economic turmoil that revealed large contingent liabilities in advanced economies. Thus, a whole pillar is developed for the analysis and management of fiscal risks that could be relevant for all countries. Therefore, the risks due to macroeconomic shocks, execution of guarantees and other contingent liabilities, risks due to fiscal pressures resulting from demographic evolutions, changes in the value of assets and liabilities, public-private partnerships, risks due to the financial sector, natural resources, environmental factors, local authorities and SOEs are taken into account. The Code is accompanied by a manual on fiscal transparency and in the case of resource – rich countries it is also accompanied by a guide on best practices related to fiscal transparency.

The Code is structured on four pillars, key-elements of the fiscal transparency, of which the first three are finalized, and the fourth pillar is currently under public consultation, being necessary to adapt the principles of the first three pillars to the particular circumstances of the resource-rich countries. Thus, the four pillars of fiscal transparency are:

- **Pillar I: Fiscal Reporting** – refers to the form and the quality of fiscal statistics that should provide comprehensive, prompt and relevant information regarding the government's financial position and performance.
- **Pillar II: Fiscal Forecasting and Budgeting** – refers to the establishment of a clear vision on government's budgetary objectives and policy intentions, and comprehensive, prompt and credible projections of the public finances evolution.
- **Pillar III: Fiscal Risks Analysis and Management** – refers to ensuring that the risks of public finances are presented, analyzed and managed, and that the fiscal policy decisions are coordinated effectively.

- **Pillar IV: Resource Revenue Management** – refers to the presentation of a transparent framework for ownership right, contracting, taxation and use of facilities on natural resources. The completion of this objective requires, among other things, adapting the first three pillars principles to the particular circumstances of resource-rich countries.

The following figure schematically shows the principles stated above, reflecting the architecture of the revised Fiscal Transparency Code.

Table 24: Architecture of the revised Fiscal Transparency Code

I. Fiscal Reporting	II. Fiscal Forecasting and Budgeting	III. Fiscal Risks Analysis and Management	IV. Budgetary Resources Management
• Coverage • Frequency and Timeless • Quality • Integrity	• Comprehension • Orderliness • Policy Orientation • Credibility	• Risk Disclosure and Analysis • Risk Management • Fiscal Coordination	• Ownership, Contracting and Fiscal Regime • Fiscal Reporting • Fiscal Forecasting and Budgeting • Fiscal Risks Analysis and Management

Source: IMF, 2014

The 4 pillars contain 36 principles, which are focused on results rather than on processes, given the practices classification in basic, good and advanced in order to provide guidelines for the less developed countries, highlighting the analysis and management of the fiscal risks and filling better other fiscal standards. In this way, the countries develop reforms based on a clear set of benchmarks towards full compliance with international standards, the new approach facilitating a comparative analysis between countries. Mainly, the basic level should be considered as a minimum standard that should be obtained by all IMF member countries, the good level is an intermediate target that implies a stronger institutional capacity, and the advanced level reflects the implementation of international standards relevant in the field.

Further, this report intends to achieve a fiscal transparency evaluation for Romania, both in terms of the theoretical framework provided by the Code of Good Practices on Fiscal Transparency developed by the IMF and through the Fiscal Responsibility Law no. 69/2010, being the first initiative of this kind for the case of Romania. In this regard, the first three pillars of the Code of Best Practices on Fiscal Transparency will be applied, as the fourth one is referring to resource-rich countries. In addition, each principle corresponding to the three pillars will be analyzed taking into account the explanations provided by the Code regarding the practices classification in basic, good and advanced levels, but also the national legislation.

Table 25: The Analysis of the Principles of the Code of Good Practices on Fiscal Transparency for Romania

	Dimension	Principle	Practices		
			Basic	Good	Advanced
1	Fiscal Reporting				
1.1	Coverage				
1.1.1	Coverage of Institutions	Fiscal reports cover all entities engaged in public activity according to international standards.		x	
1.1.2	Coverage of Stocks	Fiscal reports include a balance sheet of public assets, liabilities, and net worth.		x	
1.1.3	Coverage of Flows	Fiscal reports cover all public revenues, expenditures, and financing.		x	
1.1.4.	Coverage of Tax Expenditures	The government regularly discloses and manages revenue loss from tax expenditures.	x		
1.2	Frequency and Timeliness				
1.2.1	Frequency of In-Year Reporting	In-year fiscal reports are published on a frequent and regular basis.			x
1.2.2	Timeliness of Annual Financial Statements	Audited or final annual financial statements are published in a timely manner.	x		
1.3	Quality				
1.3.1	Classification	Fiscal reports classify information in ways that make clear the use of public resources and facilitate international comparisons.			X
1.3.2	Internal Consistency	Fiscal reports are internally consistent and include reconciliations between alternative measures of summary fiscal aggregates.			x
1.3.3	Historical Revisions	Major revisions to historical fiscal statistics are disclosed and explained.	x		
1.4	Integrity				
1.4.1	Statistical Integrity	Fiscal statistics are compiled and disseminated in accordance with international standards.		x	
1.4.2	External Audit	Annual financial statements are subject to a published audit by an independent supreme audit institution which validates their reliability.			x
1.4.3	Comparability of Fiscal Data	Fiscal forecasts, budgets, and fiscal reports are presented on a comparable basis, with			x

		any deviations explained.		
2	Fiscal Forecasting and Budgeting			
2.1	Comprehensiveness			
2.1.1	Budget Unity	Revenues, expenditures, and financing of all central government entities are presented on a gross basis in budget documentation and authorized by the legislature.		x
2.1.2	Macroeconomic Forecasts	The budget projections are based on comprehensive macroeconomic forecasts, which are disclosed and explained.	x	
2.1.3	Medium-term Budget Framework	Budget documentation includes outturns and projections of revenues, expenditures, and financing over the medium term on the same basis as the annual budget.		x
2.1.4	Investment Projects	The government regularly discloses its financial obligations under multiannual investment projects, and subjects all major projects to cost-benefit analysis and open and competitive tender.	x	
2.2	Orderliness			
2.2.1	Fiscal Legislation	The legal framework clearly defines the time table for budget preparation and approval, key contents of the budget documentation, and the powers and responsibilities of the executive and legislature in the budget process.		x
2.2.2	Timeliness of Budget Documents	The legislature and the public are consistently given adequate time to scrutinize and approve the annual budget.	x	
2.3	Policy Orientation			
2.3.1	Fiscal Policy Objectives	The government states and reports on clear and measurable objectives for the public finances.		x
2.3.2	Performance Information	Budget documentation provides information regarding the objectives and results achieved under each major government policy area.	x	
2.3.3	Public Participation	The government provides citizens with an accessible summary of the implications of budget policies and an opportunity to participate in budget deliberations.	x	
2.4	Credibility			
2.4.1	Independent Evaluation	The government's economic and fiscal forecasts and performance are subject to independent evaluation.		X
2.4.2	Supplementary Budget	Any material changes to the approved budget are authorized by the legislature.		x
2.4.3	Forecast Reconciliation	Budget documentation and any subsequent updates explain any material changes to the government's previous fiscal forecasts, distinguishing the fiscal impact of new policy	x	

		measures from the baseline.			
3	Fiscal Risk Analysis and Management				
3.1	Risk Disclosure and Analysis				
3.1.1	Macroeconomic Risks	The government reports on how fiscal outcomes might differ from baseline forecasts as a result of different macroeconomic assumptions.	X		
3.1.2	Specific Fiscal Risks	The government provides a regular summary report on the main specific risks to its fiscal forecasts.	X		
3.1.3	Long term Fiscal Sustainability Analysis	The government regularly publishes projections of the evolution of the public finances over the long-term.		X	
3.2	Risk Management				
3.2.1	Budgetary Contingencies	The budget has adequate and transparent allocations for contingencies that arise during budget execution.	X		
3.2.2	Asset and Liability Management	Risks relating to major assets and liabilities are disclosed and managed.	x		
3.2.3	Guarantees	The government's guarantee exposure is regularly disclosed and authorized by law.		x	
3.2.4	Public-private Partnerships	Obligations under public private partnerships are regularly disclosed and actively managed.	Unfulfilled		
3.2.5	Financial Sector Exposure	The government's potential fiscal exposure to the financial sector is analyzed, disclosed, and managed.	Unfulfilled		
3.2.6	Natural Resources	The government's interest in exhaustible natural resource assets and their exploitation is valued, disclosed, and managed.	Unfulfilled		
3.2.7	Environmental Risks	The potential fiscal exposure to natural disasters and other major environmental risks are analyzed, disclosed, and managed.		x	
3.3	Fiscal Coordination				
3.3.1	Sub-National Governments	Comprehensive information on the financial condition and performance of subnational governments, individually and as a consolidated sector are collected and published.			x
3.3.2	Public Corporations	The government regularly publishes comprehensive information on the financial performance of public corporations, including any quasi-fiscal activity undertaken by them.	X		

Source: IMF, Code of Good Practices on Fiscal Transparency; Fiscal Council assessment

The main results regarding the evaluation of fiscal transparency in Romania show that from the perspective of the first pillar named "Fiscal Reporting", Romania has accumulated the

qualifications "good" and "advanced" in more than two thirds of the criteria related to this pillar. Thus, the fiscal reports at a subsector and public administration level are elaborated according to the international standards (ESA 95), but in order to achieve the advanced level it is appropriate that the reporting according to ESA 95 to be extended to the entire public sector. The stock variables reporting is present on the MPF website in the periodic reports regarding the government debt, including information related to financial assets of the central government sector and public debt, while in order to get a higher grade it should cover also the non-financial assets of the general consolidated budget. The flow variables reporting is realized within the budget execution reports in cash terms for all institutions and central government subsectors, while in order to achieve the advanced level also the transfers between the general consolidated budget subsectors should appear. The government began publishing the revenue losses related to fiscal expenditure in "The Report on the Macroeconomic Situation in 2015 and the Projection for the years 2016-2018". In a fiscal year, the reports are frequently and regularly published: in this regard the budget execution reports in cash terms are monthly published on the MPF website, while the final or audited annual financial statements would be appropriate to be published in maximum 6 months after the end of the fiscal year in order to obtain the advanced level.

Regarding the quality of the information, the fiscal reports published by the MPF include administrative, economic and functional classifications that are consistent with the international standards, the fiscal statistics being conducted in accordance with the ESA 95 methodology. In addition, they are internally consistent and include reconciliations between alternative measures of the summary fiscal aggregates, but to achieve an advanced qualification for the major historical revisions they should be reported along with explanations for each major revision and also a table covering both the old series and the new series data. Regarding the statistical integrity, the fiscal statistics are compiled and disseminated in accordance with international standards and according to the protocol between NIS, NBR, MPF and NCP for developing government finance statistics, but these should be carried out by an independent body in order to receive a higher rating. Regarding the *external audit*, the Court of Auditors under art. 140 of the Constitution operates autonomously, performing three types of audit: financial, performance and compliance. The comparability of fiscal data is performed at an advanced level, given that the results of the budget execution and the fiscal statistics issued for Eurostat statements are compared and reconciled with the budget execution data and fiscal statistics.

The criteria included in Pillar II, named "Fiscal Forecasting and Budgeting" are found in the case of Romania in equal proportions between the basic level and the advanced level. Thus, the criteria regarding *budget unity, medium-term budgetary framework, fiscal legislation, fiscal policy objectives, independent evaluation and supplementary budget* are at an advanced level, while the other principles are at an elementary level in Romania. The *budgetary documentation* presented in an unwrought form consists of most budget revenues and expenditures and financing of central administration entities. Even if the social security budget and the health fund are not found in the state budget, they are still presented and included in the general consolidated budget. The budgetary documentation includes *prognoses of key economic variables*, prognoses that can be found, for example, in the fiscal-budgetary strategy, the half-year report on the economic and budgetary situation, the report on the macroeconomic situation; in order to reach an advanced level, both explanations of the key macroeconomic variables and their components, as well as forecasts and explanations of the underlying assumptions which the macroeconomic variables prognoses are based upon should be included. Regarding the *medium-term budgetary framework*, the budgetary documentation includes budget implementation, medium-term projections of revenues, expenditures and financing, having the same basis as the annual budget. The fiscal strategy includes compulsory caps for the overall balance and staff expenses of the general consolidated budget for the next two years, the budgets of the last two years, the projections for the current budgetary year and the next three years, with regard to the level of budget expenditures on economic and functional classifications. The State Budget Law includes a multiannual estimate of the expenditure of ministries and institutions, on functional and economic classification. *Investment projects* are found at a basic level, the major ones being accomplished through open and competitive acquisition procedures, yet in order to attain the advanced qualification, regular presentations on the total value of liabilities for multiannual investment projects and publications before approval of cost-benefit analyses should exist.

The principle regarding *fiscal legislation* is at an advanced level: Romania has a legal framework that defines government authority concerning fiscal policy elaboration, budget formulation and execution, accounting and audit. Still, regarding the *timeliness of budget documents*, it would be advisable that it should be finished at least three months prior to the beginning of the financial year and be approved and published at least a month prior to the beginning of the financial year in order to obtain the advanced qualifier. The *objectives of the fiscal policy* are published for the main fiscal indicators over a three-year span, this principle being at an advanced level. The budgetary documentation (fiscal strategy and report on macroeconomic situation and projection) includes information on major objectives of government policy, policy objectives and programmed objectives; however, in order to achieve an advanced qualifier, reports on achievements against stated objectives should be regularly published. The government publishes budget information more accessible to citizens, but it should also publish information on the budgetary implications on different demographic groups.

Regarding the *credibility criterion*, the Fiscal Council, as an independent institution, analyses and issues opinions and recommendations concerning official macroeconomic and budget prognoses, fiscal strategy, evaluating its conformity to the principles and rules stated by the FRL, evaluates government performance in terms of budget against the fiscal targets and policies specified in the fiscal strategy, and the conformity degree of these policies against the principles of the FRL. *Forecast reconciliation* is achieved at a basic level, in view of the few explanations offered for the changes in fiscal prognoses and the existence of only some qualitative discussions regarding the impact of the new measures on the baseline scenario.

From the perspective of Pillar III, entitled "Fiscal Risks Analysis and Management", Romania has accumulated only the basic qualifier for 41.6% of the total principles related to this pillar, good level for 25% and 25% of the total number of principles related to this pillar are not met. Thus, regarding the *macroeconomic risk* criterion, government reports include a sensitivity analysis of government debts to economic growth, interest rate and exchange rate; still, in order to achieve the advanced level, they should also include a sensitivity analysis of the budget deficit to macroeconomic variables and alternative scenarios or probabilistic forecasts of fiscal results. Additionally, several *specific fiscal risks* are published, but these rather appear in qualitative-type discussions, while in order to reach a superior level, estimates regarding their size and probability of occurrence should be made. The analysis regarding *long-term fiscal sustainability* is achieved only through the perspective of the data provided by the European Commission in the "Report on fiscal sustainability". The budget includes contingency allocations from the reserve fund, however these allotments are not regularly reported. *Asset and liability management* is achieved at a basic level in Romania, loans are controlled by law, while the risks regarding government debt are described in the "Fiscal Strategy for the period 2015-2017", but in order to receive a superior qualifier according to the Code information on government asset risks and the way these are managed should be published. The *guarantees* principle is found at a good level in Romania, guarantee level being on an ascending path, still their level is low in terms of GDP share (approximately 2.8% of GDP at the end of 2014). Moreover, guarantee issuance is controlled by law and guarantees are published in the "Report on macroeconomic situation in 2015 and its projection for 2016-2018". The public-private partnership principle is not fulfilled at the moment, these partnerships being mostly presented as objectives to be achieved in the subsequent years in the programme documents of the MPF, while in order to achieve an advanced level both rights, obligations and other government exposures, as well as earnings and payments due throughout the contractual period should be published in the case of a public-private partnership. Moreover, a cap should be imposed by law on the level of accumulated obligations from public-private partnerships. At the moment, in Romania, neither potential fiscal exposures of the government in the financial sector, nor government interest in possessing exhaustible natural resources assets are reviewed, published and adequately managed; should this be achieved, it would lead to a superior level of these principles. Still, the government published in the "Fiscal Strategy for the period 2015-2017" the estimated average cost of natural disasters based on historical data. In terms of fiscal coordination, data regarding local authority finances exists, as they have the obligation to publish quarter and annual information on their own finances. Moreover, loans granted to local authorities are controlled by law. Information on state-owned companies is scarcely published by the government, while in order to obtain an advanced qualifier, the quasi-fiscal activity undertaken by these companies should be included, according to the *Code of good practices in fiscal transparency*.

The Fiscal Responsibility Law, no. 69/2010, has played an essential role in changing the paradigm by which the fiscal policy works in Romania. In addition to the fiscal rules introduced, the normative act aims at making a more transparent way in which the fiscal policy is conducted through the introduction of a medium-term perspective, together with regular detailed reports. Certainly, in recent years Romania has taken important steps in order to increase the transparency of fiscal policy, but additional effort is necessary in this regard. Thus, in the opinion of the Fiscal Council, fiscal reporting transparency should be optimized so as to reduce fragmentation of fiscal reporting at entire public sector level and respect publication deadlines of reports. In addition, the transparency of macroeconomic variables prognoses should be improved by publishing the explanations of the assumptions that these prognoses are based upon. Budgetary documentation transparency should be enhanced through the existence of regular presentations of the total value of liabilities for multiannual investment projects, the publication of cost-benefit analyses before approval, and through the existence of a regularly published report regarding accomplishments against stated objectives. Furthermore, reports on fiscal risks should be significantly improved, considering that they are still at an incipient level, while international practice pays great importance to this subject.

VII. 2015 – Macroeconomic and fiscal perspectives

VII.1. Macroeconomic framework

In the autumn forecast published in November 2015, the European Commission projects for the current year an acceleration of the economic advance to 1.9% in the European Union and to 1.6% in the euro area, while in 2016 the real GDP is expected to increase by 2% in the European Union and, respectively by 1.8% the euro area. The moderate economic growth is relying on the increase of the private consumption, most of the data suggesting that this growth is the result of some temporary factors as low oil prices, a weaker euro and the quantitative easing programme initiated by the European Central Bank. The impact of the positive factors is lessened by the downturn in emerging market economies and in the global trade, high unemployment in some EU member states, and the persistent geopolitical tensions, particularly in Russia.

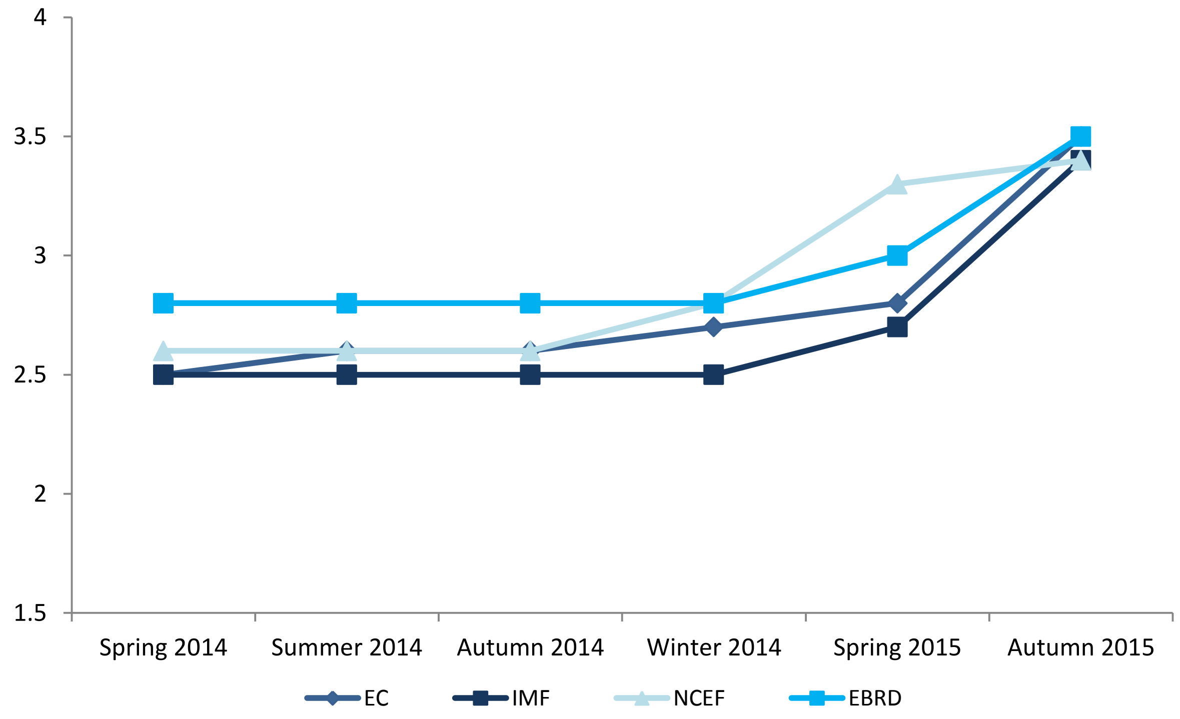
In the period 2010-2013, the EU economies evolved divergently, certain countries returning on an upward trend, while others experienced a significant economic contraction, but in 2014 only four countries registered negative growth of real GDP. For 2015, the EC estimates positive growth rates for almost all EU countries, except Greece (-1.4%). Thus, the best performing countries in terms of expected real GDP growth are Ireland (6%), Czech Republic and Malta (4.3%), but robust growths are expected also in Romania and Poland (3.5%), Slovakia (3.2%) and Spain (3.1%). At the level of the Central and Eastern Europe countries, the growth rates in the region are expected to range well over the EU average, except Bulgaria (1.7%) and Croatia (with an advance of only 1.1%, but from a negative value for GDP growth in 2014).

For 2015 it is estimated an extremely low inflation rate, respectively 0% for the European Union and 0.1% for the euro area, this evolution being favored by the decrease in energy prices and commodities. Despite the recovery in oil prices in the second quarter, in the third quarter, they recorded a further reduction (up to a minimum in September), and the inflation entered in a negative territory in September this year, both at EU level and the euro area, due to negative base effects arising from the decrease of the energy component of the HICP. Later in this year and more visible in 2016, it is expected a gradual increase of the inflation rate, this development being a combined effect of the consolidated domestic demand, the narrowing output gap, the dissipation of the effects induced by lower prices for raw materials and the consolidation of the positive dynamics of retail prices and services, and also of the gradual increase in import prices boosted by the depreciation of the euro.

For **Romania**, the European Commission’s autumn forecast anticipates an economic growth at 3.5% in 2015 (by 0.7 pp higher than in the previous year) and an acceleration of the growth in 2016 at 4.1%, while in its preliminary autumn forecast for 2015, National Commission for Economic Forecasting estimates a real GDP advance of 3.4% for 2015, and 4.1% for 2016. The estimate for the real GDP is based especially on the increase of the private consumption and investments, as well as on the favorable international context and on the manifestation of the positive effects of the tax reforms. Thus, the domestic demand is expected to continue to replace the net exports as the main driver of economic growth, as the contribution of the latter is expected to be negative in 2015 and 2016. Investments may register a positive trend as a result of small costs for lending, profit tax exemption for reinvested profit in technological equipment, favorable forecasts for economic growth, as well as in the context of an improvement in the EU funds absorption. Also, there are favorable expectations regarding the private consumption evolution as a result of an increasing households real disposable income based on the wage increase and the price decline due to the reduction of the VAT rate on food since June 2015. The advance of the domestic demand positively impacts the development of the imports, while the exports are negatively influenced by the descending trajectory in the international trade, so that the current account deficit is expected to increase in 2015 and 2016.

When analyzing the dynamics, the economic growth forecasts for Romania in 2015 have been revised only ascending during this year (initially the EC spring forecast preserved the 2014 level, but in the autumn forecast, the estimate for the economic growth is by 0.7 pp higher compared to the previous forecast), a situation significantly different from the large negative revisions made in the previous years, proving an increased optimism regarding the economic recovery in a sustainable manner. Also, other international financial institutions modified in a positive manner the estimates for real GDP growth in 2015, such as IMF from 2.7% in spring up to 3.4% in autumn and EBRD from 3% up to 3.5%.

Figure 60: The evolution of the Romania's economic growth forecasts for 2015



Source: EC, IMF, NCEF, EBRD

According to the Inflation Report released in November 2015 by NBR, the annual CPI will stand at -0.7% at the end of 2015, a value which is far below the lower limit of the variation band of ± 1 pp associated to the stationary target of 2.5%. Compared to the assessment for the annual CPI made in February 2015 (+1.9%) this major revision occurred almost exclusively as a result of the measure extending the scope of the reduced VAT rate of 9% for food and restaurant services, the annual inflation rate being expected to record negative values until May 2016, due to the cumulative effects of VAT rates reductions (including the decrease from 24% to 20% starting January 2016 for all products in the consumer basket excluding food included in the extending the scope of the reduced VAT rate). The NBR projection for 2016 indicates a value of 1.1% for the inflation rate at the end of the year.

In the Fiscal Council's opinion, the results achieved by now indicate the possibility of registering an economic growth this year around the recent EC estimated value, under the reserve of the negative impact of a weaker agricultural year. The reduction of VAT rate on food, restaurant services and catering, the solid growth of the real wages, the investments' return on a growing path, and the real GDP growth acceleration recorded at EU level will contribute to a higher economic advance in Romania than that forecasted at the beginning of this year.

VII.2. The fiscal framework

The initial budget for 2015 envisaged a general consolidated budget deficit target of 1.83%[61] according to cash methodology, while according to European standards the budget balance was projected at -1.45% of GDP, given that at the moment of preparing the budget for the current year (December 2014), the Government's estimates indicated a level of the budget balance for 2014 of -2.2% of GDP, according to both cash and ESA 2010 standards. Thus, the achievement of the medium-term objective was scheduled for 2015, with the mention that for the current year an agreement with the EC was made, allowing a temporary deviation of 0.25 pp of GDP for co-financing expenditures for the projects financed from the post-accession structural funds, as 2015 is the last year in which the European funds can be attracted from the financial year 2007-2013.

Given the achieved level of the budget deficit for 2014, of only 1.87% of GDP according to *cash* methodology and respectively 1.48% of GDP in ESA 2010 standards, mainly due to the massive underachievement of the investment expenditures compared to the announced program, the medium-term objective has already been reached last year, and this year practically it is considered the maintaining of the headline budget balance at the levels from 2014, which corresponds to a slight deterioration of the structural balance of 0.25 pp GDP, within the limits agreed with the EC.

Compared to the coordinates of the fiscal policy considered in preparing the draft budget, meanwhile the Government has adopted an Emergency Ordinance which is aimed at extending the application scope of the reduced VAT rate of 9% for food products and restaurant and catering services starting from the 1st of June, 2015, its budgetary impact being expected to be covered at least in 2015 by the revenues collected in addition by the NAFA compared with those from the program, in the first part of the current year. The Parliament also decided to double the monthly child benefit (from 42 to 84 lei); the measure will apply in the second half of 2015, implying a budgetary impact for 6 months of about 900 million lei. In addition, there were made some salary increases for certain categories of budgetary employees (since October the 1st, a salary increase of 25% for some employees in the health sector was equivalent to a bugetary impact of 300 million lei for 2015 and since August the 1st an increase of 12% for local executive authorities staff involved a bugetary effort of about 300 million lei for this year).

The coordinates of the fiscal policy for the period 2016-2019 are also radically different than in the moment when the budget for 2015 and the updated Fiscal Strategy for the period 2015-

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[61] According to the first revision operated at the end of July, 2015 the deficit target was increased at 1.86% of GDP, following the GDP recalculation, while the nominal value for the budget deficit remained unchanged (13,004 million lei).

2017 were adopted, under the implementation of the new Fiscal Code, starting with 10th September 2015 under the expenditure increases already operated. Moreover, before entering into force, this was again amended in October of this year, the current form involving the 5% quota for dividends revenue for individuals and companies starting with an earlier year, i.e. from January 1st 2016, the differentiation in the applicable tax rates on the microenterprises turnover at a level that is less than or equal to the present level, extending the application scope of the reduced VAT rate of 9% for delivery of potable water and irrigation water for agriculture.

Even though this Code differs significantly[62] from the initial draft revision of the Fiscal Code of March this year, for which, at that time, the Fiscal Council issued a negative opinion given the extremely high probability of a major deviation from the medium-term budgetary objective following the implementation of its provisions, also for the current iteration the Fiscal Council implies a major risk of deterioration in the public finances position, in the absence of coherent measures to compensate the significant revenue loss implied by the tax cuts.

Thus, in the Fiscal Council's opinion, the implementation of the draft revision of the Fiscal Code is likely to lead to a permanent and major deviation from the objectives arising from the European treaties at which Romania adhered (the Stability and Growth Pact and the Fiscal Compact) and from the relevant national legislation (the Fiscal Responsibility Law No 69/2010). The updated projection that incorporates the latest information on the macroeconomic framework, the adopted set of the fiscal policy measures and budget execution up to date, indicate a level of about 2.9% of GDP both for headline and structural deficit in 2016, assuming compensatory reductions of the public investment (of about 0.3% of GDP) and the prevalence of moderation in the public sector salary policy. The risk of re-entering in the excessive deficit procedure appears to be significant, given the fact that projections indicate a level of about 3.5% of GDP for headline deficit and 3.7% of GDP for structural deficit in 2017.

At the end of June 2015, both revenues and, especially, expenditures were, significantly below the half-year program corresponding to the initial form of GCB. Thus, the total revenues of the GCB were below the amount programmed by about 2.82 billion lei (97.5% achievement rate compare to the budgetary revenue program), and the budgetary expenditure by about 20 billion lei (only 84.7% achievement rate compared to the program). This evolution is the result

[62] The main amendments are: VAT rate reduction to 20% in 2016 and to 19% in 2017, replacing the elimination of dividends' taxation with the reduction of the tax rate from 16% to 5% starting with the 1st of January 2016, postponing the elimination of the higher fuel excise for the 1st of January 2017, eliminating the reduction of social contribution rates for employer starting with 2018 and also the reduction of the persomal income tax for physical and legal persons starting with 2019.

of the cumulative action of several factors. The first worth mentioning element refers to the budgetary programming for 2015, that, apart for the past years' routine, envisaged a fully accomplishment of the whole year deficit at the end of the first semester, following the intention of stopping the preceding years' practice according to which the budgetary expenditure, especially the investment spending, were performed mostly at the end of the year. Accordingly, the main part of the budgetary expenditure was programmed for the first semester and the failure in reaching this target caused the significant gap between the deficit target and the achieved budgetary balance at the end of the first semester.

As regarding the underachievement of the budgetary revenues, it was exclusively the effect of the massive failure of the revenues from European funds for the financial exercise 2007-2013 (-6.5 billion lei compared to the program), while the current revenues, respectively those related to the economy's development, recorded a superior growth rate compared to the programmed level, the additional sums compared to the first semester program being of 3.35 billion lei. More precisely, higher than programmed levels for the first semester were recorded at the VAT level (+2.57 billion lei), personal income tax (+552.8 million lei), corporate income tax (+487 million lei) and social security contributions (+202 million lei), while the underachievement of the program, excluding the above mentioned, was localized at the level of the nontax revenues (-858.8 million lei), but the latter is determined by the postponement of distributing the dividends by the state-own companies from the initial programming for June. The significant overachievement of the revenues in the first semester of the year can be explained by a mix between a higher than expected economic growth, an improved collection efficiency, especially for VAT receipts, and probably a pro-cyclical development for the taxpayers compliance[63].

On the expenditure side, all the expenditure categories, without exceptions, registered below than programmed levels at the end of the first semester. A significat share of the 20 billion lei deviation for total expenditure compared to the programmed level coresponds to the projects funded by external post-accession grants (-6.89 billion lei), also a major deviation being registered in capital expenditures, whose achievement rate is only 34% of the half-year program (-7.45 billion lei). An underperformance of lower magnitude compared to the program can be observed in the case of expenditures related to: interest (-713 million lei), transfers for public entities (-453 million lei), subsidies (-172 million lei), social assistance (-152 million lei) and personnel expenditures (-116 million lei). The achievement of the budgetary expenditure at

[63] The cost-benefit ratio for the decision of tax evasion varies in the favor of the perceived benefits during the recessions and in the favor of the estimated costs in the economic boom. See Brondolo, J., 2009, "Collecting Taxes During an Economic Crisis: Challenges and Policy Options," IMF Staff Position Note 09/17 and Pogoshyan T., 2011,"Assessing the Variability of Tax Elasticities in Lithuania", IMF WP/11/270.

the programmed level appears as extremely unlikely given the massive under-execution of investment spending in the first half of the current year and the implicit acceleration of the public investment flows required by the convergence to the annual allocation (it should be four times higher in the second half of the year compared to the first semester).

Also, the updated program for the third quarter in 2015 (it compares bugetary revenue and expenditure during the period July - September to the new targets that take into account the developments from the first semester, as well as the fiscal measures already adopted) confirms the same pattern of the budget execution as in the first semester of the year, respectively higher than expected current revenue, considerable minuses at the amounts received from the EU and high underperformances of the expenditure, particularly those of investment. Thus, on the revenue side, higher than program differences were localized at the level of VAT revenues (+402 million lei), excises (-539 million lei), nontax revenue (+1,042 million lei), amounts received from the EU in the account of payments made (-2,139 million lei), at the level of total revenue there were lower revenues than updated program by 1,178 million lei. On the expenditure side there is noted a lack of materialization at the level of all bugetary agregates, major minuses recording projects funded by external grants (-2,049 million lei), other transfers (-1,249 million lei), capital expenditure (-984 million lei), goods and services expenditure (-773 million lei), interest (-592 million lei), the gap at the level of total bugetary expenditure compared to the updated program is -6,561 million lei.

In the initial budget for 2015, as well as in 2014, an increase of the share of EU funds absorption in total investments was intended, a correct approach and welcomed in the Fiscal Council's opinion, considering that 2015 is the final year of attracting European funds for the financial year 2007-2013. Thus, although the draft budget for 2015 takes into account a significant increase of the public investments of about 38% from 32.36 billion lei recorded in the budget execution for 2014 (up to a level of 44.76 billion lei, target slightly modified on the ocasion of the secound budget revision to 44.2 billion lei), mainly due to an increase also extremely ambitious of the projects funded by external grants for the financial period 2007-2013 forecasted at 23.84 billion lei from 14.67 billion lei (+62.5%); however, the results after 9 months show investment expenditure of only 19 billion lei, increasing with 15.4% compared to the level registered in the same period of the last year, but much lower than program. Thus, there is an extremely high probability that Romania will lose significant amounts of EU funds (whose final beneficiary is the State, but not only – as was shown by the absorption of European funds chapter of the present report) that had been allocated within the financial year 2007-2013, which is obviously a major failure of the public administration.

The first draft budget revision for 2015, performed at the end of July, massively supplements revenues and expenditures (+6.92 billion lei, about 1% of GDP), keeping constant the budget deficit target. On the revenue side, the increase is localized at the level of current revenues (+4.91 billion lei) which appeared to be justified in the perspective of the 6 months' execution (including offsetting the impact of extending the scope of reduced VAT rate for food, restaurant and catering services and the reduction of the special construction tax from 1.5% to 1%), and at the level of the amounts received from the EU in the account of payments made (+1.98 billion lei) which appears to be quite surprising considering that the initial program at the end of the first semester was achieved only in proportion of 41.9% from the programmed level. On the expenditure side, the supplementation of the amounts was performed at the level of personnel spending (+1.48 billion lei, mainly due to some new salary related rights earned by court decisions which have generated additional obligations of the state to certain categories of employees), social assistance (+1.29 billion lei, mainly reflecting the budgetary impact of doubling the child benefits starting from 1st July), projects funded by external post-accession grants (+1.57 billion lei), capital expenditure (+0.88 billion lei).Performing some upward revisions for the investment spending during the first draft budget revision, both of those financed from EU funds as well as those from domestic sources appears as surprising in the context of the 6 months execution, but also considering the budget executions in the previous years which show a systematic trend for underachievement of the programmed allocations, despite of some ambitious projections.

The secound budget revision, operated at the end of October 2015 highlights a new additional bugetary expenses and revenues of 3.03 billion lei, maintaining the budget deficit target. A part of this review (+689 million lei) is due to the additional swap compensation schemes, these have a simetric impact both on revenue and expenditure side. Beyond the impact of the scheme, at revenue level, major pluses were found at the level of VAT (+1,236 million lei), nontax revenue (+651 million lei), taxes on using goods, authorizing the use of goods or on carrying activites (+413 million lei), while the amounts received from the EU in the account of payments made were downwardly revised by 781 million lei. Regarding the bugetary expenditure, personnel expenditure were upwardly revised (+2,140 million lei), as well as subsidies (+1,255 million lei) or taxes on good and services (+941 million lei) while major decreases were recorded at the level of capital expenditure (-2,349 million lei), as well as for projects funded by external post-accession grants (-897 million lei).

In the context of maintaining the actual parameters of the fiscal policy, the balance of risks for 2015 regarding the necessary behavior of the fiscal policy appears to be tilted to recording a lower than expected budget deficit, while the under-execution of investment spending appears to be highly probable, given the experience of both the execution in 2014 and the achievement degree of the first semester's program in this year or of the updated one for the third quarter.

Considering that the improvement in the tax collection obtained until now is of a permanent nature, wthe Fiscal Council considers that is very unlikely to respect the medium term targets as announced before the approval of the new Fiscal Code, given the implementation of the recently fiscal loosening measures and the spending increases already established. The Fiscal Council estimates indicate headline deficits right next to the reference value of 3% of GDP in 2016 (without taking into account, however, the recent decision to raise salaries for all state employess by 10% from December the 1st that will likely determine an exceeding of the threshold) and significantly above 3% of GDP in 2017, and the estimated developments in the structural budget balance suggest the reversal of the progresses made so far in terms of fiscal consolidation. Moreover, the estimated deterioration of the structural budget position is higher than that recorded in the case of headline balance in the context of expecting an increase of the output gap. Such developments are in flagrant contradiction with the principles and rules established by the FRL and with the fiscal governance treaties at the European level at which Romania adhered and would record de facto the failure of a fiscal framework based on rules that was not able to exercise strong constraints on the fiscal policy makers.

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Appendix – Glossary of terms

Adjustment program - a detailed economic program, usually supported by use of IMF resources, that is based on an analysis of the economic problems of the member country and specifies the policies implemented or that will be implemented by the country in the monetary, fiscal, external, and structural areas, as necessary to achieve economic stabilization and set the basis for self-sustained economic growth.

Aggregate demand - total expenditures of internal and external users for acquiring final goods and services produced in an economy. It is computed as the sum between internal demand and exports of goods and services.

Aggregate supply - represents all goods and services offered on the domestic market by all domestic and foreign operators. In other words, the aggregate supply is total domestic production of economic goods plus foreign countries offer (imports).

Arrears - delayed payments as result of contractual terms' violations.

Automatic stabilizers - features of the tax and transfer systems that tend to offset fluctuations in economic activity without direct intervention by policymakers. Examples are unemployment compensation and progressive taxation rates.

Balance of payments - accounting record describing the transactions concluded between a country and its external partners in a specified period of time.

Budget balance - indicator computed as the difference between overall budget revenues and budget expenditures.

Budgetary policy - financial policy of the state regarding the public expenditures; public resource allocation policy.

Capital account - account which reflects the evolution of capital transfers and acquisitions/ sale of non-financial assets.

Cash methodology - involves recording revenues when they are actually received and recording expenses at the time of payment.

Cohesion Fund (CF) – financial instrument supporting investments in transport infrastructure and environment.

Conditionality - economic policies that members intend to follow as a condition for the use of IMF resources. These are often expressed as performance criteria (for example, monetary and budgetary targets) or benchmarks, and are intended to ensure that the use of IMF credit is temporary and consistent with the adjustment program designed to correct a member's external payments imbalance.

Contagion - the transmission of shocks to several economic sectors, internally and abroad.

Contribution - compulsory imputation of a share from the revenues of employees or firms, with or without the possibility of obtaining a public service in exchange.

Countercyclical fiscal policy - is a fiscal policy behavior which has the role of stabilizing the economic cycle and helps to reduce cyclical fluctuations and inflationary pressures from excess demand.

Current account deficit - occurs when total imports of goods, services and transfers of a country are greater than exports of goods, services and transfers of that country; in this case, that country becomes a net debtor to the rest of the world.

Cyclical adjustment of budgetary revenues - elimination of the budgetary revenues component dependent to the demand excess/deficit (economic expansion/contraction), eliminating trend deviations; the level of budgetary revenues cyclically adjusted is the level that would have been collected if the GDP reached its potential growth.

Cyclical component of budget balance - modification of the budget balance due to cyclical developments in the economy.

Cyclically adjusted budget balance - general budget balance, net of cyclical component. CABB is a measure of fundamental trend in the budget balance. The structural budget balance is the CABB without the impact of "one-off" measures.

Direct Public Debt - total public debt, except guaranteed public debt.

Disinflation - process of reducing inflation.

Economic classification - expenditure structuring based on their economic nature and effect.

Economic growth - annual growth rate of the real GDP

ESA 2010 methodology (*European System of National and Regional Accounts*) - The European System of National and Regional Accounts is an accounting reporting framework used internationally for an systematic and detailed description of an economy (of a region, a country or group of countries), or its components and its relations with other economies; The main differences between ESA 2010 methodology and cash methodology are revenues and expenditures recording in "accrual" system (based on commitments, not actual payments like in cash system). ESA 2010 methodology replaces ESA 95 methodology being adopted in 2013.

Euro Plus Pact - it is also known as the Competitiveness Pact and its objective is the stability of euro area, member states committed themselves to take measures to encourage competitiveness, employment and consolidation of public finances.

European Agricultural Guarantee Fund (EAGF) - European funds for implementation of support measures for farmers.

European Regional Development Fund (ERDF) - Structural Fund which supports the less developed regions by financing investment in the productive sector, infrastructure, education, health, local development and small and medium enterprises.

European semester - additional tool for preventive surveillance of economic and fiscal policies of the Member States; the European Semester is a six-months period every year during which the Governments of the member states have the opportunity to collaborate and discover the experiences and opinion of their EU homologues in order to detect any inconsistencies and emerging imbalances of economic and fiscal policies that could violate the rules of the Stability and Growth Pact.

European Social Fund (ESF) - Structural Fund for Social Policy of the European Union, which supports employment measures for labor and human resource development.

Eurosystem - the central banking system of the euro area. It comprises the ECB and the national central banks of those EU Member States whose currency is the euro.

Exchange Rate Mechanism II (ERM II) - the exchange rate arrangement established on 1 January 1999 that provides a framework for exchange rate policy cooperation between the Euro system and EU Member States whose currency is not the euro. Although membership in ERM II is voluntary, Member States with derogation are expected to join. This involves establishing both a central rate for their respective currency's exchange rate against the euro and a band for its fluctuation around that central rate. The standard fluctuation band is ±15%, but a narrower band may be agreed on request.

Expansionary fiscal policy - is a fiscal policy behavior that has an accelerating effect in aggregate demand growth and possible amplification of inflationary pressures.

Expansionary monetary policy - the monetary policy behavior has effect in stimulating aggregate demand and a possible amplification of inflationary pressures.

Fee - the price one pays as remuneration for services provided by an economic agent or a public institution.

Final consumption - component of the aggregate demand which includes private consumption and government expenditures for public good and services.

Financial account - account which presents the transactions associated with ownership change on assets or liabilities of a country and includes foreign direct investments, portfolio investments, financial derivatives, other capital investments and reserve assets.

Fiscal Compact – part of the Treaty on Stability, Coordination and Governance signed on March 2, 2012 by all EU member states, excepting the United Kingdom and Czech Republic. The treaty is aimed at strengthening fiscal discipline by introducing an automatic correction mechanism and stricter surveillance. The fiscal compact establishes a requirement for national budgets to be in balance or in surplus. This criterion would be met if the annual structural government deficit does not exceed 0.5% of GDP at market prices. If public debt is significantly below 60% of GDP and risks addressing long-term public finance sustainability are low, the structural deficit may reach a maximum level of 1% of GDP.

Fiscal consolidation - the policy aimed to reduce budgetary deficits and the accumulation of public debt.

Fiscal impulse - the impact of discretionary fiscal policy on aggregate demand. It is computed as change of structural balance from the previous period; a positive value corresponds to an expansionary fiscal policy and a negative value - to a restrictive fiscal policy.

Fiscal policy - a policy that wants to influence the economy using the system of taxes as instrument.

Fiscal revenues - budget revenues collected through taxation. Fiscal revenues include: personal income taxes, corporate income taxes, capital gain taxes, property taxes and fees, good and services taxes and fees, taxes on foreign trade and international transactions, other taxes and fiscal fees, social contributions.

Fiscal space – 1. The difference between current public debt and a threshold of public debt, a threshold level that does not involve increasing costs for financing the deficit and which takes into account historical evolution of fiscal adjustment; 2. Financial resources available for additional expenditure required to implement development projects.

Fiscal strategy - public policy document designed to set out fiscal objectives and priorities, revenue and expenditure targets of the General Consolidated Budget and its components and the evolution of the budget balance for a three-year period.

Fiscal sustainability - a set of policies is said to be sustainable if the state is able to meet its debt payments without any major additional correction in the budget balance.

Functional classification - expenditure structuring based on their destination in order to assess public funds allocations.

GDP deflator - an indicator that reflects the change in prices of the goods and services composing GDP; it is computed as a ratio of GDP in current prices and GDP in prices of the base year.

Guaranteed public debt - loans guaranteed by the Ministry of Finance and local government authorities.

Harmonized Index of Consumer Prices - Consumer price index whose methodology has been harmonized between European Union countries; the inflation objective of the European Central Bank and the euro area inflation rate are expressed based on this index.

Implicit tax rate - the ratio between revenue collected for a particular type of tax and its associated tax basis.

Inflation - reflects the widespread and persistent increase in prices and it is typically measured by the consumer price index. Inflation erodes the purchasing power of money: the same amount is used to buy fewer goods.

Inflation target - inflation target set by central banks that have adopted inflation targeting strategy. The target can be set as a fix-level of inflation and/or as a range. The National Bank of Romania sets the target as a midpoint within a target band of +/- 1 percentage point.

Informal Economy - legal economic activity, but hidden from public authorities in order to avoid paying taxes, social contributions or to avoid compliance with legal standards on labor and with other administrative procedures.

Medium Term Objective (MTO) - is the medium-term objective for the budgetary position and differs for each EU member state. For states that have adopted the euro or are in the Exchange Rate Mechanism II, it is -1% of GDP or a budget surplus. Reassessment of medium-term objectives is done every four years or when major structural reform is adopted.

Monetary policy interest rate – the monetary policy interest rate represents the interest rate used for the main open market operations of the NBR. At present, these are one week repo operations, developed by auction at fixed interest rate.

Nominal convergence criteria (Maastricht) - the four criteria set out in Article 140 (1) TFEU that must be fulfilled by each EU Member State before it can adopt the euro, namely: 1) the inflation rate must not exceed by more than 1.5 percentage points the average of the three best performing EU countries in this respect; 2) the long-term nominal interest rate must not exceed by more than 2 percentage points the average interest rate in the first three member states with the best performance in terms of price stability; 3) the public budget deficit must be less than 3% of GDP, public debt to GDP ratio must be less than 60%; 4) exchange rate fluctuations must not exceed + / - 15 percent in the last two years preceding the examination.

Non-fiscal revenues - other budget revenues that do not include taxation, such as royalties, payments from SOE' profit, fines, charges.

Output gap - an indicator that measures the difference between actual GDP of an economy and potential GDP; the term "excess demand" is also used.

Potential GDP - real GDP that can be produced by the economy without generating inflationary pressures; Potential GDP is determined by long-term fundamental factors as organization of the economy and the productive capacity of economy determined by technology and demographic factors that affect the labor, etc.

Primary balance of the General Consolidated Budget - the difference between budget revenues and budget expenditure, excluding the interest payments with regard to public debt.

Pro-cyclical fiscal policy - the fiscal policy behavior does not fulfill its stabilizing role of economic cycle but rather contribute to amplify cyclical fluctuations and inflationary pressures from excess demand.

Quasi-fiscal deficit - takes into account public sector expenditure not recorded into the budget; particularly, it refers to the losses of state owned enterprises which translate in the defaults of their financial obligations to the public budgets and public utilities.

Real convergence - in the process of adhesion to a single currency area, it is necessary to achieve also a real convergence, respectively a high degree of similarity and cohesion of economic structures of the candidate countries; although the Maastricht treaty does not mention real convergence criteria, these can be summarized by a series of economic indicators like GDP per capita, the degree of openness, the share of the commerce with member states, economic structure.

Real GDP - represent the value of final goods and services produced in an economy in a given period, adjusted with price increases. Real GDP dynamics is used to measure the economic growth of a country.

Reference interest rate – Starting with September 1st, 2011, the NBR's reference interest rate is the monetary policy interest rate, established by decision by the NBR's Board of Directors.

Restrictive monetary policy - the monetary policy behavior constrain the aggregate demand in order to reduce inflation.

Royalty - payment to the holder of a patent or copyright or resource for the right to use their property.

S1 - indicator of the sustainability gap that shows increasing taxes or reducing expenditure (as a percentage of GDP) required subject to a debt level of 60% of GDP at the end of the period.

S2 - indicator of the sustainability gap that indicates the fiscal effort (as a percentage of GDP) required subject to the inter-temporal budget constraint on an infinite time horizon.

Seasonality - periodic pattern in the evolution of an economic variable that systematically appear at certain times of the year.

Stability and Growth Pact - The Stability and Growth Pact consists of two EU Council Regulations, on "the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" and on "speeding up and clarifying the implementation of the excessive deficit procedure", and of a European Council Resolution on the Stability and Growth Pact adopted at the Amsterdam summit on 17 June 1997. More specifically, budgetary positions close to balance or in surplus are required as the medium-term objective for Member States since this would allow them to deal with normal cyclical fluctuations while keeping their government deficit below the reference value of 3% of GDP. In accordance with the Stability and Growth Pact, countries participating in EMU will submit annual stability programs, while non-participating countries will provide annual convergence programs.

Stand-by Arrangement - A decision of the IMF by which a member is assured that it will be able to make purchases (drawings) from the General Resources Account (GRA) up to a specified amount and during a specified period of time, usually one to two years, provided that the member observes the terms set out in the supporting arrangement.

Stock-flow adjustment of public debt – process that ensures consistency between changes in debt stock and net lending flows. It takes into account accumulation of financial assets, changes of foreign currency debt and statistical adjustments.

Structural budget deficit - the budget deficit that would be recorded if GDP was at its potential level; it’s the size of the deficit recorded in the absence of business cycle influences.

Taxes - compulsory and non-refundable levy charged by a government with the purpose of financing public goods and services.

Trade balance - section of the balance of trade which presents the difference between exports and imports of goods and services recorded in a specified period of time.