

The Fiscal Council's response to the letter no. 491 / 02.07.2015 of the Department of Economic and Social Policies of the Presidential Administration

Considering your letter no. 491 / 02.07.2015, that requests the Fiscal Council's official position regarding the sustainability of public finances and the Romania's possibility to comply with its commitments regarding the medium-term objectives in the context of the measures envisaged by the Fiscal Code adopted by the Romanian Parliament on 06/24/2015, we notify the following:

- **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 set of the fiscal policy measures adopted and budget execution up to date, indicate a level of about 3% 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. According to the latest public projections of the European Commission, such a level of the structural deficit would place Romania to fourth ranked among the 28 EU Member States at the end of 2016 (after Croatia, UK and Ireland). Noting that the Government now publicly admits that the deficit could reach a level of 2.9% of GDP in 2016, although in the explanatory memorandum to the original legislative proposal submitted in Parliament claimed that the actual impact on the deficit would be fully covered by the additional budgetary revenues resulting from the acceleration of the economic growth compared to the baseline scenario and to the massive increase of the tax collection efficiency *ex ante* assumed by the government to generate extra revenue of 14 billion lei in 2016 and 18 billion lei annually in the period 2017-2019.
- **The Fiscal Council considers that there is a major qualitative difference between having structural/headline deficits still high as a result of a fiscal adjustment trajectory less abrupt and achieving a relatively similar structural/headline deficit following a deliberate slippage in flagrant contradiction to the principles and rules established both by national law and European treaties.** An adverse reaction of the financial markets, from the perspective of the required financing costs cannot be excluded especially in the context of the recent developments in Greece.

- **The aforementioned European treaties oblige Romania to correct the deviation from the medium-term objective of 1% of GDP structural deficit** - it is not at all clear at this moment how this will be done, especially since **the current budgetary projections do not incorporate the additional allocation for defense expenditure up to a level of 2% of GDP (currently, from 0.8% - 0.9% of GDP) starting with 2017 and maintaining this level for at least 10 years, according to the political commitment from the beginning of the year.** The correction of a 2 pp. of GDP deviation from the medium term objective defined as structural deficit of 1% of GDP will not be an easy one - for comparison, the cumulative fiscal adjustment in the years 2013 and 2014 was 1.1% of GDP. In addition, the accumulation of other pressures on public expenditure should not be ignored, especially from the perspective of the unified wage law revision envisaged by the Government.
- **Placing the structural deficit to such a level (3% of GDP) involves maintaining the public debt expressed as a percentage of GDP on an upward trajectory,** despite the fact that in the short term the liquidity buffer accumulated by the treasury can accommodate the additional financing requirements. **Even if the current level of the public debt stock (39.8% of GDP at end of 2014) seems much lower than the reference level of 60% of GDP, continuing an upward trend, even moderate of the public debt size as share of GDP in the upward phase of the economic cycle, instead of using such a period to reduce indebtedness, could lead to excessive accumulation of vulnerabilities that would become visible in a future downward phase of the economic cycle.** A relevant example in the sense of potential rapid growth of public debt in the context of adverse cyclical developments simultaneously with high structural deficits is exactly Romania, 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, continuing the growth of the public debt above 40% of GDP could become problematic given the present level of development of the economy and limited absorption capacity of the local financial markets.
- **It is questionable the fiscal loosening opportunity of this magnitude given that the cyclical position of the economy is likely to be at equilibrium or even to record the existence of an excess demand (zero or positive *output gap*) in 2016.** Romania risks remaining into the trap of a pro-cyclical fiscal policy, pressing the accelerator in the expansion phase of the economic cycle and risking to be forced to implement structural adjustment measures in an inevitable next phase of recession.

- **The Fiscal Council is very reserved regarding the possible implications for the economic growth in the long term given the composition of the legislative package focused on reducing consumption taxation.** We believe that the most likely scenario is that of a temporary increase of the aggregate demand, unaccompanied by a similar impact on the potential long term economic growth – the consumption tax reduction does not improve the domestic and external competitiveness of the national products, and there is a high probability that it will lead to a deterioration in the trade balance due to the increase in imports.
- The Fiscal Council doubts that the promotion of this package is consistent with the public declared objective of euro adoption in 2019.

A brief context for the above assertions

The Fiscal Council has published this year, on March 30th, the opinion regarding the initial proposed revision of the Fiscal Code approved by the Government and sent to Parliament. **The Fiscal Council could not endorse the legislative proposal in question**, considering the extremely high probability of a major deviation from the medium-term budgetary targets following the implementation of its provisions. Subsequently, the Government decided to extend one of the measures provided in the aforementioned form of the draft revision of the Fiscal Code, namely the one related to the extension of the scope of the reduced VAT rate of 9%.¹ Through its opinion from May 12th, the Fiscal Council endorsed (*post-factum* with some reservations) the legislative proposal in question, considering that the measures viewed in isolation can be accommodated without the budgetary targets to be affected in a significant manner, given the superior performance compared to the initial estimates regarding the budget revenue due to the improvement that was already made at the tax collection level. On May 20th, the Parliament approved doubling the child benefits (the annualized budgetary impact of approximately 1.8 billion lei, or 0.25% of GDP). Finally, the form approved by the Parliament on June 24th, 2015 of the draft revision of the Fiscal Code significantly differs from the original one, the main changes being aimed at reducing the size of the VAT standard rate (from 24% to 19%, instead of 20%), replacing the removal of the tax on dividends with the reduction of the tax rate from 16% to 5%, eliminating the reduction of the employee and employer social contributions starting from 2018, as well as reducing the income tax for individuals and legal entities taken into account for 2019.

¹ The Government decision makes that under a reduced VAT rate to be all the food and restaurant and *catering* services (not just meat products, fish, milk, eggs, vegetables and fruits as the initial project stipulated) and the entry into force of this provision to occur this year on 1 June and not on 1 January 2016.

Given the budget execution and the current macroeconomic context, the Fiscal Council considers that the existence of a fiscal space is apparent relative to the budget deficit target for the year 2015. This is created by a combination of an economic growth far superior than the initial projections (possibly 4% compared to a 2.5% estimate in the initial budget construction), improved tax collection (especially in the case of VAT) and the probable repetition of the 2014 situation, that of under-execution of the public investment expenses. However, we believe that this fiscal space has already been exhausted by extending the application scope of the reduced VAT rate for food products, increasing the child allowances and by the reduction of the special construction tax from 1.5% to 1% (not included in the initial budget). Considering as permanent the gains from the collection efficiency obtained until now, we appreciate as probable the enrollment in the medium-term budgetary targets in the absence of further fiscal relaxation measures introduced by the revision of the Fiscal Code approved by the Parliament and virtually impossible in the case of their inclusion.

The main measures of the Fiscal Code			
No.	Measure	Budgetary Impact	
		Billion lei	% of GDP
1	Reduction of the standard VAT rate from 24% to 19%	-8.9	-1.2
2	Reduction of the tax on dividends from 16% to 5%	-1.3	-0.2
3	Various reductions of the excises (including the impact on VAT)	-3.6	-0.5
4	Changes of income tax exemptions	-1.2	-0.2
5	Changes regarding the social contributions	-0.7	-0.1
6	Removal of the special construction tax	-1.0	-0.1
7	Other measures	-0.4	-0.1
Total		-17.1	-2.3

Overview of the obligations under the European treaties and national legislation

The fiscal policy in EU member states falls under the two arms of the Stability and Growth Pact – the corrective and the preventive arms that, in the case of the signatory states (including Romania since June 2012), are reinforced by the provisions of the Treaty of Stability, Coordination and Governance in the Economic and Monetary Union (named also Fiscal Compact). The corrective arm imposes a maximum limit for the headline deficit of 3% of GDP, while the preventive arm - under which Romania entered from 2013 along with the exit from the excessive deficit procedure at the end of 2012 – imposes a gradual convergence to the so-called medium term objective (MTO). In the case of Romania, this is defined as a structural deficit of 1% of GDP and the convergence was achieved at the end of 2014, one year before the

agreed term, given that the major under-execution of public investment and intermediate consumption (goods and services expenditure) made that the headline deficit to register a level of 1.5% of GDP, compared to the initial target of 2.2% of GDP (according to the Convergence Programme 2014-2017).

Such a level of the structural deficit (1% of GDP) is considered necessary to ensure public finance sustainability, creating safety margins to accommodate the adverse cyclical evolutions (so that the headline deficit does not exceed 3% of GDP over a regular economic cycle) and the future payment obligations arising from demographic trends (aging population) and to avoid the accumulation of an excessive public debt stock. From the perspective of the Stability and Growth Pact, the MTO that meets the above criteria is currently estimated at 1¼% of GDP – the Fiscal Compact introduces an additional restriction that limits the structural deficit to 1% of GDP. The national legislation practically operationalizes the provisions of European treaties mentioned above.

This document was approved by the Chairman of the Fiscal Council after its appropriation by the Council's members by vote, during the meeting on July 6th, 2015.

July 6th, 2015

Chairman of the Fiscal Council