Romania

Fiscal Council

2011 Annual Report

Macroeconomic and fiscal developments

2012

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I. Summary

The Fiscal Council is an independent authority established by the Fiscal Responsibility Law, 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 finance.

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

Following a difficult year of fiscal adjustment in 2010, the Romanian economy registered an economic growth of 2.5% in 2011, one percentage point higher than the forecast, mainly due to a favorable supply shock in agriculture. However, the outlook for 2012 indicates a growth rate weaker than originally expected, mainly as a consequence of the worsening external economic conditions, affecting exports directly, through the commercial channel, and domestic demand indirectly, through the capital flows channel.

The initial budget forecasted a deficit reduction to 4.4% of GDP according to cash methodology and 5%, according to ESA95. The budget execution showed a fiscal deficit of 4.12% of GDP on a cash basis, the target for the end of 2011 being achieved by a comfortable margin of about 0.3% of GDP. As regards the general government deficit in ESA 95, the clarification of the statistical treatment of state obligations to certain categories of employees in the public sector as a result of final court rulings implied exceeding the maximum of 5% of GDP by 0.2 percentage points of GDP.

In the Fiscal Council's opinion, risks affecting the macroeconomic outlook are pointing to a lower economic growth in 2012 compared to the baseline scenario. Also, the risks regarding the budget execution are rather tilted toward the negative side (a deficit higher than projected, especially given the risks related to election).

The highest domestic risks can be materialized if the Government's commitment for the fiscal consolidation process decreases due to political turmoil anticipating the 2012 elections. Potential deviations from a restrictive fiscal policy (like reversing some of the already implemented austerity measures) can lead to higher-than-target deficit in 2012 and a worsened risk perception regarding Romania.

On the positive side, a better absorption of EU funds grants and improved confidence in the economy can lead to a higher than expected economic performance, supported also by

potential foreign direct investments, attracted by a more alert pace in the area of structural reforms.

In the Fiscal Council's opinion, in the new context created by the change of government and recent adjustments in the parliamentary majority's configuration, an update of the fiscal strategy is imperative, in order to promote a predictable fiscal framework based on clear rules and targets. In terms of the fiscal responsibility law, article 23, letter c) provides an escape clause for revision of the fiscal framework in the case of a change of government.

At the time of writing this report, the information available indicated the renegotiation of the deficit target by the new government with the IMF and EU mission (to 2.2% of GDP). Even in the context of an upward revision of the budget deficit target, in the opinion of the Fiscal Council there are persistent risks in terms of achieving it, given the downward revision of projected economic growth, budget execution data at the end of first quarter and considering that compliance with the deficit ceiling occurred amid shifting in March quarterly payment of corporate income tax and an accumulation of arrears of the state budget and local budgets.

The need to improve absorption of EU funds becomes more acute in the context of the fiscal compact's provisions that will limit the room for maneuver in the fiscal-budgetary policy in the coming years

In the following years due to the new fiscal pact, ceilings for budget deficits will be much smaller and the absorption of EU funds is a stimulus solution under a more limited space in the fiscal-budgetary policy and considering the small size of automatic stabilizers. Unfortunately, so far, Romania's performance in terms of EU funds absorption is very low. Romania's top priority should be urgent and substantial increase of EU funds absorption. In addition, budgetary constraints imposed by the fiscal compact require the need to improve the efficiency of budgetary expenditures, particularly those related to public investment and purchases of goods and services.

The efficiency of tax collection remains low

Romania has one of the lowest tax revenues as a share of GDP (taxes and social contributions) compared to EU countries, amounting only 27.2% of GDP in 2011, 12.4 percentage points lower than the European average. Thus, in 2011, the efficiency of taxation for VAT and social contributions - computed as a ratio between the implicit and legal tax rate - is among the lowest in Eastern European countries, respectively 54% in the case of VAT (compared to 82% in Estonia and 71% in Bulgaria), and 61% for social contributions.

In this context, supplementary budgetary revenues can be attained by reducing tax evasion.

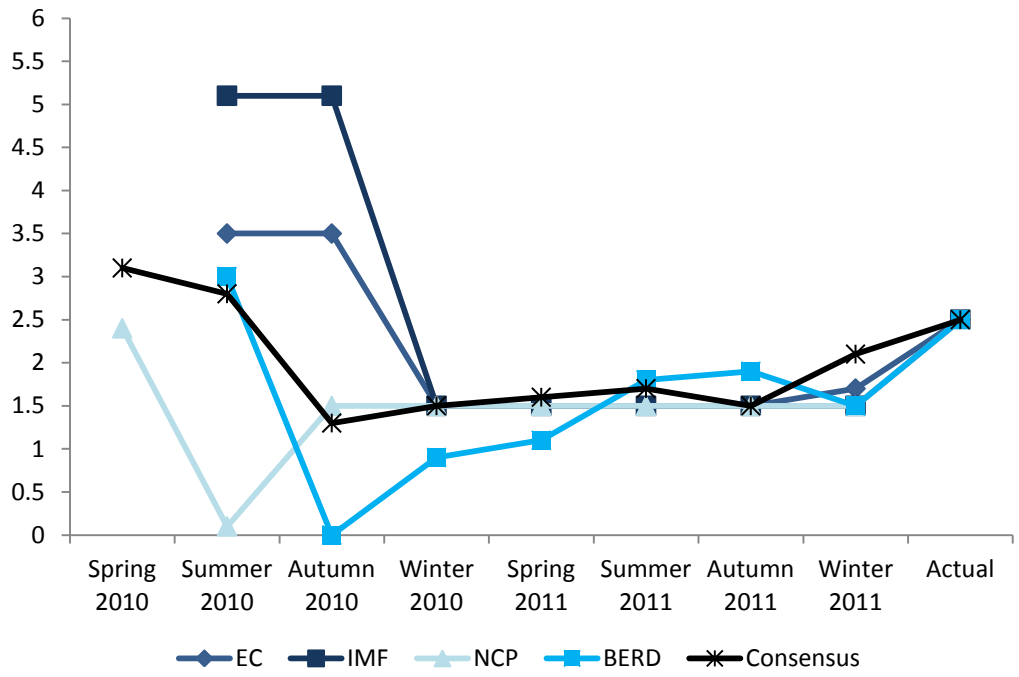
The public pension system's financial status is precarious

Expenditure on social assistance in Romania is significant, and the public pension system's deficit problem is not solved: budgetary outlays on pensions are unsustainable in relation to contributions collected, even if some measures have been taken in order to improve this shortcoming (new pensions law). There are significant threats to the medium-term sustainability of social security budget and any expenditure increases or reductions of contributions should be considered only in the context of identifying alternative solutions to reduce the deficit, particularly by broadening the tax base.

II. Macroeconomic framework in 2011

The year 2011 marked the return of the Romanian economy on a growth path; real GDP registered a 2.5% increase after the sharp decline of 6.6% in 2009 and, a contraction of 1.6% in 2010. Compared with original projections considered in the Fiscal Strategy for 2011-2013, but also with September forecasts from the European Commission and the National Commission for Prognosis, the growth rate was higher by one percentage point, mainly due to a favorable supply shock in agriculture, reflected in private consumption and change in inventories.

Figure 1: Forecasts for economic growth

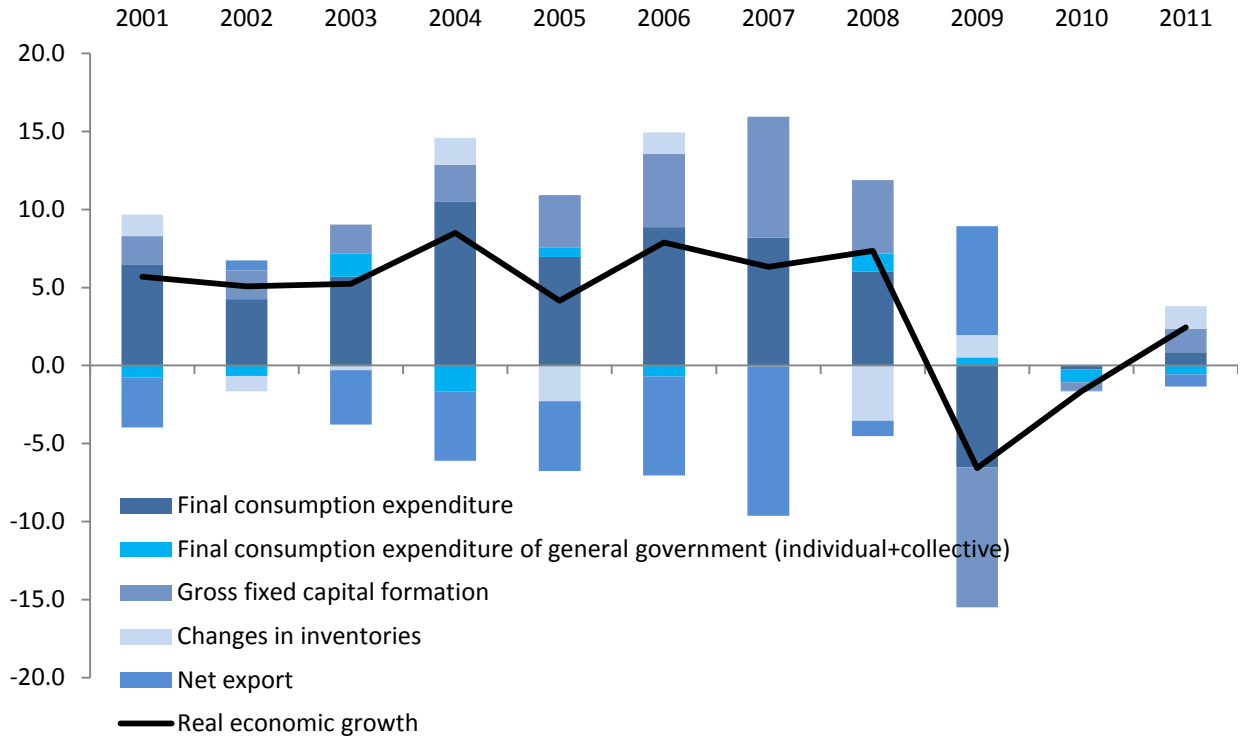


Source: Eastern Europe Consensus Forecasts

The main contributions to economic growth derived from gross fixed capital formation (+1.5 pp, corresponding to an annual growth rate of 6.3% in real terms), changes in inventories (+1.4 pp), while the increase in expenditures related to household final consumption and non-profit institutions serving households have made a positive contribution of 0.8 pp (1.3% real annual growth), due to the self-consumption component. Negative contributions came from net exports (-0.8 pp), as a result of a higher expansion in real terms in imports (10.5%) than in exports (9.9%) and, due to adjustments in the public sector spending and total government consumption (-0.6 pp, corresponding to a contraction of 3.5% in real terms). On the supply side, the largest increases were recorded in agriculture, forestry and fishing (+11.3%), industry (+5%) and construction (+2.6%), while negative developments occurred in information and

communications (-2.2%), financial intermediation and insurance (-1.1%) and public administration and defense, education, health and social assistance (-2.7%).

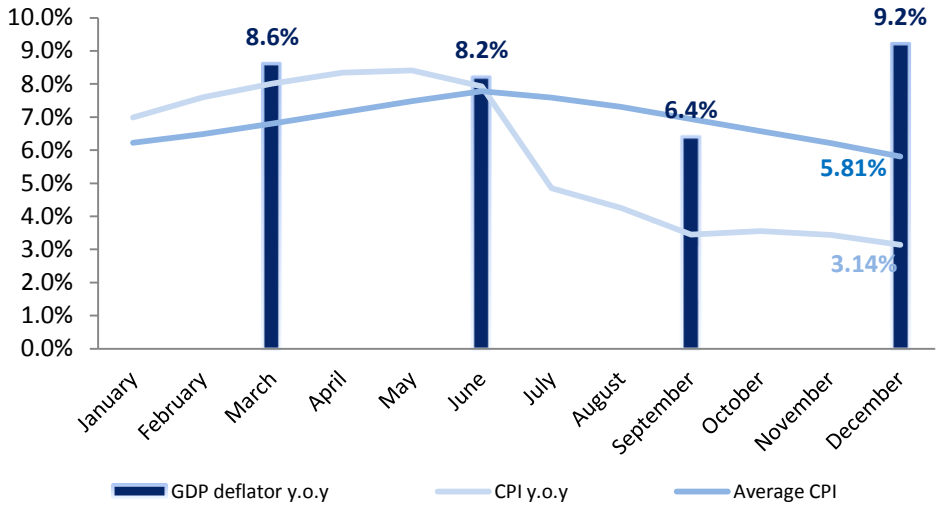
Figure 2: Contributions to economic growth



Source: Eurostat, Fiscal Council calculations

Although the inflation rate has remained in line with forecasts considered in the Fiscal Strategy for 2011-2013 (annual average of 5.8%, compared with a projection of 5.3%), the general price level, measured by the GDP deflator, rose to 8.1%, significantly above the value of 4.8% taken into account in the budget elaboration, mainly due to developments of price indices related to changes in inventories (203.7%), exports (108.8%) and gross fixed capital formation (106.7%). The higher level of the deflator, in conjunction with higher than anticipated real GDP growth, determined the nominal GDP for 2011 (578,551.9 million lei) to substantially exceed the amount taken into account at the elaboration of the budget (544.426 million lei).

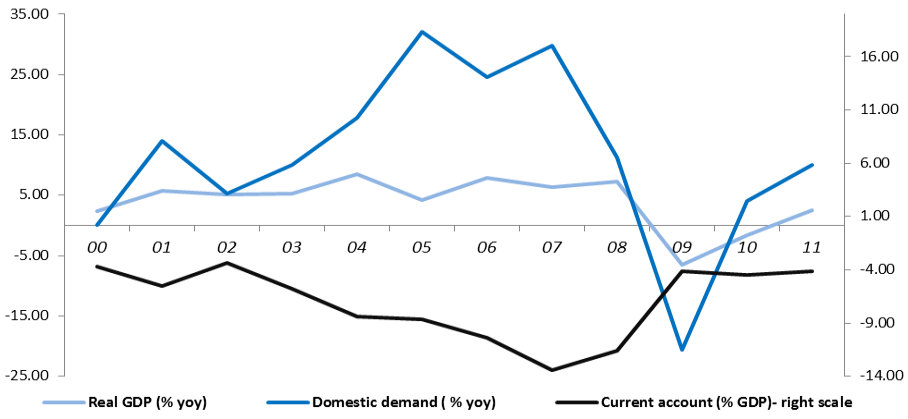
Figure 3: Consumer price index and GDP deflator -2011



Source: National Bank of Romania, National Institute of Statistics

Romania's external position continued to improve gradually. The current account deficit decreased from 4.4% of GDP in 2010 to 4.2% in 2011, in the context of a 3% increase of current account deficit, lower than the nominal GDP growth rate. The advance of nominal current account deficit from 5.518 million euros to 5.682 million euros was mainly driven by an increase in the income balance deficit of 422 million euros, which was partially offset by improved trade balance, with a positive contribution of 113 million euros, and the balance of current transfers, with 145 million euros. Exports continued their upward trend, but the growth rate has slowed, especially in the second semester, due to worsening economic situation of main trading partners. Imports advanced at a slightly faster pace, supported by the return to growth in domestic demand while the trade deficit hovered at levels comparable to the previous year.

Figure 4: Real GDP, 2000-2011



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

At end-December 2011, non-government loans granted by credit institutions increased slightly in real terms, respectively by 3.37%, compared to the same period of 2010. Revival of private sector lending was driven by loans granted to companies, with an advance in real terms of 9.09% for RON-denominated credits and 6.47% for foreign currency-denominated loans. Credits in national currency granted to households decreased by 5.6% but in real terms in the context of a relatively high level of debt compared to disposable income and short-term negative financial outlook, while foreign currency-denominated loans slightly increased, respectively with 1.43% in real terms, mainly as a result of the "First home" program.

Although the average number of employees in 2011 (4161.78 thousand persons) decreased by 1.8% compared to 2010, this evolution is mainly due to the carry-over effect of staff reductions during the previous year, while the private sector started creating jobs in March 2011, offsetting further reductions in the public sector staff. Thus, in the context of rising employment in the private sector, in December 2011 the number of employees was 1.7 percent higher than the corresponding period of last year (+71,000 employees). In the same period, the total number of registered unemployed persons fell from 627,000 persons to 461,000 persons, while the unemployment rate declined from 6.97 percent to 5.12 percent.[1]

In 2011, the average gross wage per total economy was 2,032 lei, up 4.9% from 2010 while the net average wage was 1,475 lei, increasing by 4.8%. Considering an average inflation of 5.8%, the real wage fell by about 1%, but this development is mainly attributable to the carry-over effect of reductions in public sector salaries in mid-2010, while the private sector[2] wage growth (+7.1%) was higher than the inflation rate.

The evolution of main macroeconomic indicators in 2011 compared to forecasts considered in the Fiscal Strategy for 2011-2013 are summarized in *Table 1*:

[1] Preliminary results of the census performed by the National Institute of Statistics indicate a significant decrease of the Romanian population, from 21.7 million in 2002 to a level of 19.04 million as a result of labor migration. This will likely cause a significant increase in unemployment rate after the completion of census results.

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

Table 1: Macroeconomic indicators (differences from prognosis)		
	2011-2013 Fiscal Strategy	2011
	- % yoy -	
GDP		
GDP (million lei)	544,426	578,551.9
Real GDP	1.5	2.5
GDP deflator	4.8	8.1
GDP components		
Final consumption	1.3	0.3
Households final consumption	1.5	0.7
Government final consumption	-1	-3.4
Gross fixed capital formation	3	6.3
Exports (volume)	7.7	9.9
Imports (volume)	7.3	10.5
Inflation rate		
End of period	3.2	3.14
Annual average	5.3	5.79
Labor market		
Unemployment rate at the end of period	8.0	5.12
Average number of employees[3]	0.5	-1.8
Gross average wage	5.9	4.92

Source: National Institute of Statistics, National Commission for Prognosis

III. The fiscal policy in 2011

III. 1 Assessment of objectives, targets and budgetary indicators

Under article 48, paragraph (2) of the fiscal responsibility law no. 69/2010, the Fiscal Council's annual report must contain "*a discussion and analysis of the implementation of the fiscal policy in the previous year compared to the framework set forth in the Fiscal Strategy and Annual Budget*" and will include:

a) The assessment of macroeconomic and fiscal trends and projections contained in the Fiscal Strategy and Annual Budget to which the annual report corresponds;

[3] Differences from NFC forecasts and the level effectively reported are also due to different methodologies: while the NFC forecast uses the labor force balance as a reference, the effective figures come from the NIS monthly bulletin which only considers enterprises with more than 5 employees.

b) A section containing 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) A section containing an assessment of the Government's compliance with the principles and rules of this law during the preceding budget year;

d) A section containing 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.

In the context of fiscal policy rules, nominal ceilings for general government balance in 2011, its total expenses (excluding post-accession funds, pre-accession funds and financial assistance from other donors), and personnel expenditure were established by law no. 275/2010 (see *Table 2* below). The budgetary deficit at the end of 2011 was below the nominal target, despite the total expenditure overruns, in the context of implementation, at the budget amendments, of two SWAP compensation schemes for clearing the budgetary arrears of some state companies, local authorities and ministries (with a symmetric impact on revenues and expenditures, totaling 2.5 billion lei[4]), but also in the context of discretionary spending amounting 1610 million, supported by additional tax revenues and social security contributions[5]. In contrast, the staff costs at the end of the year were significantly below the nominal threshold. In the context of a significantly higher nominal GDP than envisaged in the budget construction, the deficit expressed as a percentage of GDP stood at 4.1 percent.

[4] Additional revenues related to implementation of the two compensation schemes are found primarily in VAT (1.709 million) and social contributions (726 million), but also in excises (71.7 million) and corporate income tax (7.5 million). Their counterpart in expenditure is reflected in the categories "other transfers" (1,062.3 million), "subsidies" (823.4 million), "social assistance" (236.6 million), "capital expenditure" (238.1 million) and "other expenses".

[5] Exceeding expenditure ceiling imposed by Law no. 275/2010, decided at the first budget amendment, was made notwithstanding the provisions of Article 6, letter c) and Article 16 of the Fiscal Responsibility Law. According to the Fiscal Council, although the increase of expenditure was partly justified by arrears repayment, the temporary suspension of fiscal responsibility law provisions created an unfortunate precedent that could lead to further exemptions from the principles of a responsible and predictable fiscal policy.

Table 2: Nominal ceilings for GCB balance, total expenditure and personnel expenditure	Law no. 275/2010			2011		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
Mil. lei	**-23,953.4**	**194,419**	**40,574**	**-23.836,7**	**198,529**	**38,496**
% of GDP	*-4.40%*	35.71%	7.45%	*-4.12%*	34.31%	6.65%

* Excluding financial assistance from EU and other donors

The first budget amendment, approved in August 2011, included a significant upward revision of revenue (1 830 million, excluding the impact of the first compensation scheme for clearing outstanding obligations to the budget), mainly due to favorable developments of revenues from excises (1645.3 million), non-tax revenues (574 million) and donations (+ 364.2 million), but also an increase in the same amount of total expenditure, mainly for "goods and services" (699 million) and capital expenditure (481.2 million). In the context of the second budget amendment, approved in November 2011, estimated revenues (without the influence of compensation schemes) have been revised downward by about 1.2 billion lei and in order to reach the deficit target, total expenses have been reduced accordingly, important downward revisions being recorded in "other transfers" (-996 million), social assistance (-346 million), capital expenditure (-315 million) and personnel costs (-244 million), which allowed a substantial increase in spending on goods and services (655 million) for settlement of outstanding obligations.

Compared with the last amendment of the budget, the results of financial execution at the end of the year revealed lower revenues compared to forecasts, in the case of financial assistance from the EU and other donors (-2.3 billion lei): the post-accession funds absorption was 1.7 billion lei below target due to the delay of related reimbursements for two operational programs, while revenues from "donations" were below estimates with 0.6 billion lei. The performance of fiscal revenues was also lower than projected by about 0.3 billion lei, exclusively due to below target revenue from excises (-0.6 billion lei), partly offset by additional revenue from VAT (+ 0.3 billion lei). A significant outperformance was recorded by revenue from social contributions, which exceeded estimates by about 1.1 billion lei.

Even if the net impact of the developments above has resulted in a deficit of 0.8 billion lei in total revenue compared with estimates of the second amendment, substantial savings recorded in some chapters of current expenditure – respectively "other transfers" (-2.8 billion lei), personnel expenditure (-1.8 billion lei, due to a faster than anticipated reduction in personnel) and interest expense (-0.6 billion lei), allowed the nominal deficit target to be reached, while making additional allocations for capital expenditure (2.3 billion lei), goods and services (1.7 billion lei) and co-financing projects with post-accession funds (1.6 billion lei). Higher costs related to chapters above include amounts for arrears settlement of state

companies (for example Electrificare CFR SA) and the health sector, but also additional expenditures of local authorities and self-financing institutions. **However, supplementary allocations for goods and services recorded on the occasion of both budgetary amendments, alongside with exceeding these estimated levels in final execution (3.1 billion lei compared with the initial allocation) may reveal a trend of outsourcing certain services in the context of public sector layoffs.**

Evolution of the main budgetary aggregates during 2011 is presented in *Table 3.*

Table 3: The evolution of the main budget aggregates during 2011 (billion lei)

	2011-2013 Fiscal Strategy	Initial budget	First amendment	Second amendment	2011 Actual
Total revenues	**179.2**	**179.2**	**181.1**	**179.8**	**179.1**
Tax revenue	101.8	101.8	103.4	103.2	102.9
Social contributions	49.2	49.2	48.4	48.8	49.9
EU funds	8.7	8.7	9.1	9.1	6.9
Total expenditure	**203.1**	**203.1**	**205**	**203.8**	**202.9**
Current expenditure	182.9	182.8	184.2	183.2	180.6
Capital expenditure	20.3	20.4	20.8	20.5	22.8
Budget deficit	**-23.9**	**-23.9**	**-23.9**	**-23.9**	**-23.8**

Note: Amounts without the impact of compensation schemes

As regards the general government deficit in accordance with ESA 95, the statistical clarification of state obligations to pay to certain categories of employees in the public sector as a result of final court rulings[6], determined the violation of the 5% of GDP threshold assumed in the Technical Memorandum of Understanding with the EU (the actual general government deficit under ESA95 methodology was 5.2% of GDP in 2011), since it involved recording of additional expenses of about 6.3 billion lei (1.1% of GDP) in 2011. In the cash budget execution, following the decision of Parliament, the sums will be paid in installments during 2012-2016 (5% in 2012,

[6] The amounts correspond to claims of certain categories of civil servants who have requested the same rights as other categories of civil servants (the largest category), claims of teachers after their salaries were increased by 50% at the end of 2008 without effectively receiving this raise (the second largest category), and some state employees who have challenged in court the wage reduction from 2010 (the least numerous category).

10% in 2013, 25% in 2014, 25% in 2015 and 35% in 2016). Given that a significant share of the additional expenditures recorded at the end of 2011 was directed to clearing outstanding obligations, historical spread of 0.5% of GDP in ESA95 deficit versus cash figures has narrowed significantly[7], so that, excluding the impact of temporary expenditure mentioned above, general government deficit according to ESA95 expressed as a percentage of GDP was almost the same as cash (4.1% of GDP), a lower level compared to the one considered in the 2011-2014 Convergence Program and the European Commission's autumn projection (4.9% of GDP – not including additional temporary expense mentioned above).

III. 2. Budgetary revenues

Revenues of the general consolidated budget, without the impact of compensation schemes, increased by 6.5% in 2011 compared to the previous year, to 179 billion lei (30.95% of GDP). The reduction of revenues as a share in GDP from 32.8% in 2010 is explained by developments related to financial assistance from the EU and other donors and the evolution of non-tax revenues[8], while the income tax and social contributions, excluding the impact of compensation schemes for clearing outstanding payments to the budget, have recorded an increase of 10.6%, in line with that of nominal GDP.

Revenues related to financial assistance from the EU and other donors were lower than in 2010 (6.9 billion lei, compared to 9.5 billion lei in the previous year), in the context of natural decrease of pre-accession EU funds, which were not offset by a sufficient improvement in the absorption of post-accession funds (the effective absorption recorded in the budget was 6.1 billion lei, compared with a target of 7.8 billion lei and a level of 5.4 billion lei in the previous year). Tax revenues, in the context of a favorable impact from discretionary measures related to VAT, excise duties and social contributions decided during 2010, would have been expected to increase more than the nominal GDP; the reason why this evolution was not observed can be

[7] Considering the accounting system based on commitments (accrual), arrears are registered when the corresponding payment obligations arise. Their payment increases the deficit according to cash methodology, without adversely affecting the deficit under ESA95.

[8] Non-tax revenues, which include revenues from state property and income from sales of goods and services, registered a nominal contraction, given that the revenues in 2010 were favorably affected by the "super-dividend" paid by some state owned enterprises. Actual level of non-tax revenue was lower than originally estimated (-631 million lei), but exceeded with 305 million the level from the second budget amendment.

found in the composition of economic growth, determined largely by agriculture, a lower taxed sector.

III.2.1. VAT and excises

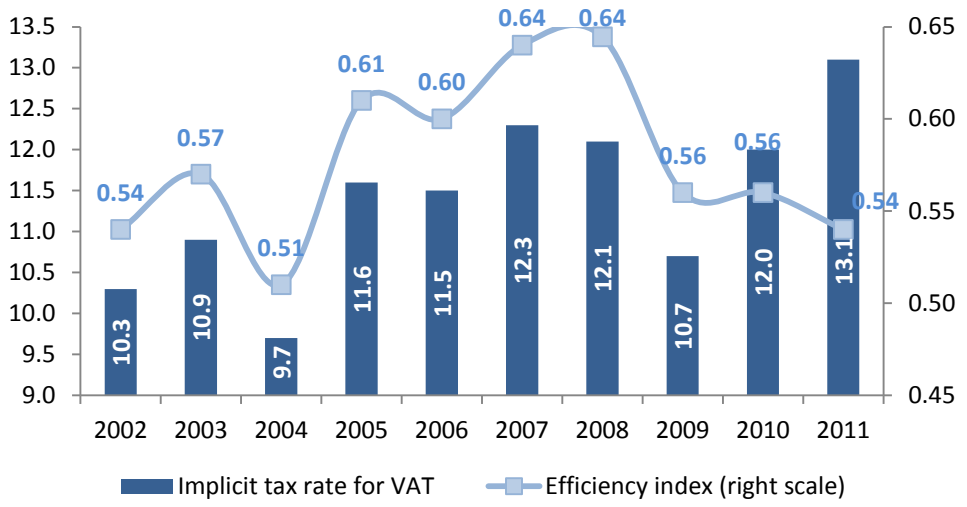
Estimated in the initial budget at 46.2 billion lei, VAT revenues reached a level of 47.9 billion lei at the end of 2011, the difference being fully explained by the impact of compensation schemes decided at the budget amendments from August and November 2011 (1.71 billion lei). Compared with 2010, VAT receipts increased by 6.9 billion lei (17.75%), in the context of the carry-over effect of the standard VAT rate increase from mid-2010, gradual revival of household consumption and rising prices.

Evaluating the efficiency of tax collection through the ratio between implicit tax rate (defined as the ratio of actual revenues collected for a particular type of tax and corresponding macroeconomic tax base) and statutory rate of taxation, it can be concluded that the efficiency of taxation for VAT decreased in Romania compared to the pre-crisis period, but it is a common feature of EU new member states (NMS 10).

The budget execution for 2011 suggests a slight loss of efficiency compared to the previous year (a degree of efficiency of 54% compared to 56%, calculated net of the impact of compensation schemes), but this may be explained by the corresponding macroeconomic tax basis structure (household final consumption and NPISH[9]). Thus, an important contribution lies in the context of favorable supply shock in agriculture, to "self-consumption" component which is not likely to generate tax revenue. Isolating the impact of this component, collection efficiency remained the same as previous year. A collection efficiency coefficient virtually unchanged indicates that revenues have varied in line with relevant macroeconomic basis, adjusted for the impact of increasing the standard VAT rate in 2010, and suggests lack of additional extraordinary revenues (revenue windfalls) – which could arise from reducing tax evasion, for example.

[9] Non-profit institutions serving households

Figure 5 : Implicit tax rate and taxation efficiency index for VAT in Romania



Source: Fiscal Council calculations

The effectiveness of taxation for VAT of 54% in 2011 is significantly lower than in Estonia (82%), Slovenia (72%) and Bulgaria (71%). Romania collected in 2011 8.1% of GDP in VAT revenue (ESA95 performance, excluding the impact of arrears clearing compensation schemes), compared to 8.2% of GDP in Slovenia, 8.4% in Estonia and 8.6% in Bulgaria, while the standard rate of VAT in these countries was 20% (compared with a level of 24% in Romania). In 2011, a lower efficiency of taxation as defined above was observed only in Latvia. Although, it must be noted that differences in the efficiency index of taxation reflect also structural differences between economies, since the higher percentage of rural population in Romania is reflected in a higher share of the self-consumption component (non-taxable). Moreover, Aizenmann J. and Y. Jinjarak (2005)[10], 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 openness of the economy – the corresponding indicators for the three variables in Romania being unfavorable.

[10] 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

Country	Standard VAT*			Implicit tax rate**			Taxation efficiency index***			Rank		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
BG	20.0	20.0	20.0	14.1	14.5	14.2	0.71	0.72	0.71	4	3	3
CZ	19.0	20.0	20.0	13.5	13.6	13.7	0.71	0.68	0.69	3	4	4
EE	19.0	20.0	20.0	16.2	16.6	16.5	0.85	0.83	0.82	1	1	1
LV	21.0	21.0	22.0	9.6	10.4	10.9	0.46	0.50	0.49	10	10	10
LT	19.0	21.0	21.0	10.4	12.1	12.3	0.55	0.58	0.59	8	6	6
HU	22.5	25.0	25.0	15.5	16.1	16.0	0.69	0.64	0.64	5	5	5
PL	22.0	22.0	23.0	11.9	12.2	12.7	0.54	0.55	0.55	9	9	8
RO	19.0	21.5	24.0	10.7	12.0	13.1	0.56	0.56	0.54	7	8	9
SI	20.0	20.0	20.0	14.9	14.9	14.4	0.75	0.75	0.72	2	2	2
SK	19.0	19.0	20.0	10.8	10.7	11.6	0.57	0.57	0.58	6	7	7

* Where standard rates have been modified during the year, a weighted average of standard rates has been reported

** 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, revenues for 2011 exclude the impact of the compensation schemes (1709 million RON)

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

The revenues from excises amounted to 19.1 billion lei (3.3% of GDP), of which 71.7 million represent the impact of compensation schemes. Excluding their influence, the extra income compared to the previous year amounts to 1.7 billion RON (equivalent to a nominal growth rate of 10%), reflecting increases in the excise duty on certain products (diesel, gasoline, intermediate products and cigarettes) but also new excises. Although revenues from excises were higher by 0.6 billion RON over the level programmed in the initial budget, the efforts to reduce tax evasion during 2011 had a lower impact than estimated due to the escalation of the phenomenon by the end of the year: the revenues collected were lower by 0.56 billion RON compared to the estimates in the second budget amendment.

Figure 6: VAT 2011 (billion lei)

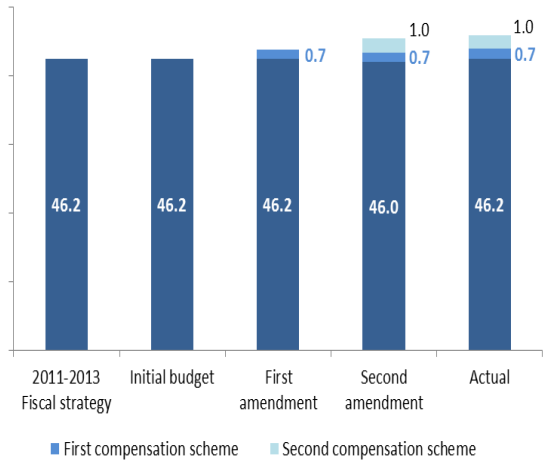
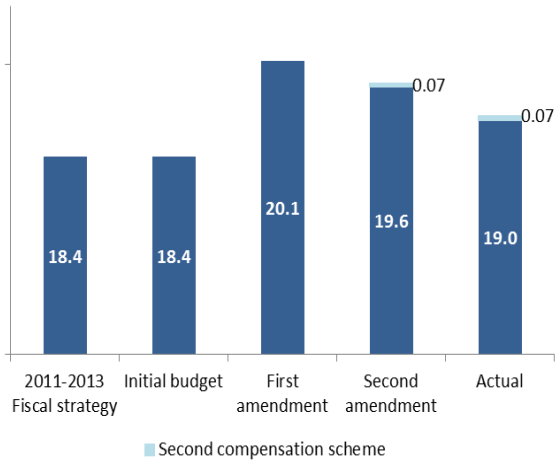


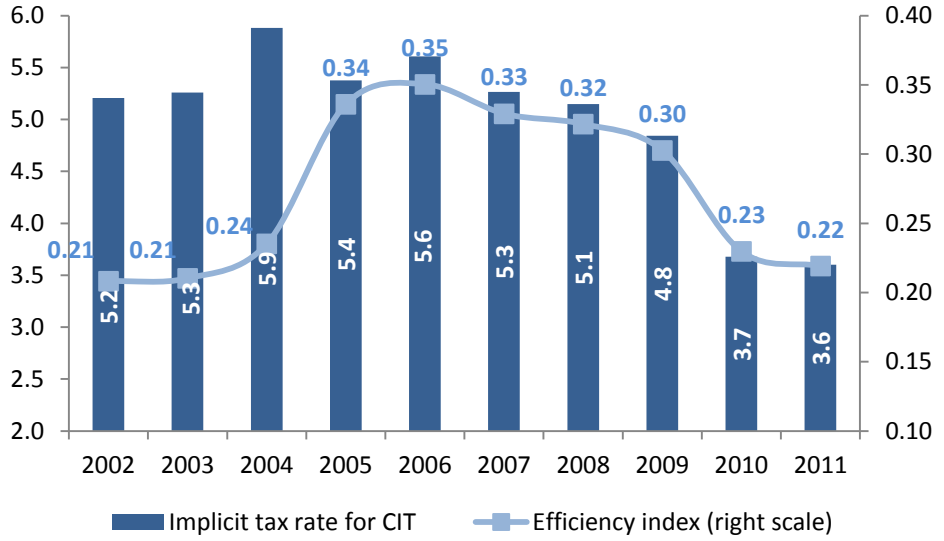
Figure 7: Excises 2011 (billion lei)



III.2.2. Direct taxes

Revenues from corporate income tax, slightly affected by compensation schemes (7.5 million RON), advanced marginally compared to the previous year (+1.8%), exceeding however the original budget estimates, by about 400 million. The modest evolution of revenues reflects also the impact of lump sum tax abrogation at the beginning of the year. Nominal revenues from corporate income tax remained significantly below pre-crisis levels. This trend can be observed also by considering the efficiency index, which showed a significant reduction in the period 2008-2011 (in line with developments in NMS 10); *Chart 8* 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 – the indicator performed in line with the relevant macroeconomic basis (gross operating surplus), excluding the impact of compensation schemes.

Figure 8: Implicit tax rate and taxation efficiency index for corporate income tax in Romania



Source: Fiscal Council calculations

Compared with other countries from Central and Eastern Europe[11], in 2011, Romania was in fifth position (same position as in 2010), with an efficiency index of 22% and an implicit tax rate of 3.6% (calculated as the ratio of direct taxes paid by enterprises and gross operating surplus from national accounts, as an approximation to the actual tax base). The evolution of the efficiency index for Romania in the 2009-2011 period is probably the consequence of a one year delay in resumption of economic growth compared with other countries in the region.

[11] Poland is not included in the rankings for the year 2011 due to unavailability of data on the gross operating surplus in national accounts.

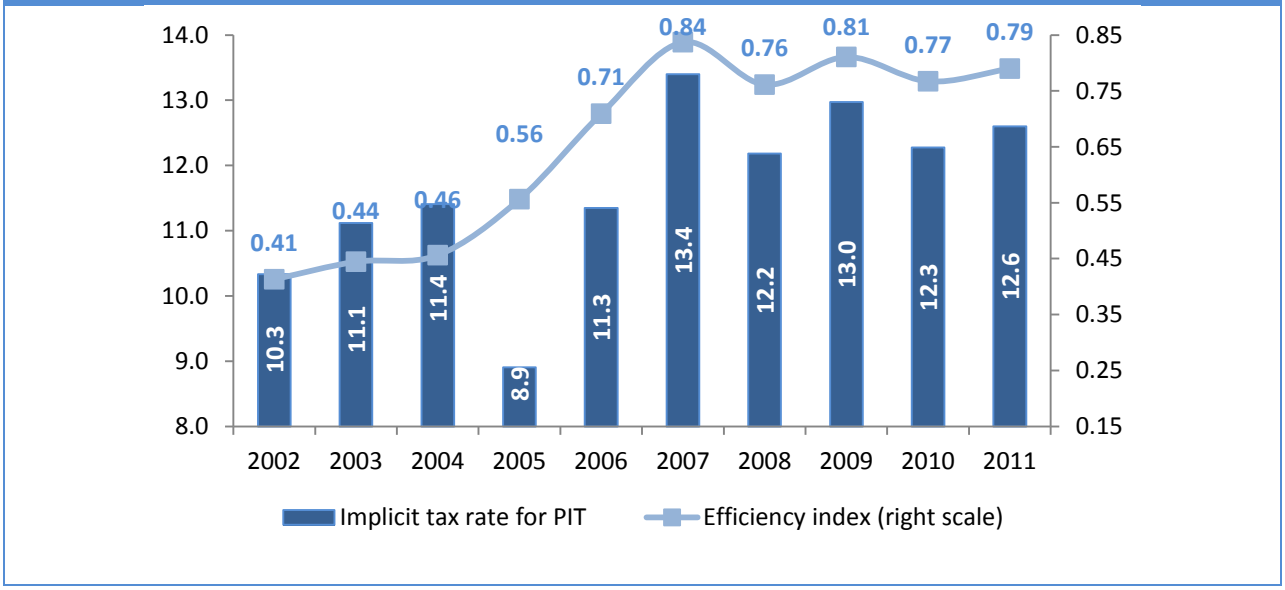
Country	Legal corporate income tax			Implicit tax rate*			Taxation efficiency index**			Rank		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
BG	10.0	10.0	10.0	5.2	4.2	3.9	0.52	0.42	0.39	1	1	1
CZ	20.0	19.0	19.0	7.2	6.8	7.0	0.36	0.36	0.37	2	2	2
EE	21.0	21.0	21.0	5.3	3.4	3.1	0.25	0.16	0.15	7	7	8
LV	15.0	15.0	15.0	3.5	2.0	2.9	0.23	0.14	0.19	9	10	6
LT	20.0	15.0	15.0	4.1	2.1	1.6	0.20	0.14	0.11	10	8	9
HU	21.3	20.6	20.6	5.6	2.8	3.0	0.26	0.14	0.15	4	9	7
PL	19.0	19.0	19.0	4.5	4.0	NA	0.24	0.21	NA	8	6	NA
RO	16.0	16.0	16.0	4.8	3.7	3.6	0.30	0.23	0.22	3	5	5
SI	21.0	20.0	20.0	5.3	5.5	5.5	0.25	0.27	0.27	6	3	3
SK	19.0	19.0	19.0	5.0	5.0	5.1	0.26	0.26	0.27	5	4	4

Source: European Commission, Eurostat, MoF, Fiscal Council 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

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



Source: Fiscal Council

Revenues from personal income tax have performed better than expected, exceeding the initial program and also the second budget amendment estimates (by about 700 million lei and 340 million respectively). This evolution reflects an average wage growth of 4.9% and improved conditions in the labor market, while the slight increase in the implicit tax rate compared to the previous year is probably attributable to the pension recalculation of former military personnel and of category I and II workers, retired before 2001 (their average pension was above the taxable threshold of 1,000 lei, which implies a revenue surplus from personal income tax).

Compared with other countries in the region, Romania retained its third position in the sample[12], with an efficiency of 79% and an implicit tax rate of 12.6% (calculated as the ratio of direct taxes paid by households[13] and gross wages from national accounts - including unobserved economy, for which social security contributions paid by employees were deducted from salaries).

Country	Legal personal income rate * (%)			Implicit tax rate**			Taxation efficiency index ***			Rank		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
BG	10.0	10.0	10.0	10.7	10.3	10.3	1.07	1.03	1.03	1	1	1
CZ	15.0	15.0	15.0	8.7	8.6	9.3	0.58	0.57	0.62	10	9	7
EE	21.0	21.0	21.0	15.1	15.6	15.7	0.72	0.74	0.75	5	4	5
LV	23.0	26.0	25.0	15.5	19.3	19.3	0.68	0.74	0.77	6	5	4
LT	15.0	15.0	15.0	13.1	12.4	12.8	0.87	0.83	0.85	2	2	2
HU	27.0	24.5	16.0	16.8	15.6	11.6	0.62	0.64	0.73	7	7	6
PL	25.0	25.0	25.0	18.6	17.8	NA	0.75	0.71	NA	4	6	NA
RO	16.0	16.0	16.0	13.0	12.3	12.6	0.81	0.77	0.79	3	3	3
SI	27.0	27.0	27.0	16.4	16.0	15.9	0.61	0.59	0.59	8	8	8
SK	19.0	19.0	19.0	11.2	10.7	11.2	0.59	0.56	0.59	9	10	9

Source: European Commission, Eurostat, MoF, Fiscal Council calculations

[12] No data available yet for Poland on 2011 gross wages from national accounts.

[13] Include also other forms of taxes paid by the population (e.g. tax on capital gains, interest income and pensions), not just wages. Unfortunately, no detailed data are available on types of taxes paid by the population to take into account only taxes on wages. This is the explanation for which value of efficiency index may be higher than one (see for example Bulgaria in 2009).

* For countries with progressive taxation system (Hungary- until 2011, Poland, Slovenia), the figure reported is the average tax rate (HU, PL- with two tax rates) or central rate (in Slovenia- three tax rates)

**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 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

Figure 10: Corporate income tax 2011 (billion RON)

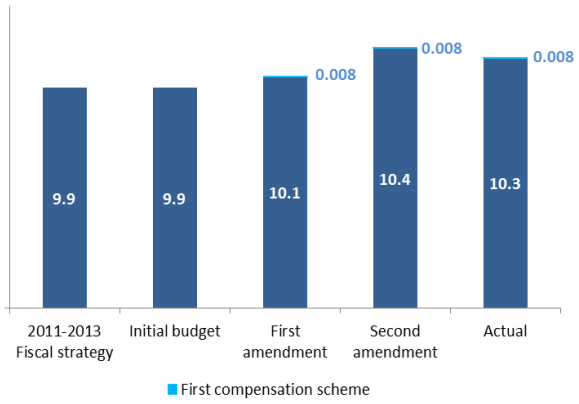
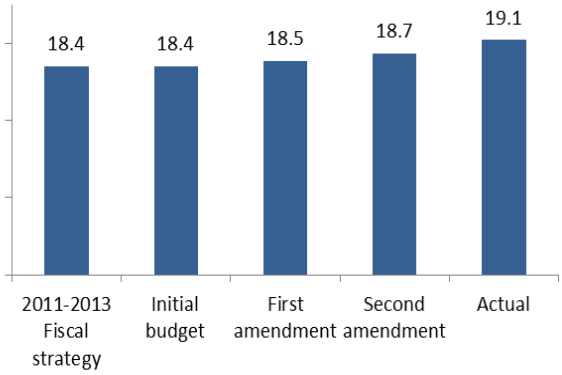


Figure 11: Personal income tax 2011 (billion RON)



III.2.3. Social contributions

Revenues from social contributions, totaling 50.6 billion at the end of 2011, have exceeded initial estimates by 1.4 billion given that the impact of implemented compensation schemes was 726 million. This level stood well above the one estimated at the second amendment by 1.1 billion, registering an increase (net of the impact of compensation schemes) of 9.2 per cent compared with the level of the previous year. Revenue dynamic surpassed that of the relevant macroeconomic base (gross wages from the national accounts), which implies an increase of the implicit tax rate and an improvement of the efficiency of taxation index (from 0.59 to 0.61).

Social security contributions trend in 2011, although largely affected by the impact of tax base widening (extended health insurance contributions for pensions over 740 RON monthly, redefining dependent activities) and the introduction of social security contributions for military personnel – which are not reflected in the evolution of the macroeconomic base considered, shows a slight improvement in taxation efficiency. Additional revenues from these sources more than offset unfavorable impact on revenues of another 0.5 percentage points redirected from social security contributions of employees to Second Pillar Pensions.

Figure 12: Social security contributions in 2011(billion RON)

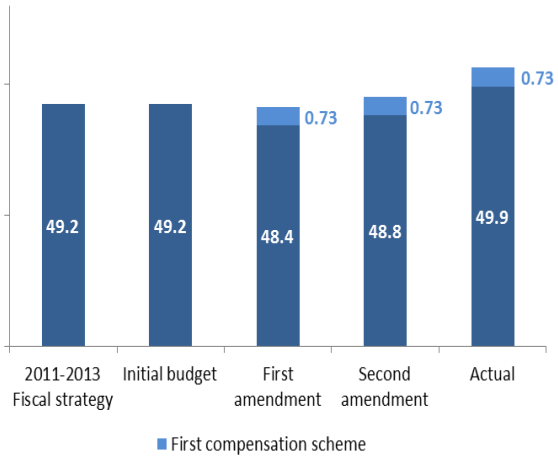
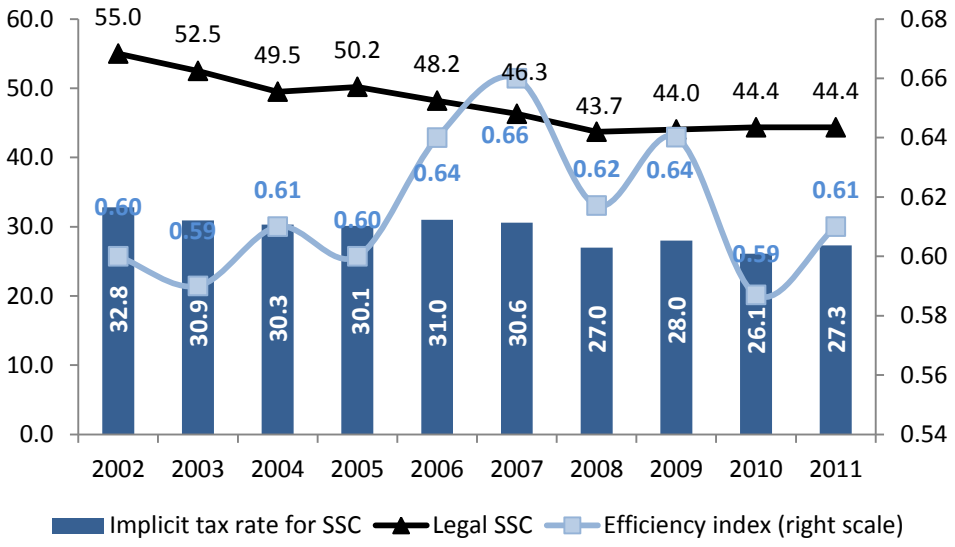


Figure 13: Evolution of implicit tax rate and taxation efficiency index for SSC in Romania



Source: Fiscal Council calculations

In comparison with other countries in region[14], Romania continues to be ranked last in the matter of social contributions collection efficiency, despite the improvement recorded in 2011. Even if the aggregate statutory contribution rate ranks third in the region (after Slovakia and Czech Republic), Romania's implicit tax rate is close to the one of Latvia, which occupies the penultimate place in the region considering the statutory rate of social security contributions. An improvement in the taxation efficiency index equal to the one of Latvia (the country with the next higher taxation efficiency index after Romania) would have generated additional budget revenues of 6.6 billion RON (1.1% of GDP) in 2011.

Country	Legal tax rate for social contributions* (%)			Implicit tax rate**			Taxation efficiency index***			Rank		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
BG	30.9	28.9	30.2	24.3	21.3	23.2	0.79	0.74	0.77	7	8	7
CZ	46.3	45.3	45.3	46.6	48.3	49.0	1.01	1.07	1.08	1	1	1
EE	35.7	37.2	37.2	34.2	36.8	34.9	0.96	0.99	0.94	2	2	2
LV	33.1	33.1	35.1	21.5	23.0	24.7	0.65	0.70	0.70	9	9	8
LT	40.0	40.1	39.8	33.2	31.8	31.8	0.83	0.79	0.80	6	6	6
HU	49.0	44.0	44.5	36.2	34.1	36.7	0.74	0.78	0.82	8	7	5
PL	37.9	37.9	37.6	35.2	34.2	NA	0.93	0.90	NA	3	3	NA
RO	44.0	44.4	44.4	28.0	26.1	27.3	0.64	0.59	0.61	10	10	9
SI	38.2	38.2	38.2	32.8	33.1	33.4	0.86	0.87	0.87	5	4	3
SK	48.6	48.6	48.6	42.2	41.8	42.0	0.87	0.86	0.86	4	5	4

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

* 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 budget revenues exclude additional receipts due to implementation of compensation scheme for clearing arrears (+726 million RON).

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

III.3. Budget expenditures

Budget expenditure, net of compensation scheme impact, has grown slowly (+ 0.3% compared to the previous year) up to 202.9 billion RON, mainly due to the declining wage fond by 10.1 per

[14] Data regarding gross wages from the national accounts in 2011 is not yet available for Poland.

cent compared to 2010 and reduced subsidies by 17 per cent. Expenditure items that registered an increase compared to 2010 are projects funded from external post-accession grants (3.4 billion RON), capital expenditure (3.3 billion RON) and goods and services related expenditure (2.1 billion RON).

Figure 14: Quarterly revenues of general consolidated budget (million RON)

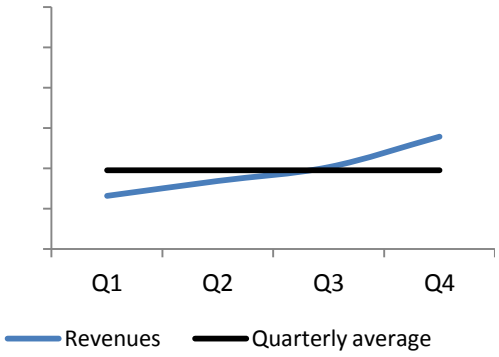
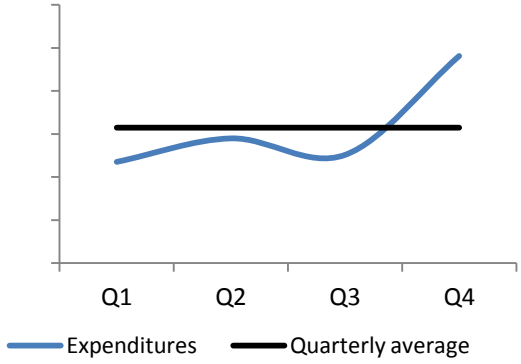


Figure 15: Quarterly expenditures of general consolidated budget (million RON)



Note: values excluding compensation schemes impact

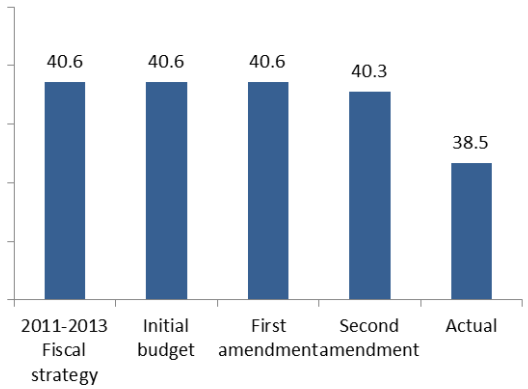
This year too, the quarterly trend of general consolidated budget still indicates a spending acceleration in the last quarter of the year. Specifically, total spending in Q4 2011 reached 59 billion RON, 24% higher than the previous quarter, and 1.5% higher than Q4 2010. More than half of the spending hike in Q4 2011 was caused by capital spending (up by 148% compared to the previous quarter[15]).

[15] Of the 7 billion capital expenditure in December 2011, one billion was used for settlement of arrears accumulated by two state owned companies.

III.3.1. Personnel and social assistance expenditure

Personnel expenditures were revised downwards during 2011, being programmed in an overly cautious manner, therefore they were constantly overestimated: the wage bill was reduced from 40.56 billion RON in the initial budget, to 40.3 billion at the second amendment, reaching 38.5 billion RON in the execution – 10 per cent lower than 2010.

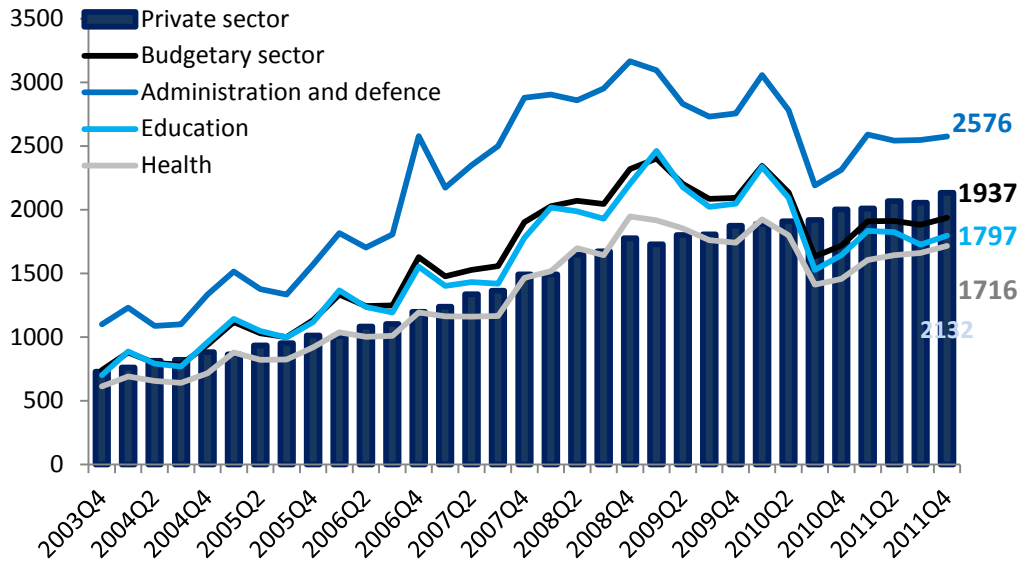
Figure 16: Personnel expenditure in 2011 (billion RON)



Diminished personnel expenditure compared to the 2010 level is due to the impact generated by wage reductions from mid-2010, reversed in part at the beginning of 2011 (+15%), the measured being accompanied by the elimination of holiday bonuses and "the 13th salary", altogether with substantially reduced number of public sector employees (both in 2010 and 2011), under strict application of the "1 to 7" staff replacement rule in the public sector.

Nominal reduction of personnel expenditure (4.34 billion RON lower than in 2010, respectively 10.13%) had the most important contribution to the fiscal consolidation undertaken. Expressed as percentage of GDP, personnel spending recorded an adjustment of 1.54 percentage points, reached a level of 6.65 per cent, explaining two thirds of the budget deficit reduction.

Figure 17: Average gross gain in the private and public sector (RON/month 2005-2011)



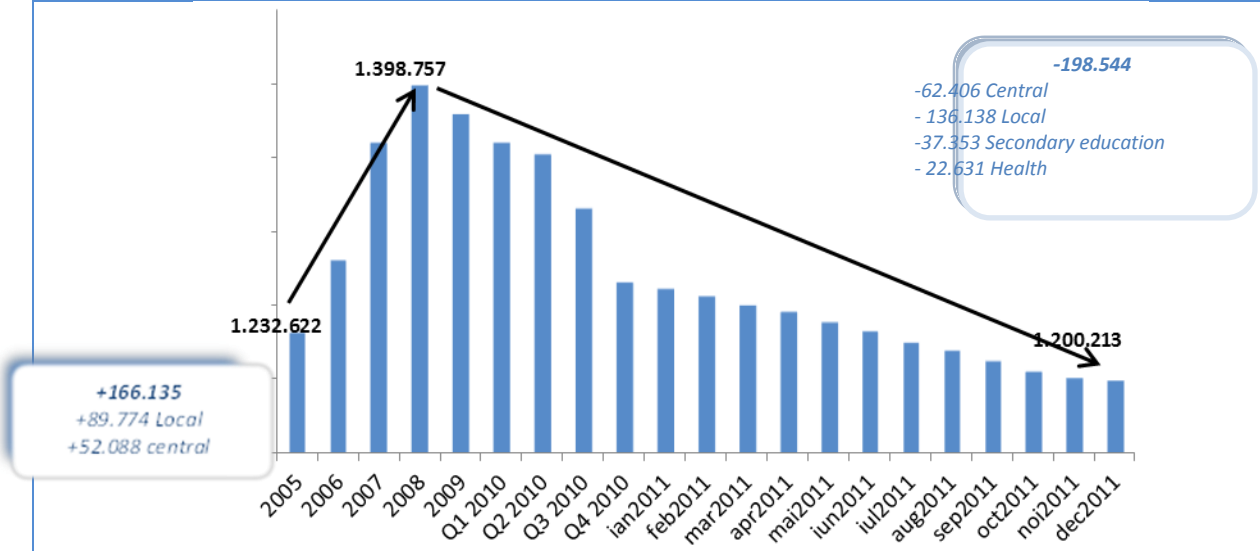
Source: National Institute of Statistics, Fiscal Council calculations

Public employment decreased by 198,544 (to 1.2 million employees) between end-2008 and December 2011 (*Figure 18*). More than two thirds of the employment decrease occurred at the level of local authorities[16] (approximately 136,000), out of which 37,000 in the secondary education staff.

Compared to the previous year, the total number of employees declined by 66,337 in 2011, mainly due to departures in local authorities (approximately 43,000), while in the central government the most important departures where noticed in the Ministry of Administration and Internal Affairs (almost 13,600) and in the Ministry of Finance (approximately 2,700).

[16] It is possible for some of these reductions to be reflected in service outsourcing explained by a significant increase in spending on goods and services.

Figure 18: Evolution of public sector employment



Source: Ministry of Public Finance

Table 4 Public employment by ministries	December 2008	December 2010	December 2011	Differences (dec. 2011-dec.2008)	Differences (dec. 2011-dec.2010)
Total employment	1,398,757	1,266,550	1,200,213	-198,544	-66,337
A. Central administration	694,995	655,582	632,589	-62,406	-22,993
1. State budget	338,727	334,533	318,604	-20,123	-15,929
Ministry of Administration	146,955	147,822	134,168	-12,787	-13,654
Ministry of Defense	79,666	79,210	77,290	-2,376	-1,920
Ministry of Finance	33,716	31,210	28,504	-5,212	-2,706
Ministry of Justice	13,558	15,053	15,093	1,535	40
Other ministries	64,832	61,238	63,549	-1,283	2,311
2. Self-financed institutions	304,132	275,861	270,075	-34,057	-5,786
Hospitals[17]	209,273	192,498	186,642	-22,631	-5,856
Universities	68,095	68,229	68,229	134	0
3. Institutions financed	52,136	45,188	43,910	-8,226	-1,278

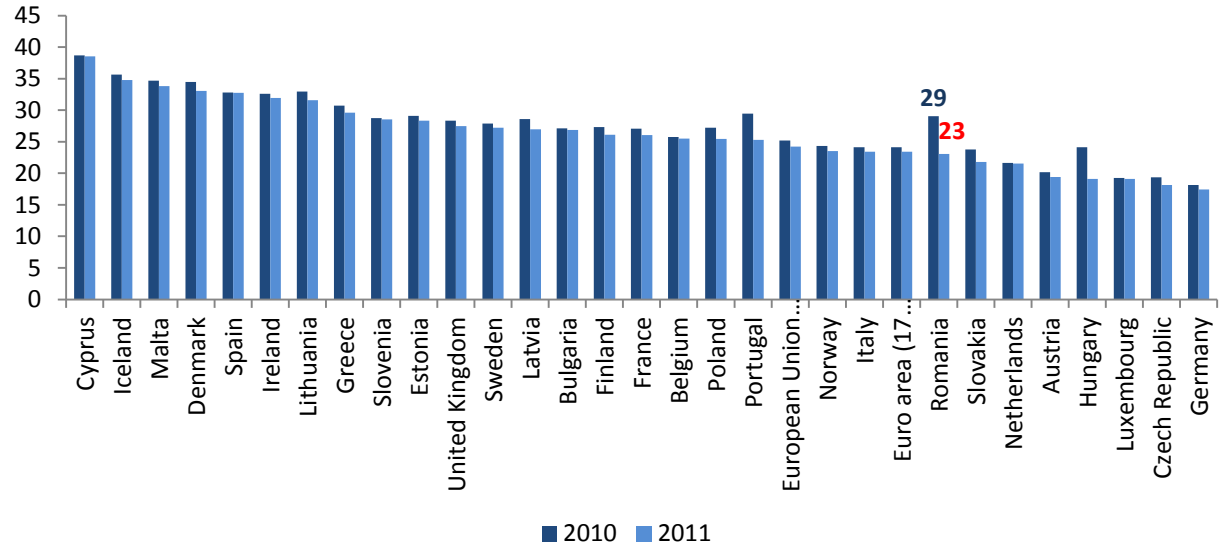
[17] For comparability, we included all medical units in central administration, although some of them have been transferred during 2010 under local authority.

from the Social Security's Budget					
B. Local authorities	703,762	610,968	567,624	-136,138	-43,344
Pre-university education	332,952	303,477	295,599	-37,353	-7,878
Local executive authorities	310,912	264,382	233,227	-77,685	-31,155

Source: Ministry of Public Finance

Compared to other European countries, Romania's position has improved due to fiscal consolidation measures undertaken since mid-2010. In 2010, the wage bill as share of total budget revenues placed Romania in the first half of the ranking, while 2011 ESA95 data presented a much better ranking for the country, though registering a higher expenditure than other comparable economies like Hungary, Czech Republic or Slovakia.

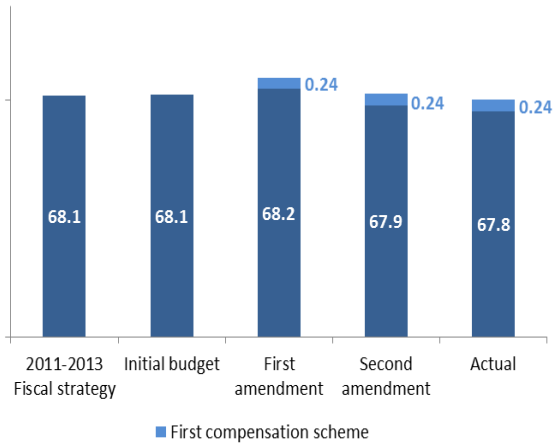
Figure 19: Wage bill as share of total budget revenues in EU27 countries



Source: EUROSTAT, 2011 data

The budgetary execution shows that social assistance expenditure was in line with the forecasts. In the initial budget, the level of social assistance expenditure, net of compensation schemes' impact, was set at 68.1 billion RON, but it only reached a level of 67.8 billion RON, 0.5% less than in the baseline scenario and 1.3% lower compared to the value registered in 2010. This reduction can be explained by the fact that the increasing in pension expenditure was exceeded by other social assistance items' decreases.

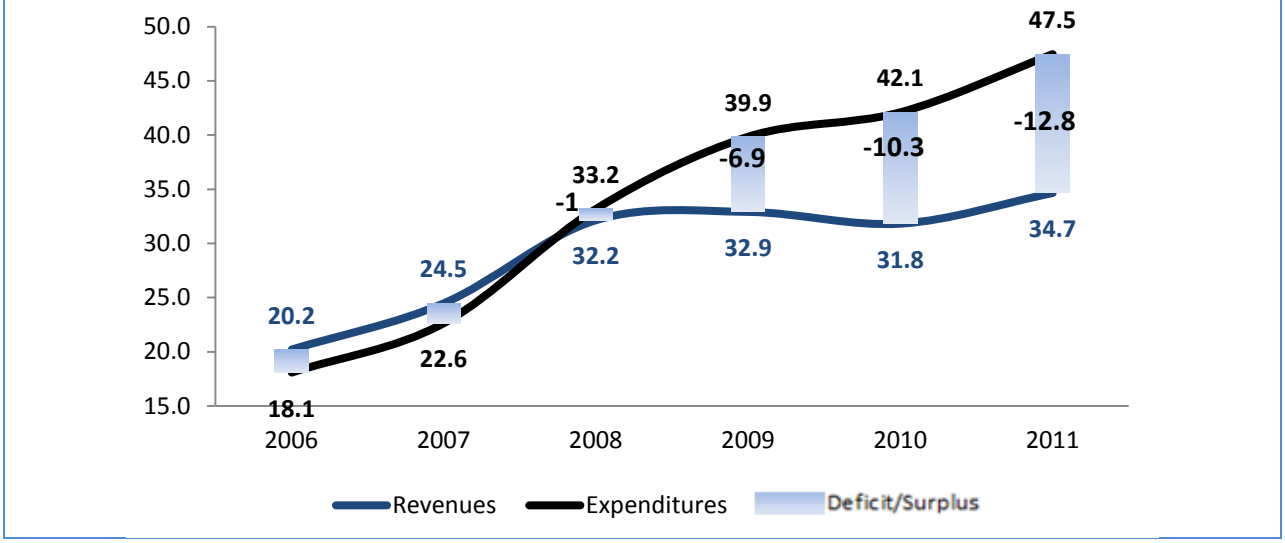
Figure 20: Social assistance 2011 (billion RON)



Social assistance expenditure has a significant share in the total budget expenditure and the structural deficit of the public pension system is not yet solved: pension expenditure is unsustainable in relation to the contributions collected, even if some measures were undertaken in order to improve this shortcoming.[18] In recent years, social security budget deficit widened, reaching 12.8 billion RON in 2011 and 2.2 per cent of GDP. Pension expenditure advanced by 5.4 billion RON in 2011, mainly due to military pensions' transfer to the social security budget, accompanied by the increasing (by recalculation) pensions of military personnel and group I and II former workers with contribution stages prior to 2001 and the entry of new participants in the pension system with higher-than-average pensions, while the revenues increased by only 2.8 billion RON. Given these changes, there are important risks regarding medium term sustainability of social security budget and the appropriateness of any potential costs increases or contributions reductions should be considered only in the context of identifying alternative solutions to reduce the system's deficit, especially by broadening the tax base.

[18] Law 263/2010 regarding the unitary system of pubic pensions modifies indexation system, increases standard retirement age and introduces more stringent criteria for early retirement

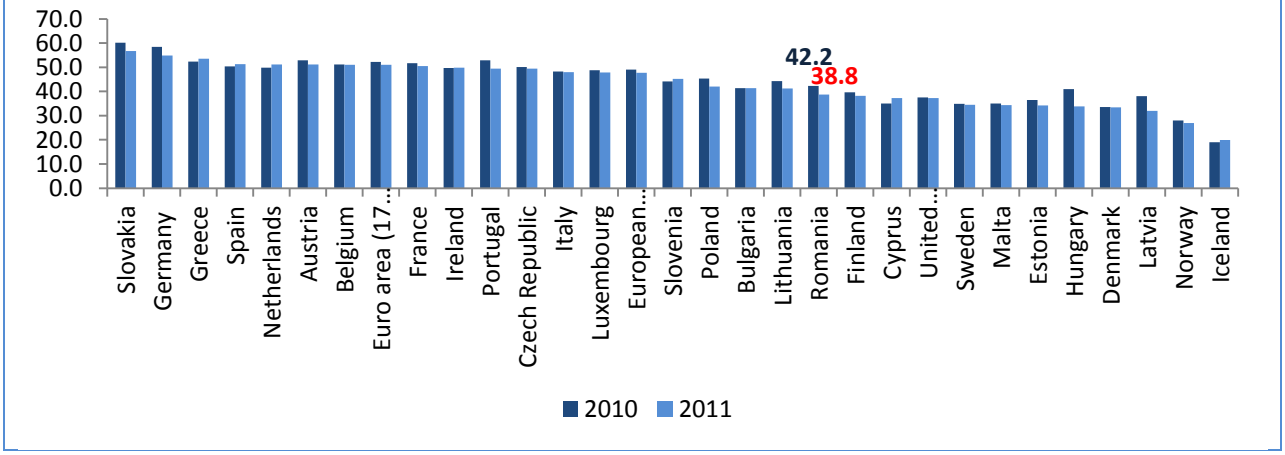
Figure 21: Revenue and expenditure of social security budget (billion RON)



Source: Ministry of Finance, cash-standard data

During 2011, Romania's position regarding social assistance expenditure's share in total budget revenue has marginally improved compared to 2010, falling in the second half of EU countries' ranking. However, this item of expenditure remains at a significantly higher level than the social contributions collected.

Figure 22: Social expenditure as share of total budget revenues in EU27



Source: EUROSTAT, 2011 data

III.3.2. Public investment expenditure

Between the items of public investment expenditure, which include capital expenditure, projects funded by external post-accession grants, expenditure for reimbursable programs and other transfers related to investments, capital expenditure registered a steep increase, exceeding the level programmed in the second amendment by 2.3 billion RON. This finding indicates significant weaknesses in the budget programming process.

Figure 23: Capital expenditure 2011 (billion RON)

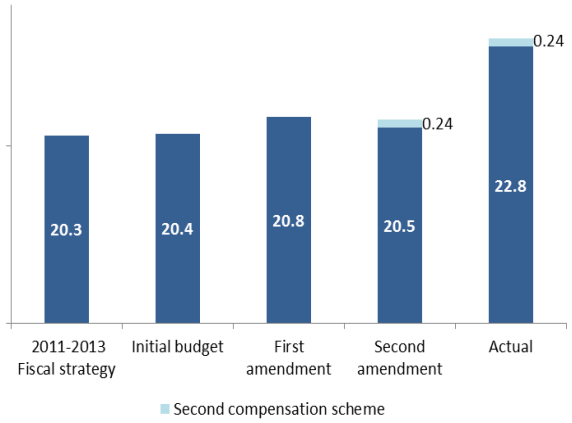


Figure 24: Projects funded by external post-accession grants 2011 (billion RON)

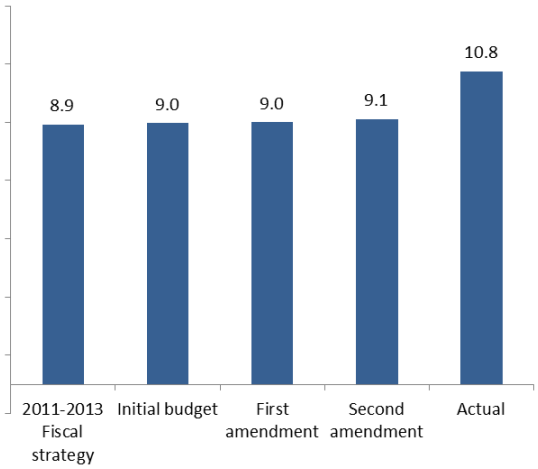
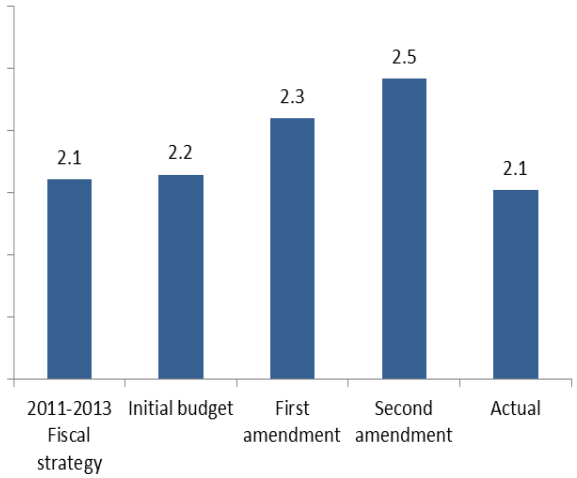
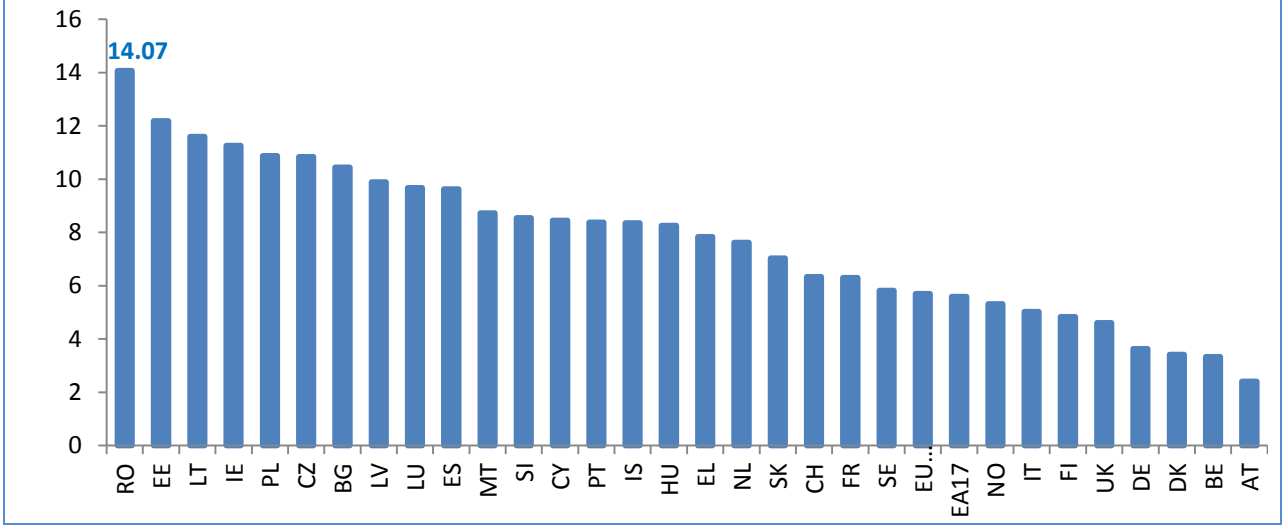


Figure 25: Expenditure funded from reimbursable funds 2011 (billion RON)



During the period 2001-2011, Romania had one of the highest allocations for public investment expenditure as a share of total budget revenues (ESA95 standards), compared to EU27 countries. However, the results in terms of improving infrastructure quality were poor.

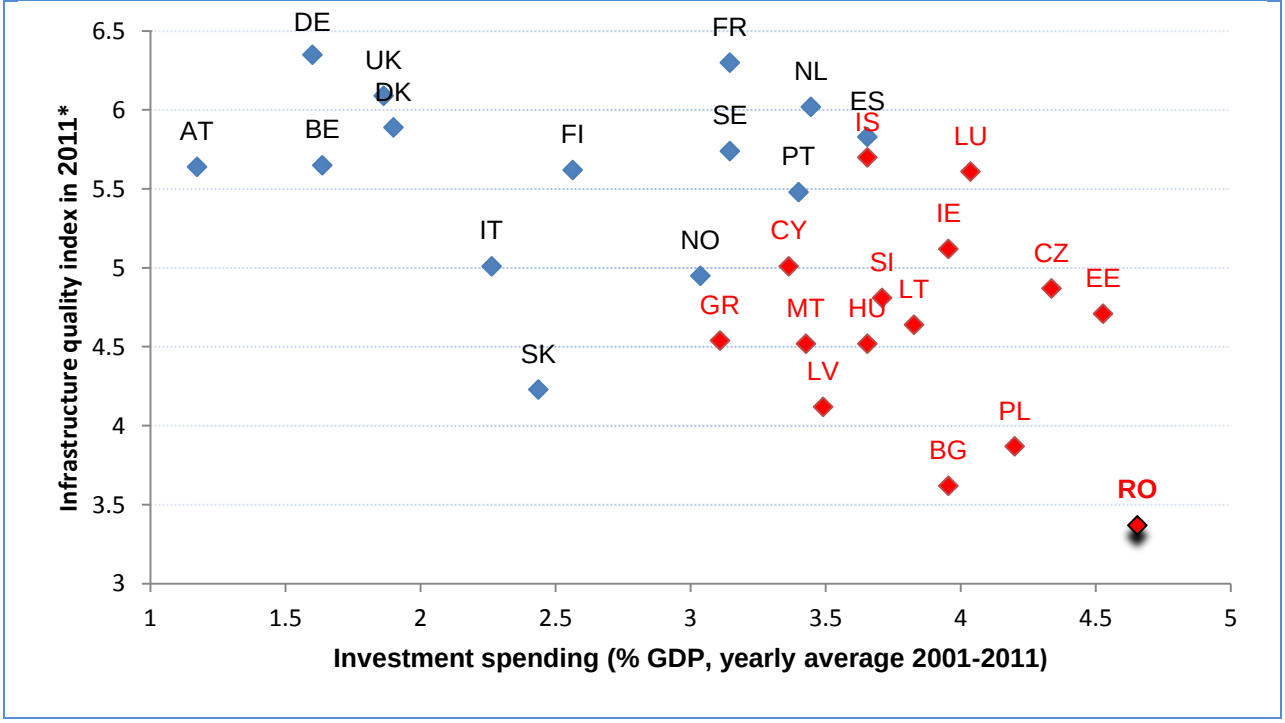
Figure 26: Public investment expenditure share in total budget revenues in EU27 (2001-2011 average)



Source: EUROSTAT

Although between 2001 and 2011 Romania had the largest public investment expenditure as share of GDP among European countries, states like Poland, Hungary, Bulgaria, Slovakia and Slovenia, with lower investment expenditure, have a better infrastructure quality, which shows the low efficiency of this expenditure item in Romania (*Figure 27*).

Figure 27: Public investment expenditure and infrastructure quality



Source: EUROSTAT, World Competitiveness Report 2011-2012

Despite previous recommendations of the Fiscal Council regarding the necessity of elaborating a list prioritizing all national investments, there are still lacking specific information on: investment distribution on sectorial policies, details on investment projects considered as being a priority and multi-annual fund allocations for these projects. In the Fiscal Council's opinion, more transparency in programming the investments' budget based on a proper analysis of the existing projects portfolio and rationalizing it by prioritizing the projects, altogether with multi-annual allocation of funds is vital for an efficient use of available resources. In addition, such an approach would be consistent with the efficiency principle defined by the Fiscal Responsibility Law, according to which "the Government's fiscal and budgetary policies will be based on achieving an efficient use of scarce public resources requiring economic efficiency to be considered in defining fiscal policies and public investment decisions, including those related to EU funded initiatives or other donors, to be based inter alia on an economic appraisal as well as an assessment of the capacity to absorb increased funding levels".

In addition, even the new budgetary constraints imposed by the fiscal pact oblige to a more efficient spending of public money. Considering the same budgetary resources, an additional limitation of the budget deficit target imposes higher efficiency in public spending.

III.3.3. The contingency reserve fund

According to the Public Finance Law no. 500/2002, the contingency reserve fund at Government's disposal is allocated to line credit officers from state government and local governments, based on Government's decision to finance urgent or unforeseen expenditures incurred during the year. However, the law does not specify explicitly the categories of expenses that can be employed from the contingency reverse fund and it does not mention any limitations on the amount of allocations, conditions which provide space for discretionary and non-transparent allocations.

The opportunity of including a contingency reserve fund into the general budget is confirmed by literature on budget programming, which also highlights the necessity of finding a balance regarding the dimension of such a fund. Thus, a level of the contingency reserve fund too low might be insufficient to cover operational costs, while an oversized fund might grant too much power for the authorities to make excessive expenditure, without the Parliament's approval.

In practice[19], national budgets include a contingency reserve fund usually between 1 and 3 per cent of total budget expenditure, the ceiling being established by the national Parliaments, which are regularly informed by the Governments on the amount and destination of the

[19] Potter and Diamond (1999), "Guidelines for Public Expenditure Management", International Monetary Fund

spending funded from this source. According to an IMF study[20], the best practice in budget programming provides strong requirements regarding reserve fund access, the type of expenditure that can be approved and the frequency of reporting to the legislative on the reserve fund utilization level.

Considering the best practice in this area, the Fiscal Council recommends explicit identification of expenditure that can be incurred from the contingency reserve fund and a higher transparency, through reporting on a regular basis to the Parliament about the utilization of this fund. Thus, detailed allocations from the contingency reserve fund, presenting conditions and criteria of allocations, and a breakdown between line credit officers are required. It is also recommended to limit the amounts that can be distributed and used from the fund as share of total budget expenditure. Without these clarifications, this report analyses the contingency reserve fund utilization during 2011 by identifying Government decisions published in Romania's Official Gazette.

Figure 28: Total contingency reserve fund allocations (billion RON)

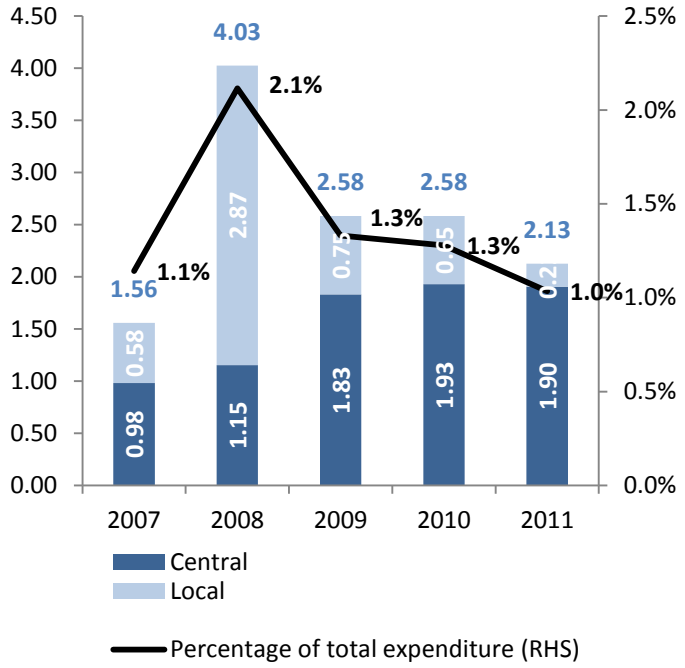
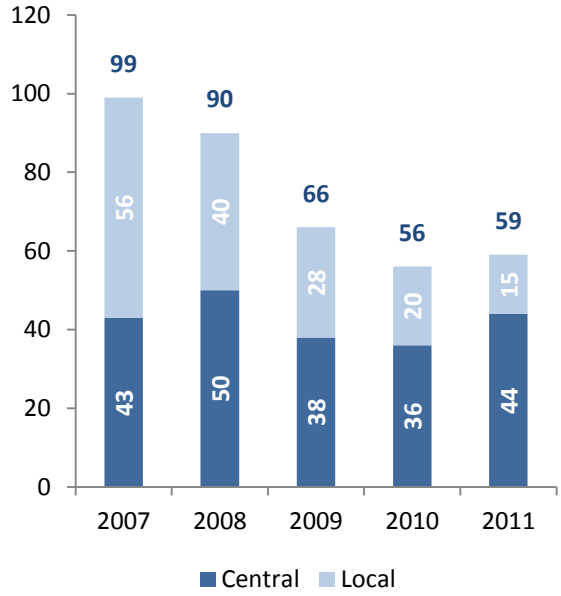


Figure 29: Number of total Government decisions regarding contingency reserve fund allocations



Source: Fiscal Council calculations

[20] Ian Lienert (2010), "Role of the Legislature in Budget Processes", Fiscal Affairs Department, International Monetary Fund

Thus, during 2011, 2.12 billion RON have been allocated from the contingency reserve fund, of which 1.9 billion were allocated for the central administration and about 222 million for local authorities. Among central government allocations, almost 600 million RON were distributed for arrears payment, for the Ministry of Transport and Infrastructure and for the Ministry of Environment and Forests. Compared to the previous year, contingency reserve fund allocations were lower by 456 million, solely on the basis of reduced amounts transferred to local administrations. Recent years' evolution shows an improvement in the budget programming process regarding the contingency reserve fund, as both the amounts allocated and the number of Government decisions promoted to use resources from this fund for unforeseen expenses decreased.

A detailed list of Government's decisions to use resources from the contingency reserve fund, detailed by line credit officers and destinations, can be found in *Appendix 1* to this report.

III.4. Public debt

The interest expenditure increased by 1.6 billion RON (+22 per cent) compared to 2010, due to public debt stock rising. Still, the final value of these expenses was lower than the one originally projected, as a consequence of the favorable evolution of government securities yields during the year.

Public debt continued to rise in 2011, its value as a share of GDP increased, according to national standards, to 38.5%[21] from 37.2% registered at the end of 2010, in the context of a 4.1% of GDP budget deficit. The growth rate of public debt decreased[22], slowing to 1.3 percentage points of GDP compared to 7.8 in 2010 due to a 2.5% economic growth, lower interest rates and a higher-than-forecasted GDP deflator. According to ESA95 standard, central public debt increased to 33.3%[23] of GDP at the end of 2011 compared to 30.5% in 2010 and 23.9% in 2009.

Government public debt[24] represents 92.86% of the total debt, compared to 91.97% in 2010, while local public debt decreased to 7.13% from 8.03% in the previous year. State loans have the highest share in total public debt, totaling 36.2%, followed by bonds, which represent 24.1%, and Treasury bills with 16.2%, while euro-bonds provide 8.2% of total public debt.

[21] 2011 GDP: 578,551.9 million RON.

[22] According to the 2011-2013 Fiscal Strategy, the forecast for public debt was 39.5% of GDP.

[23] According to Public Debt Report for December 31, 2011, published by the Ministry of Finance.

[24] According to ESA95 standard

Regarding the maturity structure of newly issued government securities, it is noticeable a predominance of short-term financing. Thus, Treasury bills with maturity up to one year account for 67% of new loans. Longer term financing is relatively low, bonds issued on more than a year totaling 33% of loans. Bonds with maturities between 5 and 10 years account for 5.8% and 4.7%, respectively, of the total, with relatively low shares, but higher than in the previous year. Moreover, an increasing share of financing on longer terms can be noticed, favored by both lower yields and an improved perception of risk regarding Romania.

The debt structure by currencies reveals an increasing share of RON denominated debt that increased to 48.1% in 2011 from 46.2% in 2010, while funding in euro registered a slight decrease to 42.5% from 42.6% at the end of last year.

The cost of attracting new resources in domestic currency registered a positive development as the government bond yields went down to about 6% at the end of 2011, compared to a level of 7% at the end of the previous year and 10% in 2009, as a result of reaching fiscal targets, reduced risk premium and a liquidity surplus in the banking system.

In order to forecast the public debt's future evolution in the coming years, its dynamic as share of GDP can be expressed by the following formula, derived from the inter-temporal budget constraint.

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

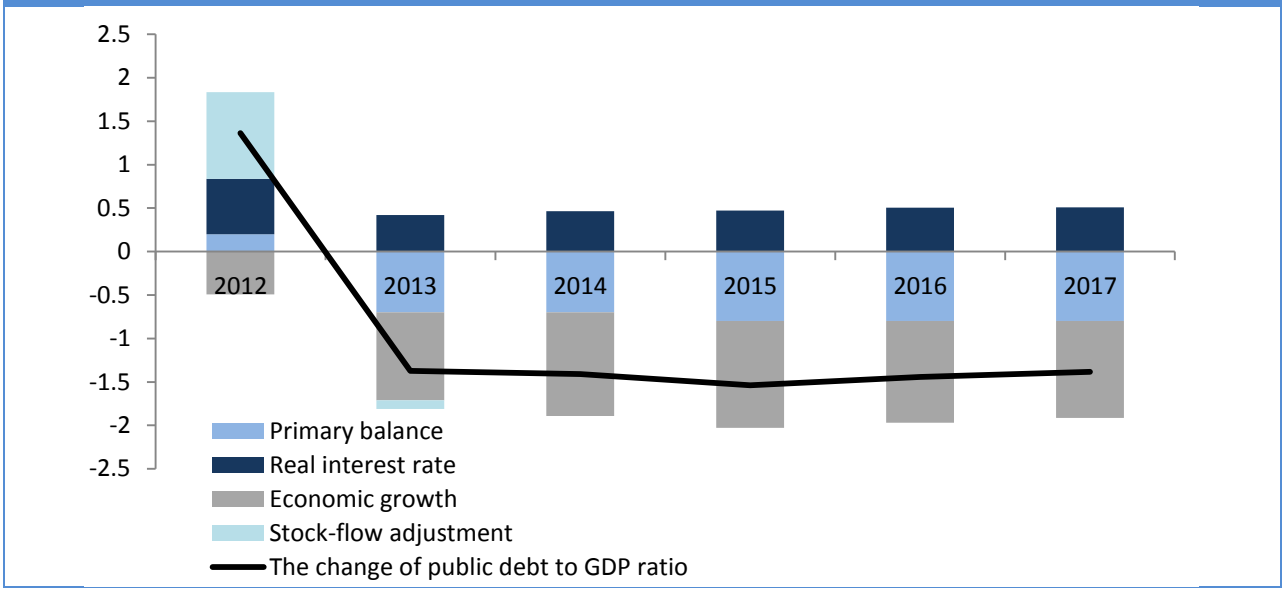
Where d_t is public debt stock at time t, y_t represents nominal GDP at time t, pb_t – is primary deficit at time t, sfa_t- stock-flow adjustments at time t, and

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

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 relationship above shows that public debt as share of GDP at time t depends on its weight in the previous period adjusted by the difference between real interest rate and economic growth rate, plus the consolidated general budget primary deficit expressed as percentage of GDP. In case of a real economic growth rate above the real interest rate on public debt, the latter, expressed as 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 λ_t coefficient can be seen as a real interest rate adjusted by the economic growth.

Figure 30: Contributions to changes in public debt as share of GDP- 2012-2017 forecasts



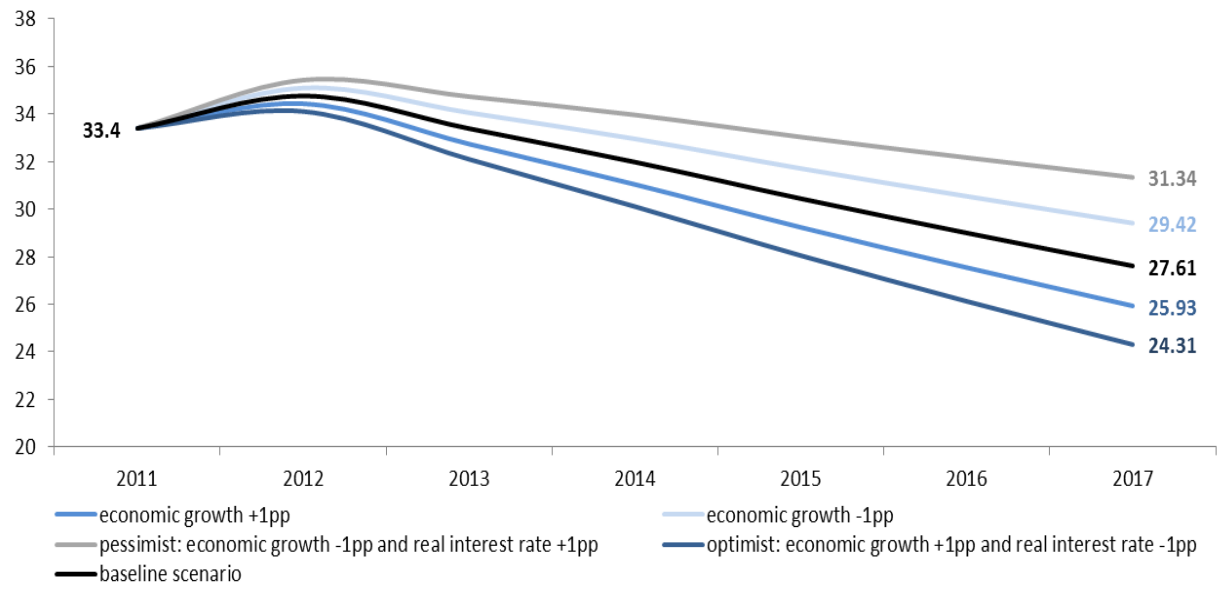
Source: IMF, Fiscal Council calculations

Using forecasts for the determinants of public debt development from the fourth review under precautionary stand-by arrangement with the IMF[25], determinants' contributions to changes of public debt as share of GDP were computed between 2012 and 2017. The forecast for public debt at December 31, 2011 was revised to 33.4% (ESA 95 standard), lower than the level from the IMF staff report, due to higher than expected nominal GDP dynamics.

The findings depend to a large extent on the forecasts used for the real interest rate and the growth rate of real GDP. A higher-than-expected real interest rate involves additional costs for financing public debt and may lead to increased public debt as share of GDP. Furthermore, a lower economic growth rate may cause an increase in public debt share compared to initial forecasts. Under the circumstances of uncertainty in achieving the forecasts, a sensitivity analysis is appropriate to assess the impact of changes in the variables used for evaluating public debt's evolution.

[25] Approved on March 25, 2012

Figure 31: Scenarios for the evolution of public debt (% of GDP)



Source: IMF, Fiscal Council calculations

A higher-than-expected economic growth rate by 1 percentage point leads to a decrease of public debt to 25.93% in 2017, while a negative trend, expressed as an economic growth rate lower by 1 percentage point, alongside with a higher real interest rate by 1 percentage point, leads to a reduced public debt as share of GDP from the actual level to only 31.34%.

III.5 The absorption of EU funds

In the period 2007-2013, Romania will be granted 19.2 billion euros of EU structural and cohesion funds. Coordinated by the EU cohesion policy, these funds are designed to support the convergence of member countries, increasing competitiveness and employment.

Table 5: Structural funds absorption by operational programs (billion EUROS)						
	Total allocations 2007-2013	Payments December 2011			Absorption rate	Absorption excl. pre-financing
		Total, o/w:	**Pre-financing**	**EU Refunds**		
Regional Development	3.726	929,5	513,1	416,4	24,95%	11,18%
Environment	4.512	535,0	351,3	183,6	11,86%	4,07%
Transport	4.565	139,8	0,0	139,8	3,06%	3,06%
Competitiveness	2.554	405,6	142,9	262,7	15,88%	10,28%
Human Resources	3.476	841,7	549,7	292,0	24,21%	8,40%
Administrative Capacity Development	208	24,5	5,5	19,1	11,80%	9,17%
Technical Assistance	170	20,5	1,2	19,4	12,06%	11,38%
Total	**19.213**	**2.896,7**	**1.563,7**	**1.333,0**	**15,08%**	**6,94%**

Source: ACIS, Fiscal Council calculations

With an absorption rate of only 15.08% of the total allocation for December 2011 (the highest rate of 24.95% for Regional Development OP and the lowest of 3.06% for the Transport OP), Romania is facing serious challenges and risks to lose these opportunities.

Transport OP is the least efficient operational program, with only 139.8 million euro paid until the end of 2011 (about 3% of the available budget for 2007-2013).

In contrast, as of December 2011, Bulgaria absorbed 22.84% of its total available budget for transport infrastructure (about 94 million euro) and has a contract ratio of 86.52%.

At the other end, the Regional OP and Human Resources OP are the best performing programs in terms of absorption of structural funds. These programs had an absorption rate of 24.95% and 24.21%, with paid grants of 929.5 million euro and 841.7 million euro respectively.

It is true that in many new member states, EU funds' absorption after accession was quite slow, so in this respect, Romania is not atypical. Nevertheless, Romania is now in its sixth year as an EU member state, and available funds have a time limit, they must be used by 2013.

Table 6: Absorption of structural funds- comparison with other EU Member States					
	Total allocations 2007-2013 billion Euros	Payments March 2012 billion Euros	Absorption Rate	Total allocations per capita Euro	Total payments per capita Euro
Estonia	3.4	1.6	46.8%	2540	1190
Latvia	4.5	1.7	36.4%	2032	740
Poland	67.2	26.4	39%	1759	690
Czech Republic	26.5	7.0	26.5%	2520	667
Bulgaria	6.7	1.6	24%	889	209
Romania	19.2	3.3	17.3%	897	155
Hungary	24.9	8.8	35.3%	2496	881
Lithuania	6.8	3.3	48.0%	2088	1002
Slovenia	4.1	1.6	38.3%	2000	767
Slovakia	11.5	3.2	27.8%	2116	587

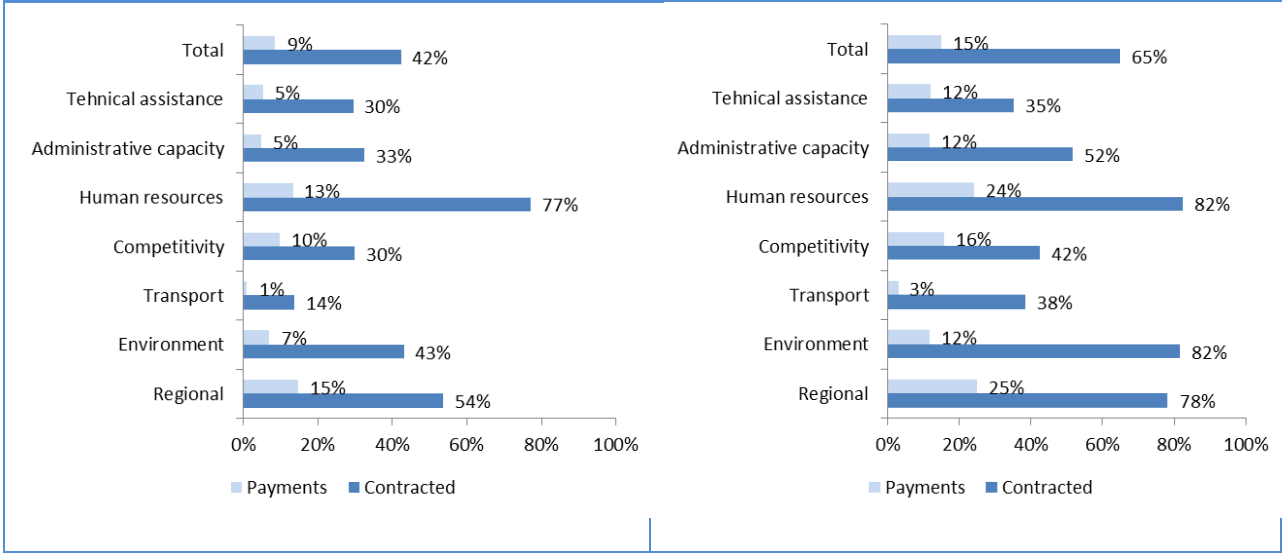
Source: European Commission

Benchmarked against other new member states, the low absorption rate in Romania is even more obvious. The average rate of absorption after five years of membership is far below the average of countries in the sample above (17.3% vs. 33.9% - ratios for March 2012).

Thus, by the end of 2011, Lithuania has used over 3.3 billion euros in EU grants, which means 48% of the available budget for 2007-2013. Similarly, Estonia, Poland, Slovenia and Latvia succeeded until now to use 46.8% (about 1.6 billion euros), 39% (26.4 billion euros) and 38.3% (1.6 billion euros), respectively, of the allocated funds. In 2011, the low absorption rate of EU grants places Romania on the last place in the 10 newest member states' ranking, far behind Bulgaria, ranked second to last country (its absorption rate being 24%).

The amount of EU funds absorbed in Romania divided by the population is also the lowest in the EU, 155 euro per capita, against 1,190 euro in Estonia or 209 euro in Bulgaria.

Figure 32: Absorption of funds: payments and contracting



Source: Fiscal Council calculations

On the positive side, the process of contracting structural and cohesion funds improved in 2011, with a contracted ratio of 65%, up from 42% in 2010.

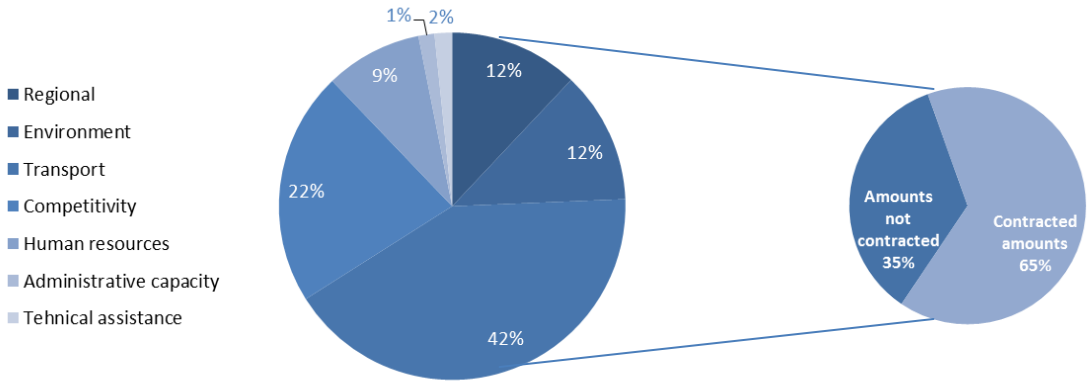
Nevertheless, there are significant discrepancies between the seven operational programs, Human Resources OP and Environment OP being the top performers, with contracted ratios of 82%, and the Regional Development OP with 78%.

At the other end of the spectrum is the Technical Assistance OP, with a contracted ratio of only 35% and the lowest allocations.

A notable performance is recorded in the transportation area, where the contracted funds through Transport OP have increased to 38% in 2011 from only 14% in the previous year.

Regarding the breakdown by operational programs of EU funds to be contracted, (*Figure 33*), Transport OP has the largest amount (approximately 2.8 billion euros and 42% of the total amounts not contracted), followed by Environment OP (0.82 billion euros and 12.3% of total).

Figure 33 : Amounts not contracted by Operational Programs



Source: ACIS, Fiscal Council calculations

The need to improve EU funds absorption becomes more stringent in the context of fundamental changes in the fiscal policy approach. Due to the new fiscal pact, in the following years the fiscal policy's room for maneuver will be reduced compared to the past, as the maximum budget deficit permitted will be much lower. Moreover, a low efficiency of automatic stabilizers is an additional constraint for Romania.

In this context, EU-funds' absorption appears to be a solution to stimulate economic activity under a more limited space for fiscal policy and modest automatic stabilizers.

The potential multiplier of EU-funds related budget expenditure is much higher than the one of projects funded entirely by own financial resources. Considering the 5% co-financing ratio for projects funded from EU-funds, with 1 RON from own resources, budget expenditure of 20 RON can be allocated (EU-fund absorption's impact on the budget deficit is represented only by the co-financing amount, as the sums received from EU are registered both on the revenue and the expenditure side of the budget), compared to a 1:1 equivalence ratio for projects financed wholly from own resources.

Revenues from post-accession European funds registered a level of 6.1 billion RON, 12.3% higher than in 2010 and 1.7 billion RON lower than the amount forecasted in the second budget amendment. Not achieving the target may be partly explained by the fact that from June to

December, the European Commission blocked the payments on one of the axis of the Regional OP, after finding problems in public procurement[26].

Unfortunately, so far, Romania's performance in terms of EU-funds absorption is very low. Romania must have as a top priority urgent and substantial increase of EU-funds' absorption rate.

IV. The structural fiscal position

The stability of public finances plays a special role in ensuring the smooth functioning of the Economic and Monetary Union (EMU). The Stability and Growth Pact (SGP) sets the regulatory framework for the coordination of national fiscal policies within the EMU. Thus, ensuring financial discipline is a prerequisite for achieving a stable price level over the medium term and a sustainable economic growth. In the context of giving up the exchange rate as a monetary policy tool, fiscal policy, through automatic stabilizers and discretionary measures, plays a fundamental role in alleviating economic fluctuations caused by asymmetric shocks that may affect the EMU countries.

The Stability and Growth Pact sets the medium-term objective for budgetary positions of euro area member states to be *close to balance or in surplus*, a situation which should enable them to deal with normal cyclical fluctuations without exceeding the 3% of GDP reference level for the effective budget deficit. Also, reaching and maintaining the medium-term objective should ensure rapid progress towards a sustainable situation, while generating sufficient fiscal space for discretionary fiscal policy measures, such as increased investments in the infrastructure.

Therefore, the maximum effective budget deficit of 3% stated in the Stability and Growth Pact is not a level that can be reached every year, but a ceiling that must not be exceeded even in adverse economic conditions. The actual budget balance is affected by cyclical fluctuations of the economy, as budgetary components are influenced by the position within the economic cycle. Thus, in periods of expansion, the revenues are higher, reducing the budget deficit, without this necessarily meaning a change in the conduct of fiscal policy or improved tax collection. In the context of the Stability and Growth Pact, the identification of a fundamental fiscal position, which is not dependent on the cyclical fluctuations of the economy and which will ensure compliance with the 3% of GDP ceiling for the budget deficit even in the event of a recession, is fundamental in order to respect the SGP provisions and to ensure a sustainable fiscal position over the medium and long term.

[26] That is the Second Axis of Regional OP- Regional and local transport infrastructure improvement. Problems in the procurement system concern using discriminatory selection criteria by contracting authorities in selecting builders, unjustified use of accelerated procedure and additional works contracted as similar works.

In order to strengthen the surveillance of budgetary positions and the coordination of economic policies, 25 EU countries signed in March 2012 The Treaty for Stability, Coordination and Governance in the EMU. The most important component, the fiscal compact, aims to strengthen fiscal discipline in the European Union by introducing automatic sanctions and a more stringent supervision of the Member States.

In essence, the new treaty includes the requirement that national budgets should be balanced or in surplus, a requirement that will be considered satisfied if the annual structural deficit will not exceed 0.5% of GDP. Member States will be obliged to introduce the "balanced budget rule" in their national legal systems, preferably at the constitutional level, while the period during which it is imperative to fulfill this obligation is one year after the entry into force of the Treaty. If a country has a debt level significantly below 60% of GDP and the risks to long-term sustainability of public finances are low, it may have a structural deficit of more than 0.5% of GDP, but not exceeding 1% of GDP. Failure to meet the requirement regarding structural balance will automatically trigger a corrective mechanism, as established by each Member State on the base of principles proposed by the European Commission.

The authority responsible for the assessment of the balanced budget rule's domestic implementation is the European Court of Justice; its decisions are binding and may be followed by fines of up to 0.1% of GDP for the euro area countries, paid to the European Stability Mechanism.

The Fiscal Compact will entry into force and become mandatory for the EMU countries after being ratified by at least 12 euro zone members. For other EU countries, the provisions of the Treaty will be binding when adopting the single currency or earlier, in case of a positive national decision regarding this matter.

Identifying the fundamental fiscal position is based on the definition and calculation of cyclically adjusted or structural budget balance. In essence, this indicator corresponds to the budget balance level that is obtained while the economy is at its potential level. Thus, the cyclically adjusted budget balance can be used to identify how changes in the fiscal position (taxes, transfers, expenses) are the result of economic conditions or the consequence of discretionary measures regarding fiscal policy. In practice, the structural budget balance is obtained by removing the effects of the economic cycle on public finances. Thus, the effective budgetary position is decomposed into two factors - temporary and permanent. Schematically, the calculation of the structural deficit is based on the following identity:

Effective budget deficit = Cyclical deficit (automatic stabilizers) + Structural deficit (discretionary policies)

Fiscal policy objectives can be better expressed in terms of cyclically adjusted budget balance, ensuring long term sustainability of public finances and allowing automatic stabilizers to smoothen economic fluctuations. In essence, the automatic stabilizers reflect that revenues and, to a lesser extent, expenditures are affected by the position within the economic cycle and contribute to smoothing cyclical fluctuations. For example, in case of economic expansion, budget revenues from value added tax, excises, social security contributions, personal and corporate income tax increase, reducing disposable income of businesses and households, thereby slowing economic growth and determining the return of the GDP to the potential level. In a case of recession, lower revenues are collected while expenses related to unemployment benefits increase, with a positive impact on firms and households revenues, thereby supporting the economic recovery and the GDP return to its potential level. The effectiveness of automatic stabilizers depends on the government sector's size but also on the elasticity of budgetary revenues and expenditures with respect to cyclical fluctuations of the economy. The larger the government sector's size and the higher the elasticity of revenue and expenditure with respect to cyclical fluctuations of the economy, the stronger the softening effect of automatic stabilizers gets on these economic fluctuations.

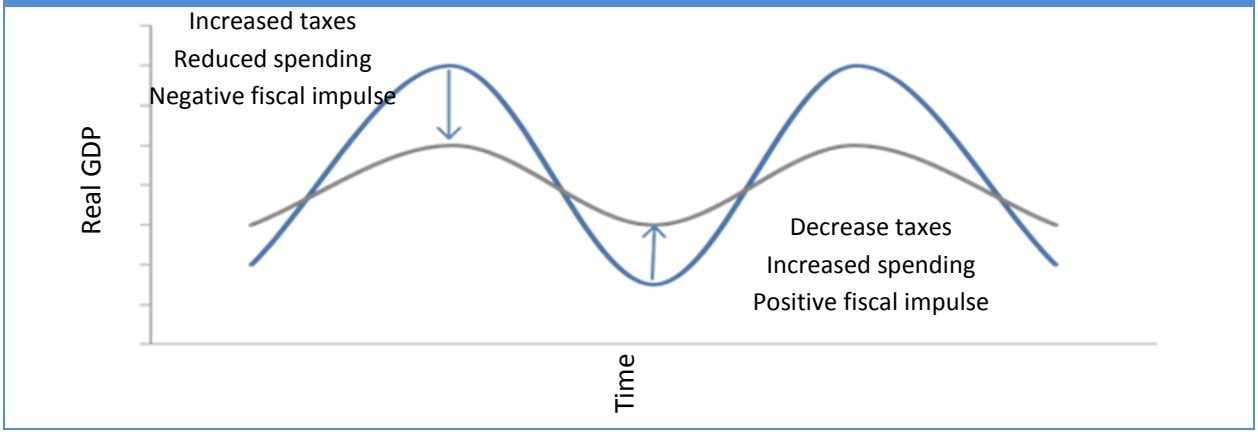
The global economic crisis showed that, in terms of demand shocks, monetary policy is unable to respond strongly enough if the transmission mechanism is blocked by adverse conditions in financial markets. Expansionary *discretionary fiscal policy* can be used in this case, when an adequate fiscal space exists, but it has several disadvantages: it requires a relatively long period of implementation, it is subject to political influences, and it is not automatically reversed when the position within the economic cycle changes. Automatic stabilizers do not have these disadvantages, but their efficiency is dependent upon the choices regarding institutional and fiscal policies. For example, the economic literature shows that the effectiveness of automatic stabilizers can be increased by increasing the share of government sector or by increasing tax progressivity[27].

[27] See for example: *Carlo Cottarelli and Annalisa Fedelino, "Automatic Stabilizers and the Size of Government: Correcting a Common Misunderstanding", IMF working paper, WP/10/155, 2010*, or *Thomas Baunsgaard and Steven A. Symansky, "Automatic Fiscal Stabilizers", IMF Staff position note SPN/09/23, September 28, 2009*

In recent years, the role of the cyclically adjusted budget balance in the conduct of economic policies in the EU has significantly increased. Before reviewing the Stability and Growth Pact in 2005, the cyclically adjusted budget balance was used as a policy tool to better assess the fiscal position of the EMU Member States, while after the reform of the SGP, it has become the focus of the fiscal surveillance mechanism within the European Union. Key requirements regarding fiscal policy in the euro area are expressed in terms of cyclically adjusted values, net of temporary or one-off measures.

The use of a cyclically adjusted budget balance is not only related to the sustainability of public finances: its annual variation (fiscal impulse) is a commonly used measure in assessing the impact of budgetary and fiscal policy on aggregate demand. Thus, a positive fiscal impulse, corresponding to an increase in the cyclically adjusted balance, reflects an expansionary fiscal policy, while a negative fiscal impulse, corresponding to a reduction in the cyclically adjusted balance, signals a restrictive fiscal policy. Analyzed together with the economy's cyclical position, the fiscal impulse enables us to assess the extent to which the fiscal policy is acting like a macroeconomic stabilizer - acting in the sense of decreasing aggregate demand pressures in times of economic boom or for the purpose of stimulating aggregate demand during recession.

Figure 34: The stabilizing role of fiscal policy (Counter-cyclical fiscal policy)



The structural budget deficit can be estimated through two alternative approaches. The first approach, developed by Blanchard (1990), implies the direct estimation of cyclically adjusted budget revenues and expenditures from regression analysis. More recently, SVAR models were used (Dalsgaard and Serres, 1999) or models based on the unobserved components method (Camba-Mendez and Lamo, 2002).

The second approach is based on a two-stage procedure: the first step is to estimate the cyclical component of the budget balance and the second step involves removing the cyclical component from the headline budget balance, thus obtaining the cyclically adjusted or structural budget balance.

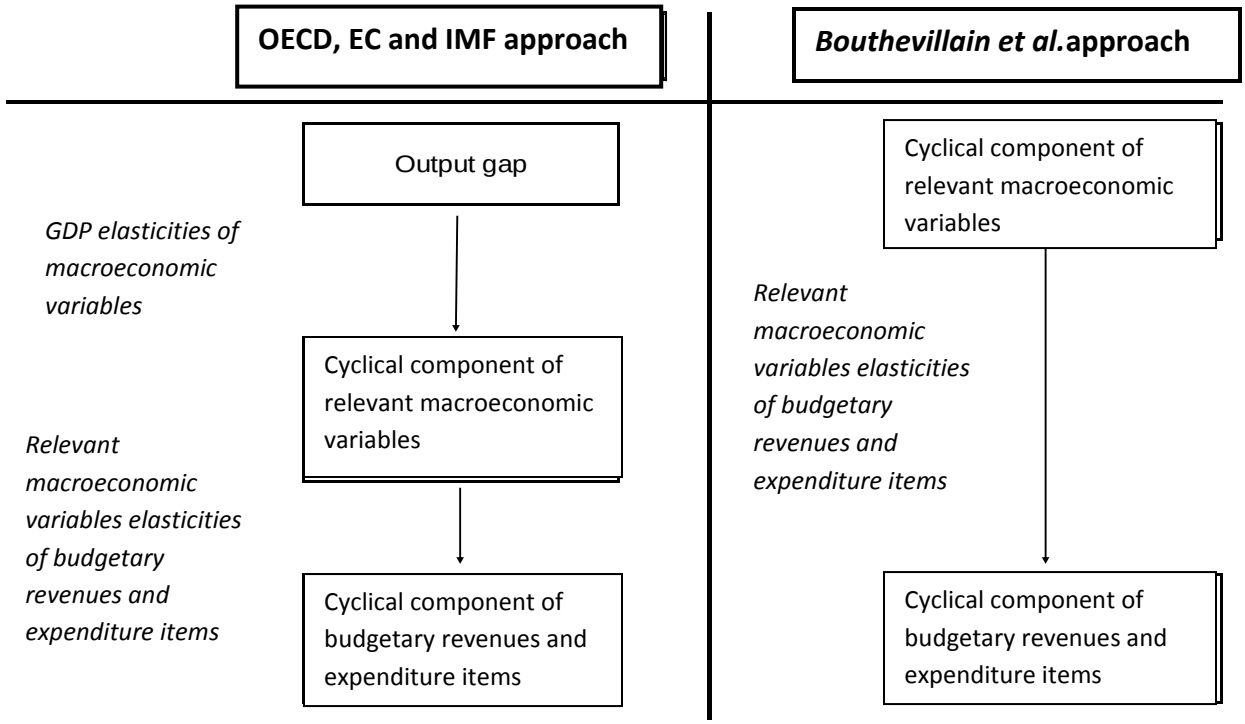
To obtain the cyclical component of the budget balance, the following inputs are necessary: a measure of the cyclical position of the economy and, after identifying the budget components that respond to the business cycle, a measure of the relationship between these components and the cyclical position of the economy. As regards the cyclical position, this is measured, in general, by the output gap (the difference between actual and potential GDP). Regarding the budget components that vary with the business cycle, most tax revenues fluctuate cyclically and, on the expenditure side, unemployment benefits are considered to be the only category affected by the business cycle. The link between the business cycle and the budget balance is given by the elasticity coefficients, which represent percentage changes in the identified revenue and spending categories to changes in the level of economic activity. Such elasticities are usually derived from national tax codes[28] and regressions.

The two-step approach is generally used by government and international institutions, including the European Commission, the OECD, the IMF and the European Central Bank (EC methodology is described in detail in *Box 1*). The methodologies applied by the EC, the OECD and the IMF are very similar, the IMF applying some simplifying assumptions when data are not sufficiently detailed. An alternative methodology is presented by Bouthevillain et al. (2001)[29], where the elasticities of budget components are estimated directly in relation to the relevant macroeconomic bases and not to the output gap (i.e., private consumption elasticity of VAT revenues), thereby taking account of changes that occur in the structure of aggregate demand and the structure of budgetary revenues. In addition, the selection of budget components which are cyclically-adjusted through this method is more rigorous (more details are presented in *Box 2*).

[28] If a tax is progressive, the elasticity of that tax to the economic activity is higher than one; if taxation is proportional, then the elasticity is unitary, and, the more regressive the tax system, the lower the elasticity.

[29] Bouthevillain et al., "Cyclically adjusted budget balances: an alternative approach", ECB Working Paper no. 77, September 2001

Figure 35: Computing Cyclically Adjusted Deficit. Alternative approaches



BOX 1: European Commission methodology for calculating cyclically adjusted budget deficit

The European Commission uses a relatively simple and transparent method for determining the structural deficit, which constitutes a common framework for quantifying the cyclically-adjusted budget balance for all EU Member States.

The basic idea of the methodology used by the European Commission is to eliminate the cyclical component of the budget balance, an idea summarized by the equation below:

$$CAB_t = BB_t - CC_t = BB_t - \varepsilon OG_t,$$

where CAB_t is the cyclically adjusted budget balance in year t, BB_t – the headline budget balance to GDP ratio in year t, CC_t- the cyclical component, ε – the sensitivity parameter, while OG_t – the output gap in year t (the difference between actual GDP and potential GDP).

In order to cyclically-adjust the budget balance, the Commission method involves three main stages. In the first phase, potential GDP is estimated and the output gap is calculated as the difference between actual GDP and the estimate of potential GDP. The second stage involves determining the budget

balance sensitivity to changes in output gap. In the third stage, the cyclically adjusted budget balance is obtained by removing the cyclical component from the actual budget balance.

Step 1. *Estimating the potential output and the output gap*

From July 2002, the European Commission uses the production function method for determining potential output. This estimation method is described in detail in ***Box 3***.

The output gap, OG_t, is calculated as the difference between actual GDP and the estimated potential GDP, the difference being expressed as a percentage of potential GDP.

Step 2. *Estimating revenue and expenditure sensitivity to the economic cycle*

To determine the cyclical component of the budget balance, it is necessary to quantify the sensitivity of public revenue and expenditure to GDP changes. In this respect, the categories of revenues and expenditures that are influenced by the business cycle are identified. In terms of revenue, there are four categories that are dependent on the business cycle: personal income taxes, social security contributions, corporate income taxes and indirect taxes. On the expenditure side, the only group affected by cyclical changes in economic activity is represented by unemployment benefits. Therefore, revenue sensitivity is more important than expenditure sensitivity as expenditure that fluctuate with the business cycle have a low share of total spending. Thus, automatic stabilizers work mostly on the revenue side of the budget.

The first step in determining the sensitivity involves calculating the elasticity coefficients of the budget components influenced by the business cycle, the coefficients quantifying the percentage change in revenue and expenditure categories in the percentage change in the level of economic activity. For these coefficients, the European Commission makes use of the published values computed by the OECD.

Further, total revenue elasticity, denoted by η_R, is obtained by weighting the individual elasticity of each category of revenue - η_{R_i}, with the corresponding share in total revenue[30]- (R_i/R).

$$\eta_R = \sum_{i=1}^{4} \eta_{R_i} \times \frac{R_i}{R}$$

Expenditure elasticity, denoted by η_G, is determined only by unemployment benefits elasticity, $\eta_{G,U}$, which is adjusted with the weight of this category of expenditure in total current primary expenditure (G_U/G).

$$\eta_G = \eta_{G,U} \times \frac{G_U}{G}$$

Since revenue and expenditure are generally expressed as percentage of GDP, the obtained elasticity coefficients are transformed into sensitivity parameters by multiplying them by the share in gross

[30] The European Commission calculates the weights as average of values recorded in recent years.

domestic product of each variable, as follows:

$\varepsilon_R = \eta_R \times \frac{R}{Y}$ *and* $\varepsilon_G = \eta_G \times \frac{G}{Y}$

Step 3*. Computing the cyclically adjusted budget balance*

Finally, the sensitivity parameter ε is the difference between the revenue sensitivity indicator and the expenditure sensitivity indicator determined in the previous step.

Thus, the cyclically adjusted budget balance is obtained by removing the cyclical component of the budget - εOG_t from the actual budget balance.

$CAB_t = BB_t - CC_t = BB_t - \varepsilon OG_t$

For example, the OECD estimated[31] sensitivity parameters for Romania are 0.28 for revenue sensitivity to the business cycle and -0.02 for expenditure sensitivity, the total sensitivity parameter amounting therefore to 0.3.

BOX 2: The alternative approach proposed by Bouthevillain et al. for calculating the cyclically adjusted budget deficit

The underlying assumption of the alternative methodology for computing cyclically adjusted budget deficit presented in *Bouthevillain et al.* states that a more accurate estimation of the impact of macroeconomic developments on the budget balance can be obtained only if the dynamics of macroeconomic variables directly influencing public finances are considered.

Thus, this methodology is different from that proposed by the EC because the cyclical deficit is determined using the cyclical components of certain macroeconomic variables, and not cyclical component of GDP.

This methodology can be summarized in the following equation and the cyclical component of the budget deficit (B_c / Y_n) can be calculated as follows:

$$B_c/Y_n = \sum_j \left(\frac{R^j}{Y_n} \times \varepsilon_{R^j,V^j} \times \left(\ln(V_r) - \ln(V_r^*) \right) \right) - \frac{U}{Y_n} \times \varepsilon_{U,u} \times \left(\ln(u) - \ln(u^*) \right)$$

where:

Rj - Individual revenues considered to be dependent on economic cycle

U - Unemployment benefits

ε_{R^j,V^j} - Elasticity of the fiscal variable with respect to the macroeconomic base

[31] Larch,M., Turrini, A., The cyclically-adjusted budget balance in EU Fiscal policy making: a love at first sight turned into a mature relationship, Economic Papers 374, March 2009, EUROPEAN COMMISSION.

$\varepsilon_{U,u}$ - Elasticity of the unemployment benefits to the number of unemployed persons

ln(Vr)-ln(Vr*) - Cyclical component of specific macroeconomic base

ln(u)-ln(u*) - Cyclical component of the number of unemployed persons

There are four main steps in determining the structural deficit under alternative method proposed by Bouthevillain et al.:

Step 1. *Identification of cyclical budgetary components and their corresponding bases:*

It is considered that four categories of revenues and one category of expenditure are influenced by the economic cycle. For each category of revenues and expenditure is associated as proxy a component of national accounts which most closely resembles the actual tax/spending base, called relevant macroeconomic base.

The fiscal variables and their corresponding macroeconomic bases are presented in the following scheme:

1. Taxes on corporate income	⟷	1. Gross operating surplus
2. Direct taxes paid by employees in the private sector	⟷	2. Number of employees in the private sector; average wage in the private sector
3. Indirect taxes	⟷	3. Private consumption
4. Social contributions paid in private sector	⟷	4. Number of employees in the private sector; average wage in the private sector
5. Unemployment benefits	⟷	5. Number of unemployed

Step 2. *Estimation of elasticity indicators*

The elasticity reflects the link between the component of the budget and the cyclical component of macroeconomic base, representing the percentage change in budget items associated with percentage change in the relevant macroeconomic base.

Elasticities are either estimated with econometric regressions or derived from tax or expenditure laws if the tax system is not complex.

Econometric approach is based on estimating regressions using annual data, in order to identify the relationship between fiscal variables and chosen macroeconomic bases. Thus, one can identify two basic

specifications:

1) Regression equations:

$$\Delta \ln R_t^j = \alpha + \delta \times t + \beta \Delta \ln V_t^j + A + \xi ,$$

where

R^j_t - revenue item

V^j_t - relevant macroeconomic base

A - captures the impact of discretionary fiscal policy measures

β - measures the elasticity of R^j_t with respect to V^j_t

α - intercept

δ - captures a change in trend

2) Specifications such as error-correction model: assess the lags in tax collection and the effects of past economic shocks on fiscal variables.

$$\Delta \ln R_t^j = \alpha + \beta (lnRjt - 1 - \gamma lnVjt - 1 + \varphi + \delta t + \ldots) + \delta 1 \, \Delta lnVjt + \delta 2 \, \Delta lnVjt - 1 + A + \xi ,$$ where

γ measures the long-term relationship, and the parameters δ_1, δ_2 measure the short term relationship.

Similarly, these two specifications can be used for unemployment benefits and their relevant macroeconomic base (number of unemployed persons).

The estimation of elasticities using econometric methods has several disadvantages, mainly related to requirements on input data:

- the annual time series should be long enough.
- data on the precise budgetary impact of discretionary measures are generally not available.
- the fiscal policy affect the economic activity, leading to endogeneity of the explanatory variables

Given these issues, often, models are used only to validate the elasticities obtained from the analysis of tax legislation.

Step 3. *Determination of cyclical component for each relevant macroeconomic base*

Corresponding cyclical components of all macroeconomic bases in real terms are determined using an HP filter, using annual data and a smoothing parameter λ equal to 30. The value of the parameter λ assumes a critical length of the economic cycle of 8 years. The compression effects (the variability of the cyclical component is underestimated) must not exceed 10 per cent of the amplitude of cycles of up to 8 years.

Step 4. *Estimation of each revenue and expenditure cyclical component*

The cyclical component of the individual revenue items can be calculated using the following relation (similarly for unemployment benefits):

$$R_i^c = \varepsilon_{R_i,V_i} \times R_i \times \frac{V_i - V_i^t}{V_i^t}$$

Where:

R_i^c - is the cyclical component of the analyzed revenue item

V_i^t - is the trend component of the corresponding macroeconomic variable

The changes in the structure of budgetary revenues are explicitly taken into account through determination of individual cyclical components.

One of the main advantages of this approach is that the impact of changes in the structure of aggregate demand and in income distribution on the budget balance is reflected explicitly. Thus, this methodology takes into account the specific composition effects of aggregate demand components (individual macroeconomic basis) which may exhibit different phases of business cycle fluctuations and have different sizes, especially in the short run.

BOX 3: Potential GDP. Concept and estimation methods.

Potential GDP reflects the level of aggregate production obtained in an economy that is operating under "full employment" of factors of production. Potential output can be defined also as the real GDP that can be sustained without generating inflationary pressures. In the long term, potential output depends on the growth of the productive capacity of the economy, that is driven by total factor productivity and the growth rates of physical capital and potential employment, which rely, in turn, on fundamental factors: the organization of the economy, the technological and demographic factors affecting the labor force etc. Therefore, potential GDP is an indicator of potential aggregate supply and of a sustainable non-inflationary growth path.

This indicator is important because it is used to calculate the output gap (the percentage difference between the actual GDP and potential), which reflects the cyclical position of the economy; the latter is a relevant input for monetary and fiscal policies, taking into account their objective to mitigate the amplitude of business cycle fluctuations.

Given that potential output is an unobservable macroeconomic variable, it can be quantified only through estimation. The methods for estimating potential GDP can be divided mainly into two categories: those based on statistical techniques and those based on theoretical models. Each of the two categories of methods, both the one based on econometric techniques for filtering and the one that relies on the production function, has its own weaknesses and is marked by uncertainty.

The main drawback of determining the output-gap through statistical methods relates to the fact that they don't account for the economic theory. On the other hand, the production function approach captures in the estimation process the economic fundamentals of the phenomena analyzed; however, as certain steps followed by this method use the Hodrick-Prescott filter and the unobserved components method, the production function method also has the same disadvantages of filtration methods.

Even if the production function method is preferable to the statistical ones, as it presents a consistent theoretical approach, linking potential GDP to existing production factors and to productivity, the alternative approach, based on filtering techniques, is used very often because of data quality or data availability problems. The HP filter, introduced by Hodrick and Prescott (1997), is the most used method in

this class. These two methodologies are explained below, as they are widely used by international bodies[32].

The Hodrick-Prescott method

The HP method is a univariate approach that determines the cyclical position of the economy in a strictly statistical sense, by decomposing real GDP in permanent and transitory components:

[1] $Y_t = Y_t^* + Y_t^C$

[2] Y_t is real GDP, Y_t^* - potential GDP and Y_t^C, the cyclical component of GDP. Y_t^* is determined by the following optimization method:

[3] $$\min_{y_t^*} \sum_{t=1}^{T} \left(\left(y_t - y_t^* \right)^2 + \lambda \left(\Delta y_{t+1}^* - \Delta y_t^* \right)^2 \right), where\ y_t = lnY_t$$

Using the formula [2], the trend of the GDP series is obtained by minimizing the deviations of actual GDP from its trend (first brackets in the formula) and the variability of the trend (second bracket). The λ parameter sets the emphasis placed on minimizing the trend variability: choosing a high value for λ ensues a linear trend, while λ = 0 involves a trend identical to the original series. This parameter is not statistically estimated, but his value is set so as to reduce the compression (underestimation of the cyclical component variability) and the "leakage" (overestimation of the cyclical component variability) effects.

The HP filter is actually a weighted moving average of actual values of the filtered series. The higher is λ, the more observations are included in calculating this average. Higher weights are allocated to GDP records that are close to the reference year (the year for which potential GDP is estimated). Moreover, the filter is symmetrical (same weights are assigned to observations at the same distance from the reference year), which means that the number of observations at the beginning and end of the data series is insufficient to secure symmetric averages. This problem ("end-point bias") is solved by extending the sample with predictions for the filtered series.

The production function approach[33]

This methodology consists in estimating an aggregate production function and employing the potential level of factors of production in this function. It is considered that potential GDP is the output associated with a “normal” use of labor force and physical capital, so a natural rate of unemployment and a certain unused production capacity is accepted.

The production function is specified as a Cobb-Douglas functional form:

[4] $Y_t = TFP_t K_t^{1-\alpha} L_t^{\alpha}$

where TFP is total factor productivity (it measures the efficiency with which inputs are transformed into

[32] The production function method is used by the OECD and was adopted from July 2002 by the European Commission also, which previously applied the HP method. The International Monetary Fund uses different methods on a case by case basis, depending on the specific situation of each country. For cyclically-adjusted budget balance estimates, the European System of Central Banks (ESCB) uses HP filter to derive trends of macroeconomic data series.

[33] The approach described here is the one implemented by the EC.

outputs), L - labor input and K, capital stock; α is the GDP elasticity of the labor factor and 1 - α is, analogous, the GDP elasticity of capital[34]. These coefficients can be viewed as being the contribution of each factor of production to GDP.

It is assumed that labor supply depends on the size of the working age population (POP^W), the trend of labor force participation rate (PART *) and the structural rate of unemployment (NAWRU – "non-accelerating wage rate of unemployment"[35]):

[5] $L^* = POP^W \times PART^* \times (1\text{-}NAWRU)$

where L * = potential employment.

The inputs needed for this method are determined as follows:

- **Total factor productivity** (TFP_t^*) trend is measured by applying the HP filter to the Solow residual (s_t), which is determined by the relationship:
  [6] $s_t = \ln(Y_t) - [\alpha \ln(L_t) + (1-\alpha)\ln(K_t)]$
- The **capital stock** and the **working age population** are assumed to be always at their potential levels; therefore, these variables do not require cyclical adjustment, although they fluctuate over the economic cycle.
- To obtain the **participation rate trend**, the HP filter is used.
- To estimate **NAWRU**, the Kalman filter is used: the unemployment rate is decomposed into a structural component (NAWRU) and a cyclical component that can be interpreted as being the unemployment gap. The change in (wage) inflation is linked to the unemployment gap through a Phillips curve. The cyclical component of unemployment is modeled by a stationary AR (2) process with zero mean.

  Thus, potential output is computed following the formula:

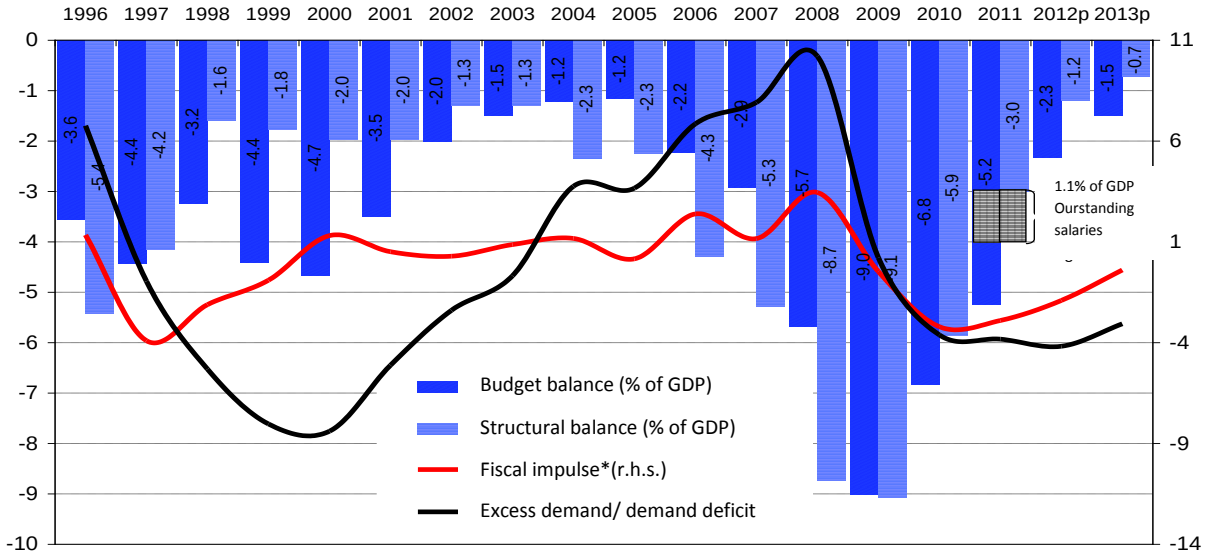
[7] $$Y_t^* = TFP_t^* \times K_t^{0,37} \times [POP_t^W \times PART_t^* \times (1 - NAWRU_t)]^{0,63}$$

In Romania, during the rapid economic growth before the financial crisis, the fiscal impulse was positive, contributing to the overheating of the economy and thereby deepening the accumulated imbalances in the economy (see *Chart 36*). In addition, fiscal policy pro-cyclicality during the pre-crisis period of economic boom exhausted the necessary fiscal space to stimulate the economy during the recession that followed; the need to reduce the budget deficit during the crisis (primarily due to financing constraints) lead inevitably to maintaining the pro-cyclicality of fiscal policy. Thus, the automatic, beneficial and stabilizing action of the cyclical deficit (automatic stabilizers) was canceled by discretionary policy.

[34] In the EC approach, these parameters are the same for all countries: α = 0.63 and, accordingly, 1-α = 0.37.

[35] The unemployment rate corresponding to a constant wage inflation rate. OECD uses NAIRU ("non-accelerating inflation rate of unemployment").

Figure 36: Structural deficit, fiscal impulse and excess demand



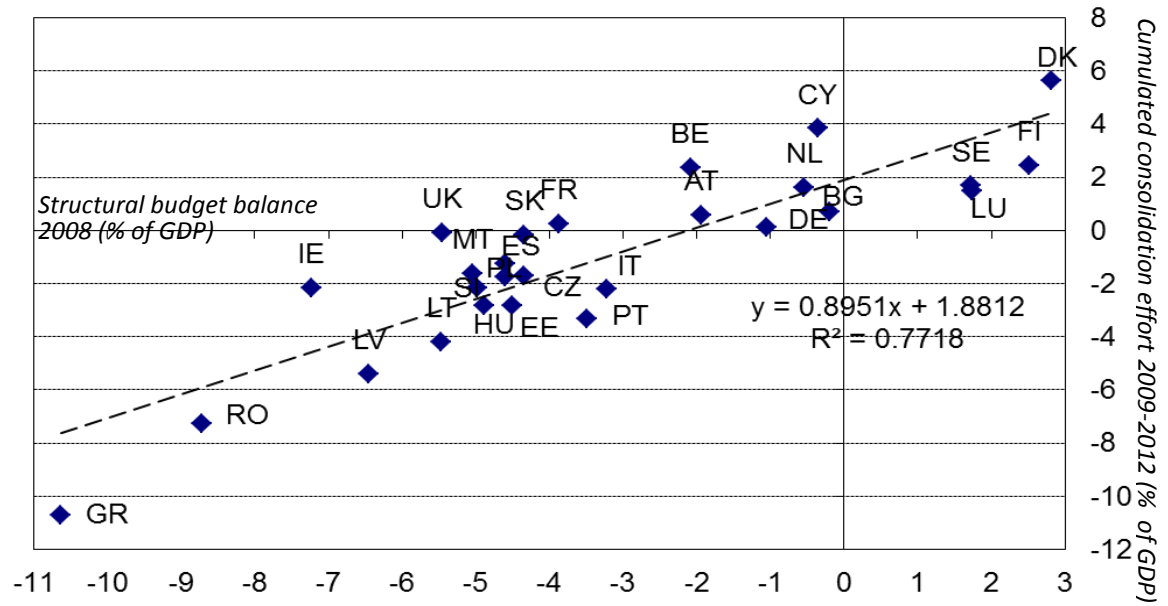
*change of primary structural balance (% of GDP) (+ stimulus effect, - contractionary effect)

Source: AMECO, 2012 -2014 Convergence Program, Fiscal Council calculations

In 2009-2011, the structural budget deficit fell from 9.1% of GDP to 3.0%[36], the adjustment pace of about 2 percentage points per year is very fast (see *Figure 36*); at the same time, the high starting level required rapid adoption of decisive measures to ensure fiscal policy sustainability. The adjustment was made mainly on the expenditure side, the promoted structural reforms regarding particularly the salaries of public employees, the public pension system and the budget programming. On the revenue side, the most important measure was increasing the VAT standard rate from 19% to 24% starting from July 2010. The estimated cumulative adjustment for 2009-2012 undertaken by Romania is the second most ambitious from the European Union - but the chart below reveals that its size is directly proportional to the size of the initial structural fiscal imbalance (of 2008).

[36] The estimation uses the cyclical component of the autumn 2011 projection of the European Commission, making the assumption that the forecast error in real GDP (2.5% increase compared with a projection of 1.5%) is incorporated in the potential GDP (favorable supply shock from agriculture).

Figure 37: The size of consolidation effort 2009-2010



Source: AMECO, Fiscal Council calculations

The new structural deficit ceiling, i.e. 0.7% of GDP (given the small size of the debt stock, Romania will be allowed by the European fiscal treaty to set a medium term objective – MTO - higher than the level of 0.5%[37]), will impose strict controls on public finances in Romania, this having clear advantages, but also disadvantages. An important advantage is represented by the impossibility of engaging in pro-cyclical fiscal policies and by a pronounced fiscal discipline, given that Romania has a bad experience in this field.

The disadvantage for Romania of the new European fiscal rule is that the existing operating space to stimulate the economy during recessions will be very low. In Romania, the 0.7% of GDP ceiling for the structural budget deficit will likely be reached before the actual government deficit reaches 3% of GDP, making it significantly more stringent than the Maastricht criterion per se. The magnitude required for a negative shock to move the budget deficit from MTO (achieved assuming a zero output gap) to 3% of GDP would be 7.4% of potential GDP -

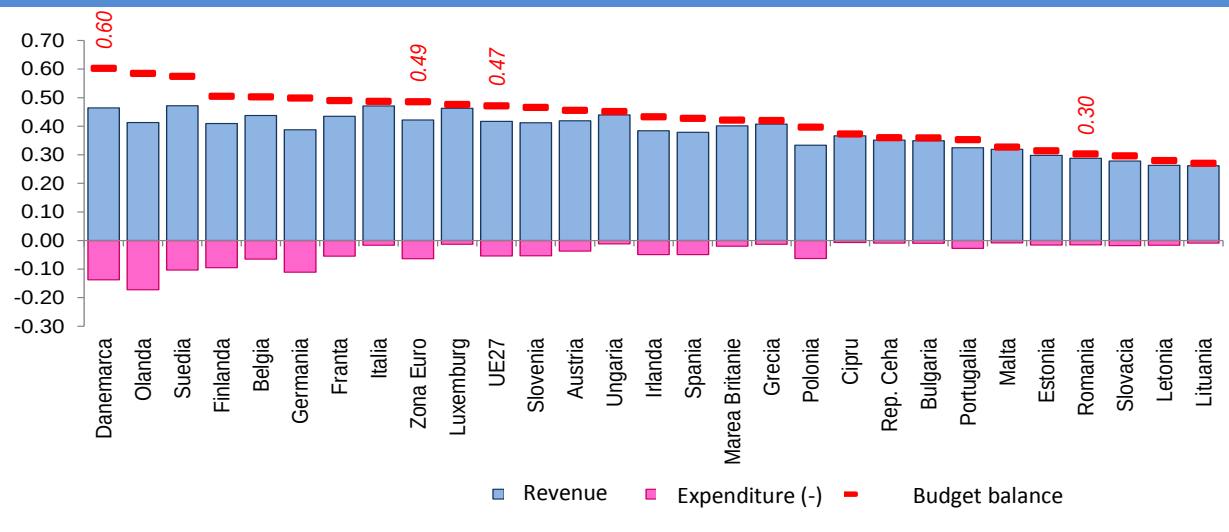
[37] The Fiscal Compact allows signatory states with low levels of public debt, that do not face severe problems of long-term sustainability of public finances (the cost of aging population), to establish a higher medium-term objective than the 0.5% of GDP benchmark for structural budget deficit, but not more than 1% of GDP. The Convergence programme provides a MTO of -0.7% of GDP for the structural fiscal position, which incorporates a part of the cost of aging and has the advantage of already being stipulated by the 2010 version of the 2009-2012 Convergence Programme (in March 2010).

comparable variations of the cyclical position of the economy were observed only in 1997 and 2009, years characterized by extreme economic contractions.

It can be shown both theoretically and empirically that in the medium and long term (over a full business cycle), the average actual deficit is equal to the average structural deficit, while the average cyclical deficit is 0. By targeting a maximum structural deficit of 0.7% of GDP, Romania is committed to reduce the actual budget deficit, as an average over a business cycle (and as a long-term average), to a maximum of 0.7 % of GDP; in comparison with historical standards (3.8% of GDP average of structural deficit in the 1999-2011 period), this will mean a much lower budget deficit and a reduced room for "manoeuver". Due to relatively weak automatic stabilizers (see *Chart 38*), Romania may need the possibility of implementing stronger discretionary fiscal stimulus (higher structural deficit) in times of recession, in order to help the economy get out of recession faster and return to potential. *Chart 39* suggests that the size of automatic stabilizers is largely explained by a scale effect - the share of tax revenues (including social security contributions) in GDP. Other factors that may explain their size are the revenue structure by types of taxes (corporate income tax, for instance, has usually significantly higher sensitivity to the cyclical position of the economy), but also the progressivity of personal income tax.

But it must be said that the Stability, Coordination and Governance treaty (The Fiscal Compact) is flexible in this regard, given that it explicitly allows temporary deviation from the MTO when the economy faces a severe economic contraction.

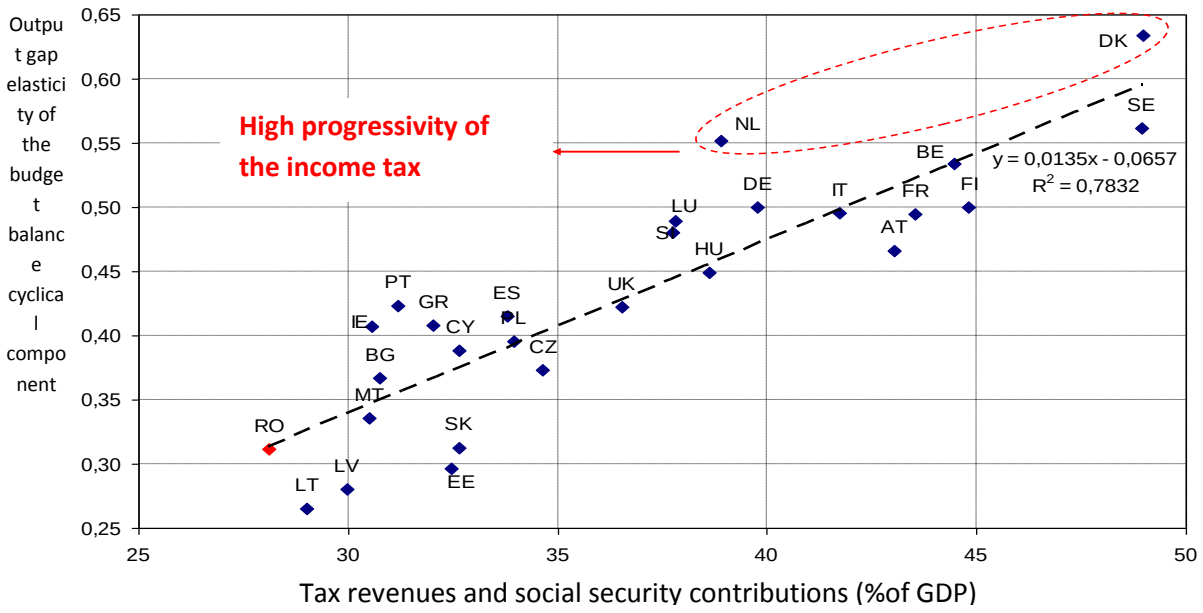
Figure 38: Change of the actual budget balance due to a one percentage point increase in the output gap (in percentage points) *



* For the budget balance, the impact is in % of GDP

Source: AMECO, own estimates.

Figure 39: The relationship between the size of automatic stabilizers and the fiscal burden



Source: AMECO, own estimates

V. The Sustainability of public finances

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

A potential risk for the fiscal sustainability on the medium run is the accumulation of losses and arrears in companies where the state is the major shareholder (SOEs). If these companies fail to streamline their activity, sooner or later the Government will be forced to intervene, which may deteriorate the fiscal balance.

At the end of the first quarter of 2011, there were 645 SOEs that reported financial statements to the Ministry of Finance, with an aggregate turnover of nearly 55.8 billion lei. The table below shows the disproportion between the SOE's contribution to the overall economy turnover and the share of these companies in total arrears. Although the contribution of SOEs to the overall economy turnover was only 11.5%, the accumulated outstanding payments represented 31.2% of the arrears registered in the economy. Moreover, compared to the end of 2009, arrears increased by 5 billion lei, but the positive aspects that can be noticed are the increased SOE's contribution to the overall economy turnover in the context of decreases in the number of employees.

Table 7: SOEs share in total economy		
Indicator (2011 QI)	State Owned Enterprises (SOEs)	
	Value	% of overall economy
Number of companies	645	0,3
Value added (billion RON)	43	11,5
Turnover (billion RON)	55.8	6,1
Arrears (billion RON)	28	31.2
Employees	354.271	9.8

Source: Fiscal Council's calculations based on financial statements from the Ministry of Finance

The persistence of arrears in the public companies sector indicates a culture of non or late payment to the budget and private sector, thus undermining efficient allocation of resources and creating uneven playing field among enterprises.

There are several factors accounting for the continued prevalence of arrears. First, the budgets of public enterprises are often approved with little attempt to ensure that the enterprises concerned will be able to pay their budgetary obligations. Secondly, certain legal provisions favor the lack of financial discipline, particularly in relation with the utility suppliers. Thirdly, offsetting schemes and frequent debt cancelations create low incentives for state companies to pay their outstanding obligations. Even during 2011, two schemes for clearing budgetary arrears were implemented through the two budget amendments. According to these schemes, 2.5 billion RON (1.426 billion in the first budget amendment and 1.075 billion in the second one) were transferred from general state budget to local budgets and to some SOEs and Ministries, so that, in the end, these transfers would lead to clearing some outstanding obligations to the budget.

In terms of arrears to turnover ratio, the public enterprises stand out with a much higher share than the private companies. The bulk of their arrears are directed towards the general consolidated budget, particularly to the social security budget. In contrast, most of the outstanding payments of private companies are contracted to suppliers. SOEs are the largest debtor towards the social security budget; their total outstanding debt amounts over 2.4% of GDP (about 14 billion RON) as of June 2011.

Figure 40: Arrears to turnover ratio, for public and private companies

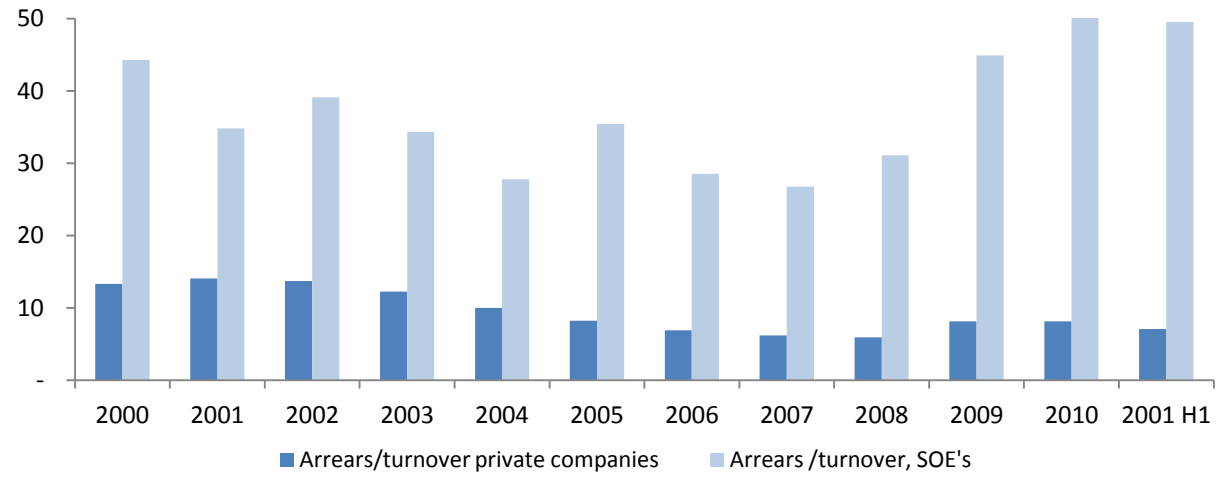
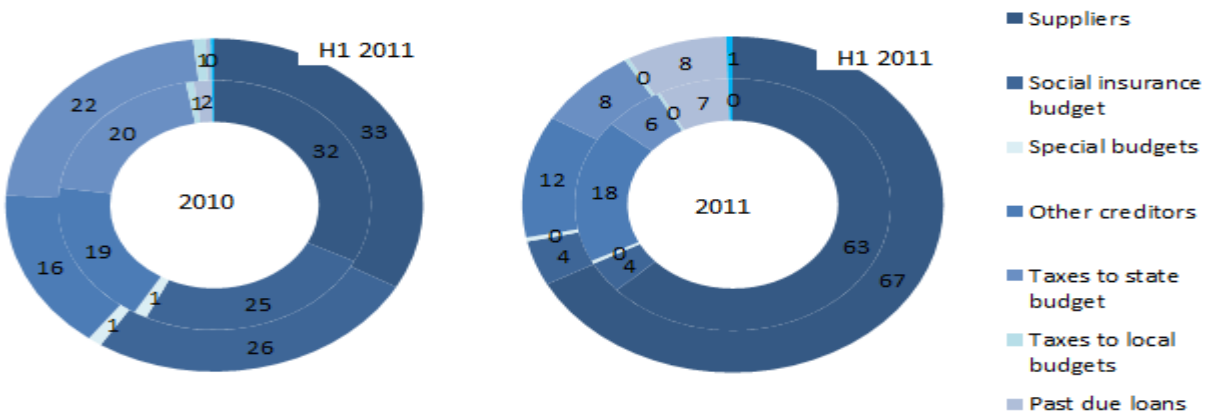


Figure 41: Structure of arrears on types of creditors (%)

SOEs **Private companies**



Source: Fiscal Council's calculations on financial statements from MoF

The data for 2006-2011 shows a constant increase in the stock of SOEs' arrears, up to 3.85% of GDP (22 billion RON) in June 2011.

Besides direct fiscal consequences generated by such arrears - revenue shortfalls to general budget – the accumulation of arrears 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 50% of the total arrears of SOEs, while the arrears are particularly high in the railway and mining sectors.

Table 8: SOE's arrears (billion RON)	2006	2007	2008	2009	2010	2011
Total SOEs	**15,8**	**14,0**	**16,9**	**23,1**	**28,01**	**27,0**
Top 150 SOEs	**8,7**	**10,1**	**12,1**	**18,0**	**21,5**	**17,5**
Compania Naţională a Huilei SA	1,3	3,2	3,5	4,1	4,8	5,2
Compania Naţională de Căi Ferate "CFR" S.A.	1,8	1,1	1,6	3,2	4,5	4,5
Oltchim SA		0,5	0,7	0,8	1,1	1,6
SN de Transport Feroviar CFR de Marfă	1,8	1,1	1,6	0,7	0,9	1,2
SC Electrocentrale Bucureşti	0,1	0,0	0,4	0,6	0,5	0,9
SC CUGIR SA					0,4	0,4
SN de Transport Feroviar CFR Călători	0,2	0,3	0,2	0,5	0,5	0,4
Termoelectrica	3,0	2,1	2,4	3,2	3,0	0,3
SC Uzina Mecanică Orăştie					0,2	0,2
SC Electrica furnizare SA	-	-	-	-	-	0,2

Source: Ministry of Finance

V.2 Arrears of the general budget

Considering that during 2010, the general budget arrears towards private sector were a recurrent problem, all targets agreed with the IMF being exceeded, in the year of 2011 the situation has improved. The stock of outstanding payments decreased from 1,126.7 million lei at the end of 2010 Q4 to 839.5 million at the end of 2011, all quarterly targets agreed with the IMF being reached.

Although outstanding payments of the general budget have decreased considerably since 2010 and arrears of the social security budget have been practically eliminated, pressures still arise from local authorities, as their arrears accounted for almost 90% of total arrears. However, the nominal amount of local authorities' outstanding payments decreased in 2011 too by 157 million lei (17% respectively). Still, further efforts are needed to reduce and also prevent the accumulation of new arrears. This is even more stringent since in the first quarter of 2012 the stock of arrears increased again (for both state budget and local budgets) and the ceiling agreed with the international financial institutions was exceeded.

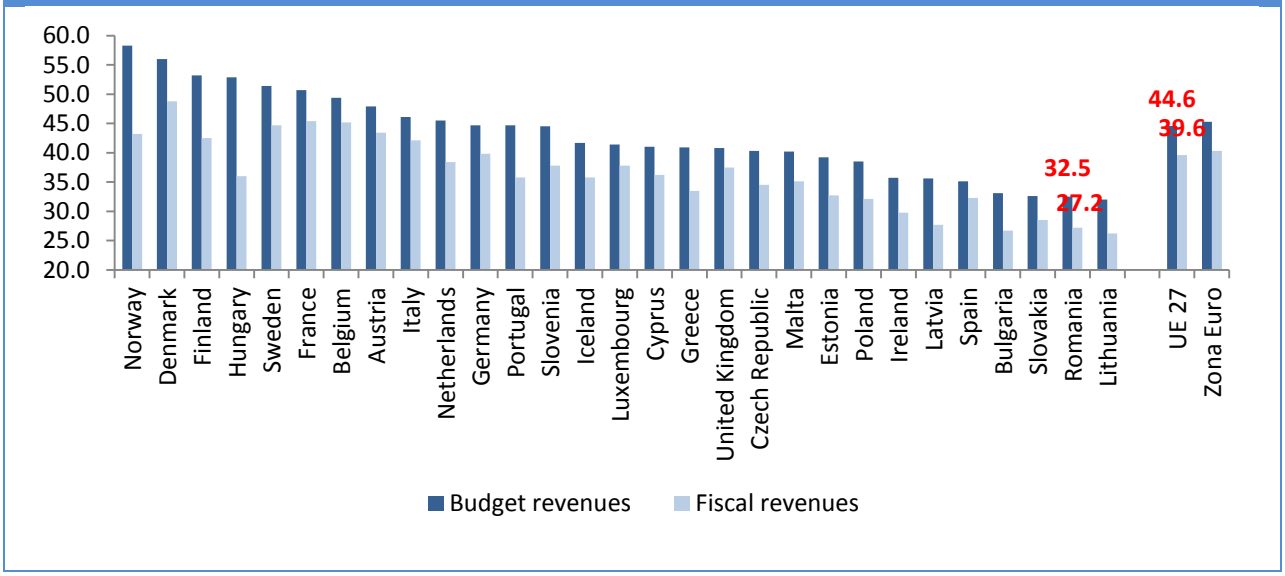
Table 9: Quarterly evolution of general consolidated budget arrears in 2011 (million lei)						
	2010 QIV	2011 Q1	2011 QII	2011 QIII	2011 QIV	2012 Q1
State budget	**57.4**	**84 .6**	**99.1**	**104.1**	**85.9**	**119.9**
Over 90 days	21.6	32.9	23.4	25.7	19.2	38.4
Over 120 days	24.1	35.3	55.4	57.8	46.0	59.7
Over 360 days	11.7	16.4	20.3	20.5	20.7	21.8
Local authorities	**910.0**	**819.4**	**809.2**	**822.9**	**752.8**	**793.5**
Over 90 days	247.4	209.7	191.2	197.7	172.6	206.6
Over 120 days	342.2	298.2	316.2	333.9	280.7	263.1
Over 360 days	320.4	311.4	301.7	291.3	299.6	323.8
Social security budget	**159.3**	**40.2**	**19.0**	**0.8**	**0.8**	**0.8**
Over 90 days	109.9	25.7	10.9	0.0	0.0	0.0
Over 120 days	39.9	11.7	5.9	0.3	0.2	0.2
Over 360 days	9.6	2.8	2.2	0.4	0.5	0.6
Total	**1 126.7**	**944.1**	**927.3**	**927.7**	**839.5**	**914.2**
Over 90 days	378.8	268.3	225.5	223.5	191.5	245.0
Over 120 days	406.1	345.2	377.6	392.0	326.9	323.0
Over 360 days	341.7	330.6	324.2	312.3	320.8	346.2
IMF target	**480**	**1150**	**1100**	**1000**	**900**	**800**
Overrun	**646.7**	**(205.9)**	**(172.7)**	**(72.3)**	**(60.5)**	**114.2**

Source: Ministry of Finance

V.3 Tax collection in Romania- international comparisons

Romania has one of the lowest shares of overall government revenues to GDP in the EU (tax and non-tax revenue), of only 32.5% of GDP in 2011, 12.1 percentage points of GDP lower than the EU average. Tax revenue to GDP (taxes and social contributions) in Romania was equal to 27.2% in 2011, 12.4 percentage points lower than the EU 27 average (39.6%). The share of tax revenue to GDP is significantly lower than in Slovenia (37.8%), Hungary (36%), Poland (32.1%) and Slovakia (28.5%).

Figure 42: Budget revenues and fiscal revenues (% of GDP, ESA 95, 2011)



Source: EUROSTAT; tax revenues include social contributions

The structure of tax revenue in Romania reveals a high share of revenues from indirect taxes supplying 46.32% of total tax revenue compared to the EU 27 average of 33.08%, while the share of revenue from social security contributions was 32.35% (EU 27 35.1%) and from direct taxes - only 21.32% (EU27 31.81%). The weight of indirect taxes as a percent of GDP increased by almost three percentage points, compared to the previous year, due to higher standard VAT rate and higher excises. The relative importance of contributions and direct taxes decreased but the decrease of their share in GDP was higher than the decrease of tax revenue's share of GDP. Under these circumstances, it can be assumed that indirect taxes were the fiscal consolidation's main component on the revenue side of the budget.

The tax system in Romania is characterized by weak tax collection, with inefficient administration and excessive bureaucracy (*Table 10*), a relatively small tax base, with many legal exemptions and deductions and increased tax evasion (*Chapter V.5 Tax evasion*).

According to an OECD report on tax administration[38], the efficiency of tax administration on collection is very low in Romania, being second to last in the NMS group. Another report, "Paying taxes 2012" published by the World Bank, places Romania on the 154th rank from 183 countries worldwide on ease of paying taxes, while the number of total tax payments per year a

[38] "Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2010)", 2011.

company from Romania has do is 113. Between the countries selected from Central and Eastern Europe, Romania ranks last at this chapter.

Table 10: Efficiency of tax administration

Country	Administrative offices			Number of administrative offices to 1 million people	Revenue (% of GDP)/ Administrative offices	Number of employees	Total tax revenue(% of GDP)	Tax revenue (% of GDP) to 1000 employees*	Total payments number**	Rank	Ease of paying taxes (rank) ***
	Total, o.w.:	Central	Local								
	2009			2009		2010			2011		
Bulgaria	29	29	0	3.8	0.9	7976	26.9	3.37	17	59	84
Czech Republic	207	8	199	19.7	0.2	15533	33.5	2.16	8	17	117
Estonia	4	4	0	3.0	8.5	878	34	38.72	8	17	47
Latvia	63	0	63	27.9	0.4	4300	27.3	6.35	7	11	62
Lithuania	10	10	0	3.0	2.7	3816	27.2	7.13	11	40	57
Poland	417	16	401	10.9	0.1	60401	31.6	0.52	29	96	127
Romania	440	42	398	20.5	0.1	25387	27.9	1.1	113	182	154
Slovakia	111	8	103	20.4	0.3	5686	28	4.92	31	103	129
Slovenia	76	76	0	37.3	0.5	2470	38	15.38	22	83	83
Hungary	8	8	0	0.8	4.6	15182	37	2.44	13	46	114

Source: OECD, Eurostat, World Bank

* The index is computed as ratio between tax revenues (% of GDP) and total employees in the tax collection system, reported by OECD in 2010, expressed as thousands of employees.

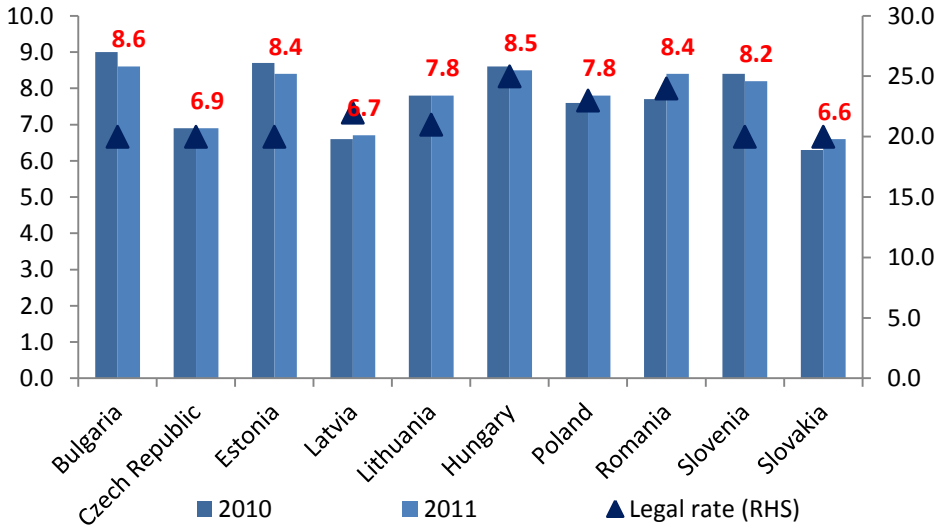
** This index shows the total number of taxes and contributions paid, payment method, payment frequency, frequency of completing tax returns and the number of agencies involved in the tax collection process for companies in the second year of operation.

*** Getting the ranking on ease of paying taxes involves making an arithmetic average of the ranks occupied by each state on the three pillars analyzed: total tax rate, number of tax payments per year and time to comply.

As an example of poor tax collection, Romania collected 8.4% of GDP from VAT revenues in 2011, as much as Estonia, while the legal VAT rate in Romania is much higher than that of Estonia (24% compared to 20%). Moreover, Bulgaria, having a structure of the economy similar

to that of Romania and a lower legal VAT rate (of 20%), collected much more revenues from VAT in 2011, respectively 8.6% of GDP.

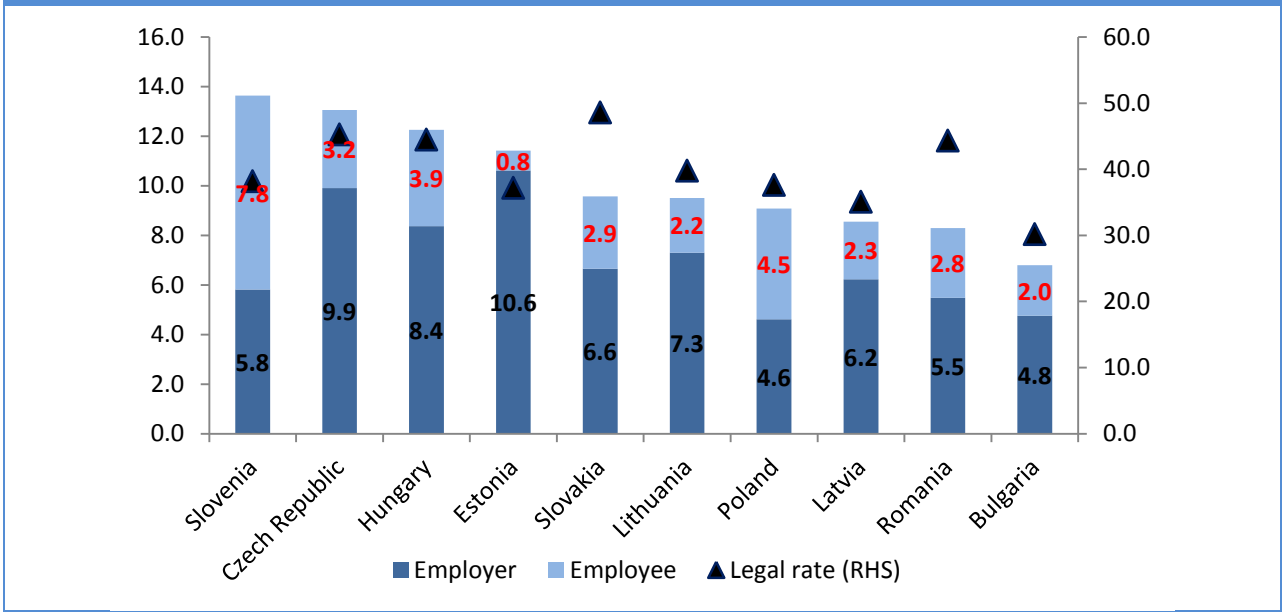
Figure 43: VAT revenues (% of GDP) – 2011



Source: European Commission, Eurostat

Regarding social contributions paid by both employees and employers, revenues collected in 2011 amounted to 8.3% of GDP, a much lower result than in the Czech Republic (13.1% of GDP) and Hungary (12.3% of GDP), even if the three countries have relatively similar legal contribution rates. Romania's collection ratio is also much lower than the ones of Slovenia (13.6%), Estonia (11.4% of GDP), Lithuania (9.5%), Poland (9.1%) and Latvia (8.6%), where statutory social contribution rates are significantly lower than in Romania.

Figure 44: Social contributions revenues (% of GDP) – 2011



Source: European Commission, Eurostat

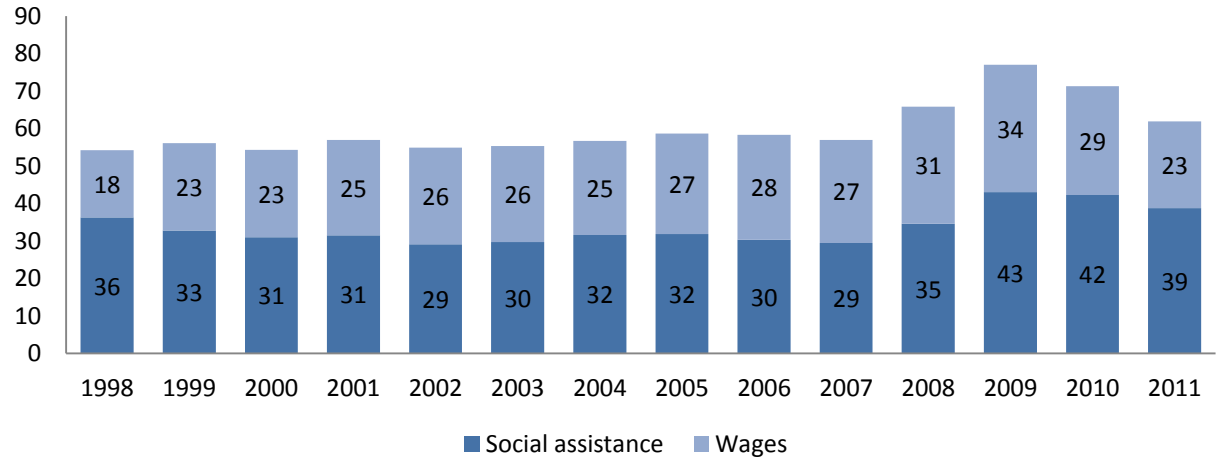
In the Fiscal Council's opinion, Romania needs a sound reform of the tax collection system, which has to meet two key objectives: a significant increase in the collected revenues and lower administrative costs. In the Fiscal Council's opinion, this reform must focus primarily on the following components:

- an increase of the voluntary compliance of taxpayers, especially by simplifying the Tax Code and the Tax Procedure Code and also through a comprehensive program of total transparency regarding public expenditure;
- an increase in efficiency and the reduction of collection costs, particularly by decreasing the number of tax administration offices, system computerization and aggressive promotion of electronic filling of tax returns and also electronic payments of taxes;
- the increase of staff professional quality and the reduction of corruption, especially through appropriate training programs, introducing a code of ethics and a clear system of measuring and rewarding performance, respectively punishing un-performance and corruption;
- the indirect stimulation of a more sustainable economic growth model through increased tax collection rates in order to allow accommodation of potential adjustments in the tax system aimed especially to stimulate employment (especially by reducing social security contribution statutory rates, which are high at the moment) and increase domestic savings in order to reduce reliance on foreign capital inflows to finance investments.

V.4 Public expenditure- structure and sustainability

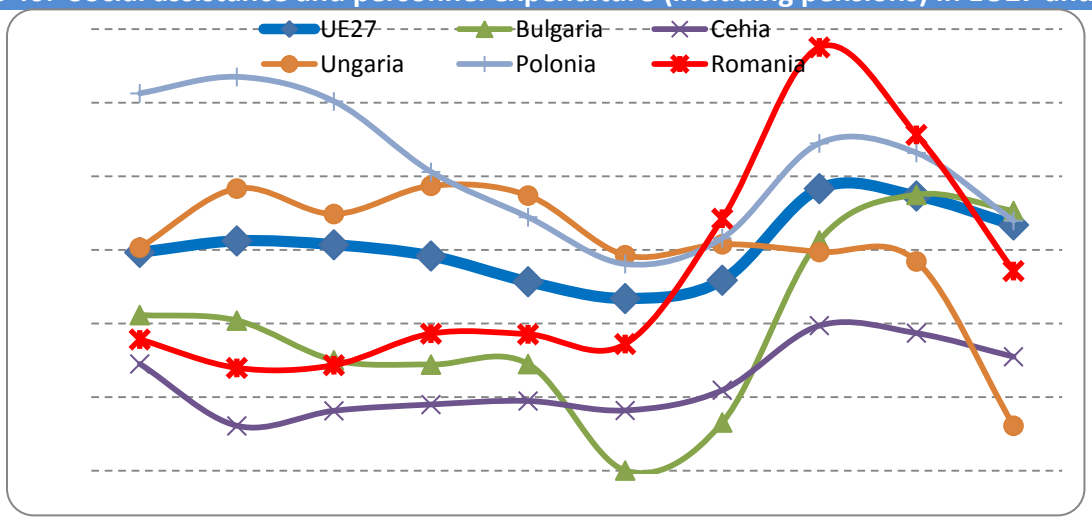
In Romania, the structure of budget expenditures is characterized by the dominance of personnel and social expenditure (salaries, pensions, social assistance). After a relatively stable evolution of these items of expenditure, as share of budget revenues, before 2007, they strongly increased during 2008 and 2009, high over EU-27 average, followed by a major adjustment in the period 2010-2011. At the present time, the allocations from budget resources for personnel and social assistance expenditure are similar to European averages (*Figure 45*).

Figure 45: Social assistance and personnel expenditure as share of total budget revenues (%)



Source: EUROSTAT

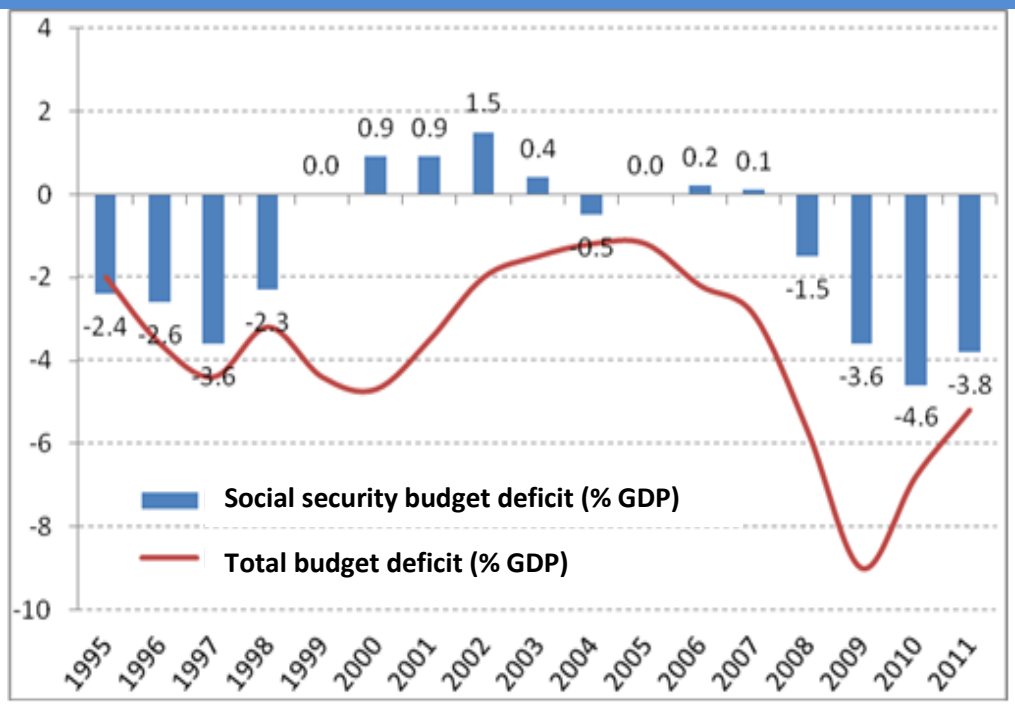
Figure 46: Social assistance and personnel expenditure (including pensions) in EU27 and CEE



Source: EUROSTAT

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 the economic activity and, especially, with productivity gains. As regards social assistance expenditure (especially pension expenditure), the financial status of the public pension system is very precarious, requiring extreme caution in dealing with any increases of this item of expenditure and/or eventual reductions of social security contributions statutory rates thereafter. Therefore, a medium and long term strategy is mandatory to rebalance the financial status of the public pension system, particularly by broadening the tax base.

Figure 47: Social security budget deficit and total budget deficit



Source: EUROSTAT

On the expenditure side of the budget, the top priority for upcoming years is improving the efficiency of public expenditure.

Efficiency reserves on the side of public expenditure are very high. For instance, Romania had the largest allocation for investment expenditure as share of GDP (and also as share of total budget revenues) of all European countries during 2001-2010; however, the results were modest; Romania is still having the poorest infrastructure in the EU. This example clearly shows that the resources were spent inefficiently.

Figure 48 : Infrastructure quality

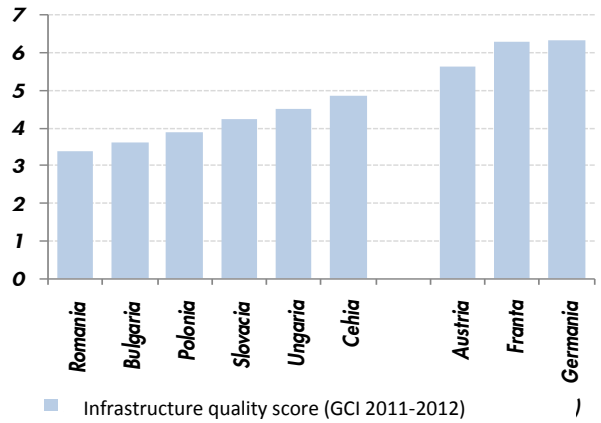
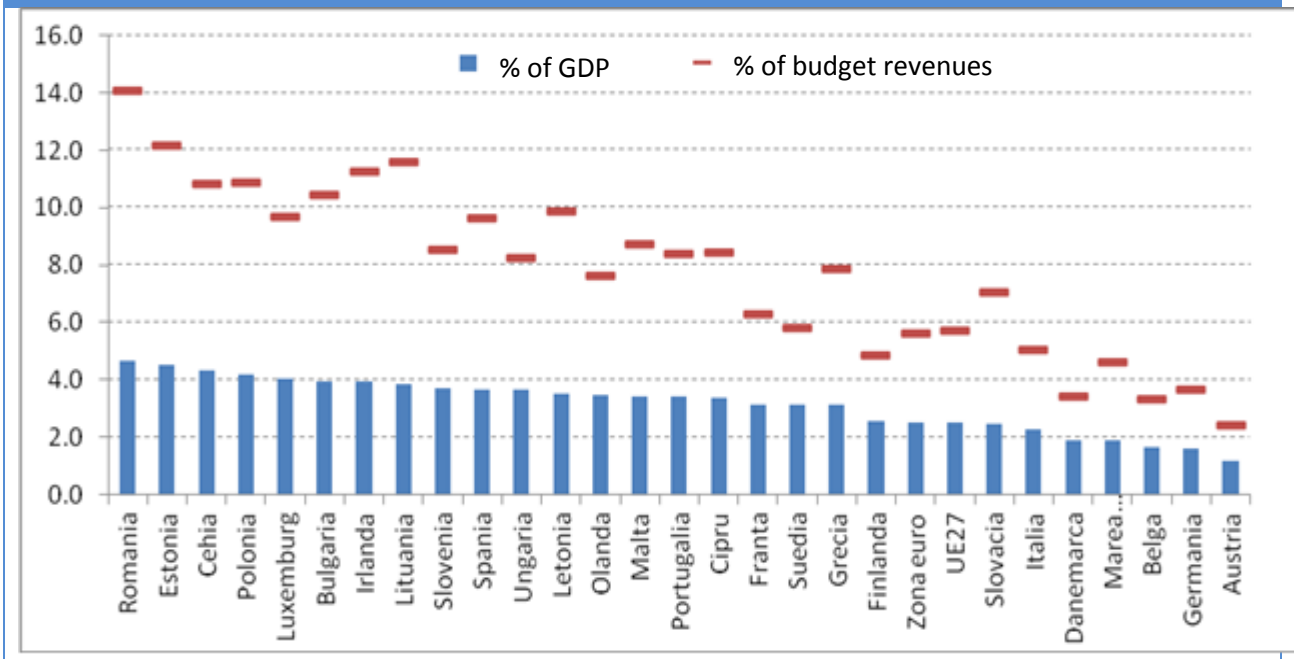


Figure 49: Investment expenditure



Source: EUROSTAT, World Economic Forum, Global Competitiveness Report 2011-2012

V.5 Tax evasion

According to the Fiscal Council's calculations based on NIS data, tax evasion has a large share in the Romanian economy, as SSC, VAT and personal income (PIT) tax evasion alone accounts for 10.3% of GDP in 2010 (*Table 12*). If Romania collected taxes at their maximum potential, the

budget revenues as a percentage of GDP would be close to the European average. Consequently, a profound reform of the tax administration targeted towards increasing tax collection is absolutely necessary.

Table 11: Evolution of the number of employees	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Average number of employees in the national accounts*, thousands of people (1)	5,882	5,786	6,138	5,900	6,408	6,162	6,412	6,436	6,513	6,573	6,633	6,647
Average number of employees reported by employers, thousands of people (2)	4,623	4,619	4,568	4,591	4,469	4,559	4,667	4,885	5,046	4,774	4,376	4,297**
Average number of employees unobserved economy- „undeclared work", thousands of people (3)=(1)-(2)	1,259	1,167	1,570	1,309	1,939	1,603	1,744	1,551	1,467	1,799	2,257	2,349
Share of employees from unobserved economy (4)=(3)/(1)	21.4%	20.2%	25.6%	22.2%	30.3%	26.0%	27.2%	24.1%	22.5%	27.4%	34.0%	35.3%

Source: Fiscal Council's calculation based on Nation Institute of Statistics data

** Also includes employees from the unobserved economy*

*** Figure estimated based on the assumption that the share of employees from companies with more than 4 employees in total number of employees reported by employers in 2011 remained at the 2010 level.*

Table 12: VAT, SSC and PIT tax evasion							
million RON	2004	2005	2006	2007	2008	2009	2010
Tax evasion from undeclared work:	9032	11298	14951	19044	23675	29125	30842
- personal income tax (PIT)	1885	2358	3259	4277	5623	6743	7140
- social security contributions (SSC)	7147	8940	11692	14767	18052	22383	23702
VAT fraud	7441	10684	16437	18901	19548	19266	18766
Tax evasion from informal economy (households)	1511	2158	2819	3626	4480	3340	4076
Total VAT, SSC and PIT tax evasion	17984	24140	34207	41572	47703	51732	53684
Unobserved economy grass value added	35814	47849	66117	83063	100741	104667	112569

% of GDP	2004	2005	2006	2007	2008	2009	2010
Tax evasion from undeclared work:	3.7%	3.9%	4.3%	4.6%	4.6%	5.8%	5.9%
- personal income tax (PIT)	0.8%	0.8%	0.9%	1.0%	1.1%	1.3%	1.4%
- social security contributions (SSC)	2.9%	3.1%	3.4%	3.5%	3.5%	4.5%	4.5%
VAT fraud	3.0%	3.7%	4.8%	4.5%	3.8%	3.8%	3.6%
Tax evasion from informal economy (households)	0.6%	0.7%	0.8%	0.9%	0.9%	0.7%	0.8%
Total VAT, SSC and PIT tax evasion	7.3%	8.4%	9.9%	10.0%	9.3%	10.3%	10.3%
Unobserved economy grass value added*	14.5%	16.6%	19.2%	20.0%	19.6%	20.9%	21.5%

Source: Fiscal Council's calculation based on Nation Institute of Statistics data

** Nation Institute of Statistics estimate*

BOX 4: Identification of unobserved economy in Romania[39]

In order to identify the unobserved economy in Romania, the economy is divided into two sectors: formal and informal.

For the formal sector, it is considered the underreporting of labor force utilization and also tax evasion by non-financial corporations, with an impact on gross value added underreporting.

The assessment of undeclared work is the most important component of the unobserved economy. The method used is based on the comparison of labor demand and supply in order to identify individuals who work in the formal sector, but are not registered with the authorities. The estimation of the labor supply uses AMIGO data and other administrative sources regarding population participation in the labor market. The survey provides information on the number of people who said they have worked during the reference period. The estimation of the labor supply is achieved by considering homogeneous branches of activity, respectively two-digit NACE, excluding agriculture and public administration. The agricultural production is calculated in the national accounts using quantitative data, while for the public sector an assumption of inexistence of underreporting is used.

The annual structural survey is the data source for labor demand. Thus, data on average number of

[39] Extract from the methodology regarding computation of non-financial national accounts, National Institute of Statistics, Official Gazette No. 292 of May 5, 2009 (Official Gazette. 292/2009).

employees from homogeneous 4-digit NACE activities are used.

The difference between the number of people who said that they were working in an enterprise and the number of people employed by enterprises represents "undeclared work". Undeclared work is evaluated in the same conditions as legal wages: average gross salary, social security contributions, etc. The intermediate consumption is determined using the same production weight as that obtained in small enterprises that operate in the same branch.

Romanian national accounts also include estimates regarding VAT evasion. Tax evasion is obtained as the difference between the theoretical and the actual VAT collected. The theoretical level of VAT is estimated using Intermediate consumption, household final consumption, public and private administration final consumption and GFCF, based on VAT legal rates. The fiscal fraud is included in the value of production, and also in the gross value added for each corresponding branch.

In the case of the informal sector, estimation of the unobserved economy is carried out for all activities performed by family associations and self-employed population. Information about these activities is provided by the Ministry of Finance. The estimation does not include only underreporting because the method suffers also a problem of non-registration and lack of surveys regarding this part of the economy.

The number of people working in family associations and private entrepreneurs / freelancers is estimated based on data from labor force surveys. The estimates are based on the principle that the income of self-employed persons cannot be lower than the average gains of employees working in small enterprises from the same branch. Income statements of family associations and self-employed, submitted to MoF, are compared and adjusted based on such calculations. Thus, with the adjusted incomes, tax evasion in the informal sector registered units is totally eliminated.

Another important category of the unobserved economy comes from the economic activity carried out by unregistered units from the informal sector. This includes: tailors, car mechanics, hairdressers, painters, plumbers, teachers giving private lessons, people who rent holiday houses etc. For such activities, separate assessments are carried out, using specific assumptions and data sources for the following industries: hotels, construction and education.

VI. 2012- Risks and perspectives

VI.1 Macroeconomic framework

In the European Commission's spring 2012 interim forecast, the projected growth rate for the global economy was maintained at 4.25%, yet the risks regarding economic growth remain high, due to the contagion effect of the Eurozone debt crisis.

For the EU economy, the European Commission forecasts economic stagnation, compared with a 0.6% growth rate estimated earlier. Downward revision was due to several factors. Thus, many countries have decided to implement further measures necessary to ensure sustainable consolidation of public finances in the context of the economic outlook deterioration from fourth quarter of 2011, while the positive effect on growth driven by lower tensions in financial markets as a result of measures against sovereign debt crisis manifested slower than expected. However, uneven developments of the member states economies are expected. On the one hand, Germany and France (0.6% and 0.4% expected growth in 2012) will experience only a slowdown in economic growth, while in Italy, Spain, the Netherlands, Belgium, Hungary gross domestic product will contract slightly. In the euro area as a whole, the economy will shrink by 0.3%. Portugal and Greece will face a severe economic contraction, over 3%, as estimates were also negatively revised compared to the autumn forecast.

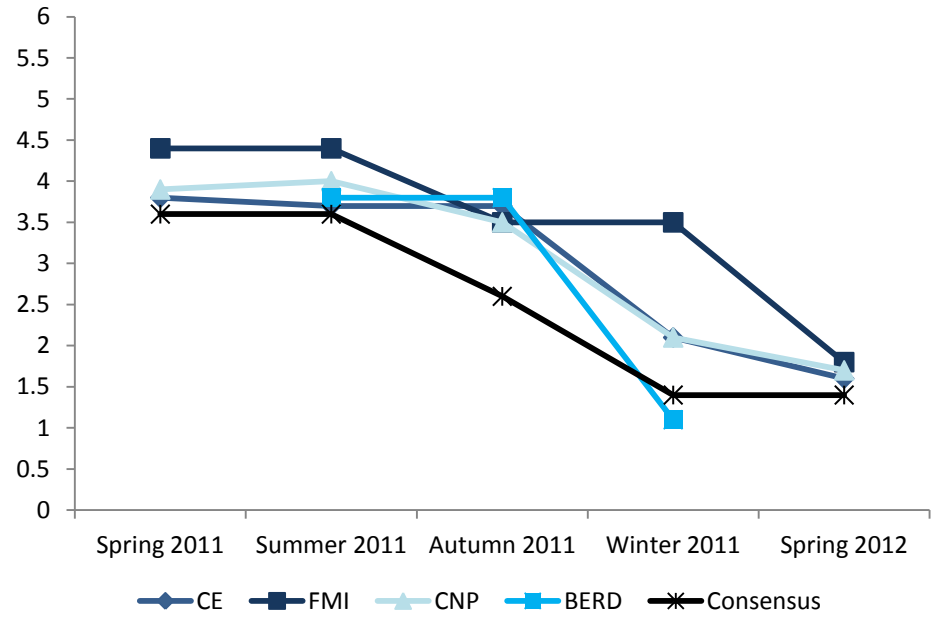
Inflationary pressures have started to grow moderately in both developed and emerging countries, as the main causes are related to advances in energy prices and indirect tax changes. For 2012, total inflation was revised upward for the European Union and the euro area and is projected to reach 2.3% and 2.1% respectively, due to the cumulative effect of administered prices and indirect taxes increases in many Member States, higher oil prices and new fiscal measures to be imposed in 2012.

In Central and Eastern Europe (CEE), economic activity will probably advance at a pace significantly slower than in 2011. According to European Commission's forecasts, economic recovery in this region was driven mainly by external demand, which is expected to have a lower contribution due to economic developments in the euro area.

Domestic demand remains weak in most CEE countries due to difficult conditions in the labor market, rising prices of raw materials, the effects of fiscal consolidation and as a result of the debt reduction process in the corporate, public and banking sector. Growth forecasts have been revised significantly downward for the Czech Republic (economic stagnation from 1.7%), Poland (2.5% from 4.3%), Hungary (-0.1% compared to 1.7%), Bulgaria (from 1.8% to 1.4%) and Romania (+1.6% from +2.5%).

In Romania, the economic advance is projected to be weaker than originally expected, mainly as a consequence of the worsening external economic conditions, affecting exports directly, through the commercial channel, and the domestic demand indirectly, through the capital flows channel. The latter will probably be negatively affected by increasing capital requirements for financial institutions in the EU (see capital requirements of European Banking Authority, EBA), which involves, at least in part, an accelerated reduction of debt (deleveraging) in banks and their branches in Central and Eastern Europe.

Figure 50: Economic growth forecasts



Source: Eastern Europe Consensus Forecasts

According to the European Commission, domestic demand is likely to be the main driver of economic growth. Public investment can make an important contribution in the context of significant improvements of EU funds absorption, while private investment could be affected by domestic and international uncertainties, and therefore postponed at least until the second half of 2012. Private consumption is projected to recover gradually, especially in the second half of 2012, due to income growth supported by rise in employment and a reduced inflation.

According to European Commission's forecasts, inflation in Romania is expected to decline in the first half of 2012 and accelerate in the second half, in the context of a negative base effect, but will remain within the range of the NBR target.

VI.2 Fiscal framework and risks

In the agreements with the IMF and European Commission, the Government committed to a reduction of the consolidated budget deficit for 2012 to 1.9% of GDP, a target revised from the previous level of 3%, in the context of a prudent approach of the fiscal policy, given the uncertainties due to the sovereign debt crisis in the euro area. Thus, the application of the new pension's law provisions, which required an increase with the rate of inflation (and part of previous year real wage growth rate, if positive), was delayed and initial budget was elaborated in the hypothesis of freezing public sector wages at end-year levels.

Downward revision of the budget deficit target for 2012 was not accompanied, however, by a change of parameters in the 2012-2014 fiscal strategy, which was approved in the context of a different macroeconomic framework than the one considered in the 2012 budget elaboration, or a proper review of medium-term budgetary deficit targets and corresponding projections of budgetary revenues and expenses. This is likely to affect the predictability of fiscal policy over medium term, explicitly stated in the fiscal responsibility law. The Fiscal Council reiterates its recommendation to update the fiscal strategy whenever a change of macroeconomic framework or fiscal policy occurs, in accordance with Article 23 of the fiscal responsibility law.

A prompt update of the fiscal strategy is even more necessary in the new context created by the change of government and recent adjustments in the parliamentary majority's configuration, in order to promote a predictable fiscal framework based on clear rules and targets. In terms of the fiscal responsibility law, article 23, letter c) provides an escape clause for revision of the fiscal framework in the case of a change of government. At the time of writing this report, the information available indicated the renegotiation of the deficit target by the new government with the IMF and EU mission (to 2.2% of GDP), in order to accommodate a two-stage wage indexation of public sector wages, (8% in June 2012, 7% in December 2012), a negative impact on revenues as a result of changes in the calculation for pensioners' contributions to health fund in accordance with the decision of the Constitutional Court, and also to allow for a gradual refund of the difference between the actual amount of health insurance contributions collected between January 2011 - April 2012 and the one determined in accordance with the calculation based on the Constitutional Court's judgment.

Even in the context of an upward revision of the budget deficit target, there are persistent risks in terms of achieving it, given the downward revision of projected economic growth, budget execution data at the end of first quarter and considering that compliance with the deficit ceiling occurred amid shifting in March the quarterly payment of income tax and an accumulation of arrears to the state and local budgets. The impact of the economic growth downward revision over the budget balance is however mitigated by the fact that this is mostly

due to deteriorating external demand, as a negative development of exports will not generate a proportional decrease in revenues.

In addition, the wage indexation, even implemented in a manner that limits the impact on the budget for 2012, will be completely operational in 2013, substantially complicating the process of adjusting the structural budget deficit over the medium term objective (MTO) in the context of obligations deriving from the Treaty for Stability, Coordination and Governance in the EMU (fiscal compact). At this point, the measures necessary to ensure convergence trajectories to MTO are unspecified, as is the date when this objective would be achieved. European commitments require a prudent conduct of fiscal policy over the medium term.

In the Fiscal Council's opinion, the risks associated to macroeconomic indicators are tilted toward a lower economic growth than projected. Also, the balance of risks regarding the stance of the fiscal policy seems to be biased on the negative side (a higher effective deficit compared to estimations).

The highest domestic risks can be materialized if the Government's commitment for the fiscal consolidation process decreases due to political turmoil anticipating the 2012 elections. Potential deviations from a restrictive fiscal policy (like reversing some of the already implemented austerity measures) can lead to a higher-than-target deficit in 2012 and a worsened risk perception regarding Romania.

Regarding economic growth, risks also are tilted toward the negative side, emanating especially from external sources. The reduction of economic growth in the euro area and recurrent financial market uncertainties may reduce Romania's economic advance through several channels: lower external demand negatively affects exports and worsens economic sentiment index, while turbulence in international financial markets could increase the country's risk premium, with adverse effects on capital inflows to Romania.

On the positive side, a better absorption of EU funds grants and improved confidence in the economy can lead to a higher than expected economic performance, supported also by potential foreign direct investments, attracted by a more alert pace in the area of structural reforms.

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Appendix 2- 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.

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.

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.

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.

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.

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 95 methodology (European System of Accounts) - The European System of National 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 ESA95 methodology and cash methodology are revenues and expenditures recording in "accrual" system (based on commitments, not actual payments like in cash system) and treatment of EU funding (EU is considered in ESA95 system a separate sector).

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 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.

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 Eurosystem and EU Member States whose currency is not the euro. Although membership in ERM II is voluntary, Member States with a 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 Consolidated General 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 - represent the interest rate used by NBR in order to achieve its monetary policy objectives. At present this is defined as the interest rate used for deposit within a week, 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 Consolidated General 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 - represent the average interest rate at which the central bank takes deposits on the interbank market during a month.

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 – 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