Fiscal Council's Opinion on the draft revision of the Fiscal Code

Released into public debate in late February, the proposed amendment to the Fiscal Code in its final form was formally notified to the Fiscal Council for approval according to Law no. 69/2010 as amended and supplemented (Fiscal Responsibility Law, henceforth FRL) on March 20th, 2015 by letter no. 40943/17.03.2015.

From the perspective of FRL, for this case are relevant art. 13 and 14, according to which:

"*Art. 13: Proposals for any legislation leading to a reduction of budgetary revenues must provide a financial statement according to article 15 of Law no. 500/2002, as amended and supplemented and meet at least one of the following conditions:*

a) ***to have the endorsement of the Ministry of Public Finance and of the Fiscal Council, confirming that the financial impact was taken into account in the budgetary revenue forecast and does not affect the annual budget targets and medium term targets;***

b) to be accompanied by proposals for measures to compensate the financial impact, by increasing other budgetary revenues*.*

Art. 14: The initiatives promoted under article 13 are adopted concurrently with the proposed compensating measures, approved by the Government."

Moreover, art. 40 let. d) and e) of FRL states among the responsibilities of the Fiscal Council:

„d) analysis and issuing opinions and recommendations on the annual budget laws before approval by the Government and before submission to Parliament, on the supplementary budgets and other legislative initiatives that may have an impact on the budgetary targets, as well as assessing their compliance with the principles and rules specified in this Law;

e) ***preparation of cost estimates and issuing opinions on the budgetary impact of the normative ordinances, other than the ones mentioned on (d) and the amendments made on the annual budget law during the parliamentary debates****;"*

Given the above law articles, the Fiscal Council will assess the aforementioned draft law in terms of **principles, objectives and rules of fiscal policy**.

1. Brief description of the project amending the Fiscal Code and Government's impact estimates

The draft of the new Fiscal Code introduces major changes in the tax rates and tax bases of the main categories of taxes. In short, the changes with significant budgetary impact include:

- **VAT**:
  - Reduction of the standard rate by 4 pp. in 2016 (up to 20%) and by 2 pp. from 2018 (to 18%);
  - Extending a reduced VAT rate for meat products (including live animals and poultry), fish, vegetables, fruits, milk, eggs and sporting events;
- **Excises**:
  - Reduction in excise duties on major energy products (petrol, diesel);
  - Reduction in excise duty on alcohol and alcoholic beverages;
  - Exclusion from the excise duty sphere of crude oil from domestic production and products currently included in "other excise goods" including coffee, jewelry, furs clothing, cars etc.;
- **Personal income tax**:
  - Reduction in tax rate from 16% to 14% starting with 2019;
  - Removal of deductibility for health insurance contributions starting with 2016;
  - In the case of salary income, increase of personal deductions for the basis function, for levels according to the number of dependent persons, between 300 and 800 lei (compared to current levels between 250 and 650 lei), while increasing the income threshold beyond which those deductions are diminishing from 1,000 to 1,500 lei;
  - In the case of pensions, the annual increase of taxable income threshold by 50 lei starting with 2016, up to the value of 1,200 lei (currently the threshold level is 1,000 lei);
  - Change of parameters of the special deduction for rescheduled loans by eliminating income limits for eligibility, by eliminating the time frame in which the restructuring should occur and by raising the ceiling for the granted deduction from 900 to 1,500 lei;
  - Elimination of tax on dividends starting with 2016;
- **Corporate and microenterprises income tax**:
  - Reduction in the corporate income tax rate from 16% to 14% since 2019;
  - Change of the reference value for the previous year turnover used for categorizing as "micro" to 75,000 EUR in 2017, 85,000 EUR in 2018, and 100,000 EUR 2019, compared with a current level of 65,000 EUR;

    - Differentiation according to the number of employees for the tax rate applied to microenterprises turnover (currently 3%), such that it becomes 1% for firms with at least 2 employees, 3% for companies with 1 employee and 3% + 1530 RON quarterly for those with no employee, while implementing a turnover tax of 1% for microenterprises start-ups in the first two years of operation regardless of the number of employees;
- **Social contributions:**
    - Reduction of social contribution rates by 3 pp. in the case of employee (to 7.5%) and by 2.3 pp. in the case of employer (to 13.5%) since 2018;
    - Extension of the applicability of a maximum ceiling of 5 average gross salaries currently applicable to pension contributions payable by the employee for health insurance contributions as well;
    - Extension of the payment obligation for social contributions (pensions and health) for all persons with income;
- **Other taxes:**
    - Removal of the special construction tax (currently 1% of the previous year balance sheet gross value) since 2016;
    - Elimination of the differentiation of the property taxes according to the legal nature of the holder (legal or natural person) and introduction of differentiation according to the property's destination (residential or non-residential). Tax rates for buildings can be between 0.08% and 0.2% for residential constructions (compared to a current level of 0.1% for individuals) and between 0.2% and 1.3% for non-residential (compared to the current range of 0.25-1.5% applicable to legal persons).

The explanatory note attached to the draft project amending the Fiscal Code assess the net first round effects[1] of the proposed measures in an amount of -16.4 billion lei in 2016, -16.8 billion lei in 2017, -28.7 billion lei 2018 and -37 billion lei in 2019. The document presents as sources of compensation for the tax cuts impact on budget revenues, the second-round effects (resulting from the additional economic growth) and the supplementary revenues expected from the implementation by the National Agency for Fiscal Administration (NAFA) of the structural measures designed to make the system of revenue collection more efficient and the increase of voluntary compliance, both on declaration and payment. The second-round effects (derived from the additional economic growth) are assessed by the Government at about 7 billion lei in the period 2016-2017, 10.6 billion lei in 2018, and 18 billion lei in 2019. The document also quantifies the additional income receipts from the improvement of NAFA's

[1] taking into account the economies of budgetary expenditure occasioned by the reduced VAT rates and employer social security contributions.

activity to about 14 billion lei in 2016, and respectively 18 billion lei annually in the period 2017-2019.

2. General considerations

The Fiscal Council considers particularly relevant for the case under consideration the following principles and rules established by the Fiscal Responsibility Law:

The principle of fiscal responsibility stated in article 4 of FRL according to which:

„The Government has the obligation to carry out the fiscal and budgetary policy and to manage budgetary resources, obligations and fiscal risks in a manner that ensures sustainability of the fiscal position in the medium and long term such that the Government is able to manage financial risks and unforeseen events in future periods without having to introduce economically or socially destabilizing expenditure or revenue adjustments".

- The fiscal rules stated at article 5^1, 5^2 and 5^3 paragraph (1) according to which:

„Article 5^1

In order to comply with the reference values for budget deficit and public debt, as they are mentioned in the Protocol no. 12 on the Procedure Applicable to Excessive Deficits, attached to the Treaty on the Functioning of the European Union, the budgetary position of the public administration is either balanced or in surplus.

Article 5^2

The rule provided under article 5^1 shall be considered complied if one of the following requirements is fulfilled:

(a) The medium-term budgetary objective does not exceed a lower limit of the annual structural balance of the public administration of -0.5% of GDP expressed at market prices;

(b) When the ratio between the public debt calculated according to the EU methodology and the GDP at market prices is significantly below 60% and when the risks related to long-term sustainability of public finance are low, the lower limit of the medium-term budgetary objective may not exceed an annual structural balance of the public administration of maximum -1.0% of GDP at market prices;

(c) The annual structural deficit of public administration converges towards the medium-term budgetary objective according to an adjustment path agreed with the

institutions of the European Union, according to the Council Regulation (EC) no. 1466/1997, as subsequently amended and supplemented.

Article 5^{3}

(1) Temporary deviation from the rules provided by article 52 and article 62 is allowed only due to extraordinary circumstances and provided that it does not endanger the medium-term fiscal and budgetary sustainability."

Considering the above-mentioned principles and fiscal rules, the Fiscal Council considers appropriate to answer the following questions in the present opinion:

1) To what extent the proposed amendments are consistent with the provisions of the preventive arm of the Stability and Growth Pact, namely achieving a structural deficit of 1% of GDP since 2015? What are the implications of defining the fiscal policy targets in structural terms compared to a situation where they would be defined in terms of headline deficit?
2) How plausible is the first-round assessment of the effects of the legislative changes according to the explanatory note attached to the legislative proposal?
3) How plausible is the assessment of the second round effects supposed to materialize according to the explanatory note attached to the legislative proposal?
4) To what extent is it prudent to consider the favorable effects due to a collection improvement in the amounts set out in the explanatory note attached to the legislative proposal?
5) To what extent is the legislative proposal appropriate in terms of the fiscal policy effectiveness in achieving its scope of smoothing the business cycle fluctuations (countercyclical policy)?

3. The fiscal policy objectives. The implications of their definition in structural terms

The fiscal policy in EU Member States is ruled by the two arms of the Stability and Growth Pact - the corrective arm and preventive arm that, in the case of the signatory states (including Romania) are reinforced by the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (known as the Fiscal compact). The corrective arm enforces the limit of the actual deficit to 3% of GDP, while the preventive arm - under which Romania entered from 2013 following the exit from the excessive deficit procedure at the end of 2012 - requires gradual convergence towards the so-called medium term objective (MTO). In the case of Romania, the MTO is defined as a structural deficit of 1% of GDP and the convergence towards this value should end this year[2].

This level of the structural deficit is required to ensure the public finances sustainability, creating safety margins to accommodate the adverse cyclical developments (such as the actual deficit should not exceed 3% of GDP during a normal economic cycle) and allowing to pay future contingent liabilities arising from the demographic trends (population aging) and avoiding excessive accumulation of public debt stock.

The structural balance is defined as the budgetary position that would prevail when the economy is operating at its potential level. This means that when in the economy a demand deficit is recorded (negative output gap – actual GDP is below potential GDP), the actual deficit is larger than the structural deficit by an amount directly related to the size of the recorded demand shortfall[3] while in the conditions under which the economy operates above its potential level (there is an excess demand/a positive output gap), the actual deficit is lower than the structural deficit[4].

Defining the objectives of fiscal policy in terms of structural deficit has major implications for the projection of the fiscal policy discretionary measures. The effect of any discretionary measures introduced can be decomposed into a structural component and an automatic stabilizer, the latter with opposite impact on the actual deficit, which is basically equivalent to the first-round effects, respectively, the second round effects[5]. Referring particularly to the discretionary measures targeting the budgetary revenue, the first-round effects describe the impact on the income aggregates based on the assumption that the macroeconomic base/the economic growth remains at the same level as in the baseline scenario (which would have prevailed in the absence of the fiscal measures), while the second-round effects describe the impact on the budgetary aggregates of the changes stirring from the macroeconomic bases/ economic growth (compared to the baseline scenario, basically the additional economic growth) following the introduction of the discretionary measures. The first-round effect is contained exclusively by the category of budgetary revenue targeted by the discretionary

[2] An adjustor of 0.25% of GDP under the so-called "investment clause" is included in the 2015 budget and allows a temporary deviation from the MTO.

[3] Thus, in 2012, 2013 and 2014 for actual deficits of the consolidated budget (ESA 2010) of 3%, 2.2% and 1.8% of GDP (European Commission estimates of Winter forecast 2015), the corresponding structural deficits were 2.1%, 1.4% and 1.41% of potential GDP (estimated by the European Commission).

[4] Such a situation was observed, for example, in 2007 and 2008, when the levels of the actual deficit were 2.9% and 5.6% of GDP while the structural deficits estimated by the European Commission amounted to 5.3% and 8.6% of the potential GDP.

[5] The overlap between the structural effect and first-round effect, i.e. between the effect of the second round and the automatic stabilizer is perfect under the assumption that potential output does not change under the impact of discretionary measures. If, hypothetically, the impact of measures would be found fully in the potential GDP, the structural component would be the sum of the first-round and second-round effects.

measures, while the second-round effect occurs in all categories of revenue and expenditure that could response to changes in macroeconomic bases/economic growth - in essence, the categories that may be affected include on the revenue side the fiscal revenues and social contributions, and on the spending side the unemployment benefits.

The implication of the above statements is that the second-round effects which are attributable to the action of automatic stabilizers appear only when the first-round effects attributable to the structural component, are accommodated. In other words, the structural deficit should be allowed to vary (increase in this case) with the amount of the structural component of the discretionary measures addressed to budgetary revenue (a fiscal impulse should exist) to allow the second-round effects occurrence. **Specifically, in the case of a reduction in the level of taxation, the structural deficit should be allowed to increase by the amount of the first-round effects permitting the second-round effects that are likely to generate an increase in the actual deficit lower than in the structural deficit, to manifest.**

The arguments presented above point out that the use of the second round effects as a source of compensation for the expected impact of tax cuts is irrelevant given that the deficit target is defined in structural terms. The additional economic growth necessarily implies a proportional reduction in the level of the actual deficit target corresponding to the structural deficit target, unless is recorded an almost impossible to imagine case, when the whole amount of the additional growth would be included in the potential GDP without any changes in the cyclical position of the economy compared to the baseline scenario (in the absence of the discretionary measures).

Practically, defining the deficit target in structural terms moves the attention, in terms of respecting the fiscal policy rules, to the first-round effects and significantly diminishes, to almost irrelevance the importance of the second-round effects.

The compliance with the structural deficit target when adopting permanent fiscal loosening measures (as tax cuts according to the Fiscal Code draft) involve the necessity to adopt compensatory structural measures also of a permanent nature (i.e. reduction/freeze of spending compared to the baseline scenario, tax increases, increases in collection efficiency etc.). These measures have, in turn, second-round effects opposite to those which, *ceteris paribus*, would be generated by the fiscal loosening measures. In such a case, the existence of net second-round effects, although possible, would be due only to taking advantage of favorable differences in the fiscal multipliers, between the various components of the discretionary measures *mix* and, necessarily, should be of low magnitude.

As regards increasing the collection efficiency/diminishing the informal economy, this may represent, in theory, a source of additional income to reduce the impact of the discretionary measures on the structural deficit, but an *ex ante* evaluation of the amount of additional income is impossible to be done. Given this, and the prudence required by the fiscal responsibility principle stated in FRL, in the Fiscal Council's opinion, these revenues cannot be considered *ex ante* as a valid source of compensating the financial impact as in the meaning of article 13 letter b) of FRL, especially at the excessively optimistic levels presented in the substantiation note. The Fiscal Council will return to this topic in the section dedicated to this subject.

Concluding this section and anticipating its own estimates presented further down, the Fiscal Council considers that the implementation of the Fiscal Code draft will lead to a permanent and major weakening of the structural fiscal position. The second-round effects are relevant from the perspective of structural deficit target compliance, only in the proportion in which the additional economic growth is reflected in the potential GDP, which is unlikely to happen in a significant extent, especially given that reducing consumption taxation is the main part of the discretionary measures package contained in the new Fiscal Code: or, in a hierarchy of effects on long-term economic growth, according to the literature, consumption taxation is considered to be among the categories with lower influence on the long-term economic growth (Cournède et al., 2013).

4. An evaluation of the first and second round effects of measures included in the draft revision of the Fiscal Code

Following its own assessment, the Fiscal Council doesn't have significant reserves to the aggregate amount of the first-round effects included in the explanatory note associated to the normative act draft. However, it should be noted that an own estimate of the income loss related to extending goods and services categories that are subject to a reduced VAT rate could not be achieved given that by the time of writing this opinion, NAFA failed to provide to Fiscal Council the necessary data required under art. 41, paragraph 1 and 2 of FRL by letter no. 49/11.03.2015. Annex 1 summarizes the results of the parallel assessment undertaken.

We argued earlier the idea that the second-round effects are virtually irrelevant in terms of ensuring compliance with a structural deficit target. However, their quantification is important in terms of determining the actual deficits that would prevail after implementing the measures stipulated by the new draft Fiscal Code.

The Fiscal Council considers that the government estimates regarding the amounts of additional revenues generated by the economic growth driven by the fiscal stimulus are excessive. These involve a degree of recovery of nearly 50% of the income loss associated to the first-round effects, both at the level of 2016 and at the end of 2019. It is impossible to reconcile such a level of additional income with reasonable and plausible levels of the fiscal multiplier (describing GDP growth in response to the reduction of budget revenues due to tax cuts, both in absolute terms[6]) and of elasticities to GDP change of the main income categories.

The Fiscal Council undertook an alternative estimation of the second-round effects using a calibrated level of the fiscal multiplier based on the methodology described in Battini et al. (2014) and the set of aggregate elasticities of budget revenues to GDP change to those used by the European Commission for Romania (Mourre et. al., 2014), estimated at their request by OECD (Price et al., 2014).

The literature review generally indicates that the "normal" dimension of the fiscal multipliers lies between 0 and 1; those associated to the budgetary revenues tend to be lower than those related to budgetary spending (government consumption and public investment) – the standard Keynesian theory explains the latter phenomenon by the fact that households save some of the extra disposable income arose from the reduction of taxation. Recent studies using a qualitative approach for the advanced economies identify fiscal multipliers associated to budgetary revenues significantly higher than those typically obtained through econometric estimates. Moreover, the recent literature identifies major deviations in the size of the multipliers as compared with the 'normal" ones depending on the cyclical position of the economy (Auerbach, A.J., Y. Gorodnichenko, 2012; Baum et al., 2012), in the sense that they tend to be higher in severe recessions and lower in situations characterized by the existence of excess demand.

Analyzing the literature dedicated to emerging economies, the estimated fiscal multipliers are in general significantly lower than those in developed countries (Ilzetzki et al., 2013; Ilzetzki, 2011; Estevão și Samake, 2013), without identifying relevant differences between the multipliers size associated to budgetary revenues and to budgetary expenses. For example, Ilzetzki (2011) obtains a range of 0.1-0.3 for the impact spending multipliers and 0.2-0.4 for those of revenues (long-term multiplier reaches about 0.8).

From a theoretical perspective, the factors contributing to a higher size of the fiscal multipliers are (Battini et al., 2014):

- Prevalence of the lack of "smoothing" behavior of consumption, consistent with the existence of high marginal propensity to consume, given that a high proportion of households are facing liquidity constraints;
- Accommodative monetary policy;
- Small automatic stabilizers;

[6] The impact multiplier is defined as $-\Delta Y(t)/\Delta T(t)$, and the one at the i horizon as $-\Delta Y(t+i))/\Delta T(t)$, where ΔY is the variation of nominal GDP (in absolute terms) and $\Delta T(t)$is the first-round impact (in lei) of tax cuts initiated in year t.

- Low level of public debt.

Towards reducing the fiscal multipliers dimension the following factors would impact, in accordance to the article quoted above:

- A more pronounced tendency to precautionary saving given the history of economic instability;
- Inefficiency in public expenditure management and tax collection system;
- Higher risk premiums, an increased potential for credibility effects;
- Reduced size of the economies and the existence of high trade openness that increase the likelihood of “leakages” by increasing imports.

Battini et al. (2014) conducted a comprehensive review of the results regarding the size of fiscal multipliers and, on this basis, they constructed a calibrated algorithm of fiscal multipliers dimension taking into account the structural characteristics of the economy and the existence of conjunctural factors that may cause temporary deviations from the ”normal” values of the structural multipliers. The calibration methodology, described in Annex 2, indicates a level of the impact multiplier for Romania of about 0.4. Regarding the persistence effects of discretionary measures, we assume that the size of the annual multiplier decreases linearly to zero at the end of a period of five years, similar to the standard assumption of Battini et al. (2014), considering a maximum level in the second year from baseline (+10% compared to the first year level); in the case of an impact multiplier of 0.4, the hypothesis regarding the persistence implies a multiplier at the end of the action horizon of about 1.2. The hypotheses appear as optimistic and favorable in terms of the second-round effects size- the impact multiplier t is quantified at the top of range results for emergent economies and the persistence assumption is possible excessive especially in terms of fiscal loosening measures dominated by cuts in consumption taxes. In addition, it is arbitrarily assumed that the monetary policy is accommodative, so it is likely to determine a higher size of the multiplier than it would be normal.

The combined use of the parameters described above (fiscal multipliers and elasticities[7]) and the first-round effects estimated for the entire package in the year of implementation involves additional GDP growth rates and second-round effects on the aggregate categories of income and expenses sensitive to the GDP change (personal income tax, social contributions, unemployment benefits) as follows:

[7] The elasticities of budgetary aggregates to GDP reported for Romania by Price et al. 2014 are presented in the table from Annex 2.

Table 1: Second-round effects of the Fiscal Code amending proposal on real GDP and on general consolidated budget during 2016-2019				
	2016	**2017**	**2018**	**2019**
Additional increase in real GDP if the impact multiplier is 0.4 (pp.)	0.9	0.9	1.2	1.2
Aggregate budgetary effects of the second round if the fiscal multiplier is 0.4 (billion lei)	1.6	3.5	6.2	9.3
Aggregate second round effects according to MPF (billion lei)	7.0	7.0	10.6	18.0

Source: Fiscal Council's calculations

Compared to the budgetary aggregates elasticites of Price et al. (2014), the second-round effects trajectory estimated by the Government in the explanatory note associated to the draft normative act most likely imply the impact fiscal multipliers significantly higher than those used by the Fiscal Council, together with a lower persistence. Assuming that the full effect acts in the same year that the discretionary measures occur, levels close to the government's estimates of the second-round effects can be obtained (using the elasticities of Price et al., 2014) only if the impact multiplier is 1.7 – an excessive amount, far outside any range of estimators in the literature, and that would imply an economic growth of about 7% in 2016.

Combining the first-round effects reported by the MPF and the second-round effects identified by the Fiscal Council as in Table 1, the increases of the actual deficit relative to the baseline scenario as a result of the introduced measures would be of about 14.8 billion lei in 2016, 13.2 billion lei in 2017, 22.5 billion lei in 2018 and 27.7 billion lei in 2019, that is equivalent to 2.0%, 1.7%, 2.7% and respectively 3.0% of the (higher) GDP that would prevail in the event of the measures. Defining the baseline scenario characterized as actual deficits of 1.1% of GDP in 2016 and 2017[8] and effective deficits consistent with a structural deficit of 1% in 2018 and 2019[9], the effective deficits that would prevail after the adoption of the new Fiscal Code would be **3.1% of GDP in 2016, 2.7% of GDP in 2017, 3.5% of GDP in 2018 and 3.7% of GDP in 2019**. Based on the assumptions described in the previous footnote, the appropriate level of the structural deficit **is estimated to be 3.2%, 3.3%, 4.7% and 5.5% of the potential GDP in 2016, 2017, 2018 and 2019**. This is equivalent to a high and growing deviation from the MTO – at the end of the interval, the structural deficit returning around the level from the end of 2010 (5.8% of the potential GDP according to the European Commission estimates). Moreover, the Fiscal Council's calculations indicate a level higher than the 3% limit stated by the Stability and Growth Pact on

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[8] In line with the targets defined in the 2015-2017 Fiscal Strategy.

[9] At the level of structural deficit of 1% of potential GDP we added the cyclical component, determined as the product of the standard semi-elasticity of 0.33 used by the European Commission and the level of excess/deficit demand. The latter is determined as difference between the path of the latest GDP projection of NCP and the level of potential GDP, all relative to potential GDP. To this end, for 2016 the level of potential GDP from the 2015 Winter Forecast of the European Commission is used, that implies a growth rate of 2.6%, while for the period 2017-2019 we arbitrarily assume that the growth rate of potential GDP would be 3%.

almost the entire considered period (exception being 2017), that would involve the reentry of Romania in the excessive deficit procedure. Table 2 summarizes the results presented above.

Table 2: The impact of the amending proposal of the Fiscal Code on the effective and structural deficit in the period 2016-2019				
	2016	**2017**	**2018**	**2019**
Effective deficit baseline scenario	1.1	1.1	0.9	0.7
Effective deficit post-measures	3.1	2.7	3,5	3.7
Structural deficit baseline scenario	1.0	1.1	1.0	1.0
Structural deficit post-measures	3,2	3.3	4.7	5.5
Output gap baseline scenario	-0.4	-0.1	0.3	0.8
Output gap post shock	0.5	1.6	3.2	4.8

Source: Fiscal Council's calculations

5. The reduction of the tax evasion as a source of covering revenue losses

The explanatory note of the draft revision of the Fiscal Code indicates as sources of coverage for the negative impact on budget revenues due to the lowering in the taxation level, the additional revenue from the improvement in the collection of taxes by NAFA, valued in 2016 at about 14 billion lei, and respectively at about 18 billion lei annually in the 2017-2019 period (around 2% of GDP).

The principle of fiscal responsibility stipulated in the article 4 of the FRL, requires the government "to manage the fiscal and budgetary policy prudently". It is obvious that *ex ante* quantification of any additional income generated by the institutional reform of NAFA is impossible - there is not a history of performance that can substantiate such calculations, and in no case the interpretation, no matter how benevolent, of the existing data could generate comparable figures with those from the explanatory note. There is no doubt that the potential for acquiring additional revenues from better collection exists - actually, the Fiscal Council is among the institutions that have published estimates relating to the size of the tax evasion (see its annual reports), but the existence of this potential does not mean that the *ex-ante* assumption of its materialization is reasonable or prudent, especially in a so consistent amount.

A basic principle of a healthy budgetary design is that permanent reductions in revenue (as is the case following the proposed measures by the draft revision of the Fiscal Code) must be offset by measures which are likely to also be permanent. The Fiscal Council however fully agrees with the idea of including the additional revenue from the improvement of collection *ex-post* in the budget construction as a source of compensation for the tax cuts, but only after their amount could be measured with a high degree of confidence and sufficient evidence of the occurrence of a trend of reducing the tax evasion would exist - that would be equivalent to a permanent character of these revenues. We are extremely skeptical that the existence of several months of budget execution showing greater revenues than those that would be justified by the development of the macroeconomic bases (as seems to be the case for the first two months of this year) allows the identification of such a trend, given the high monthly volatility prevalent in the history of the budget revenues aggregates. In addition, at least at the VAT level, high annual growth rates reported for the first two months of 2015 are in a significant proportion affected by the temporary effect of the payment in advance of VAT refunds at the end of 2014 (in the approximate amount of 1.5 billion lei).

6. Conclusions

The Fiscal Council considers that the Government's initiative to rewrite the Fiscal Code is justified and welcomed given the numerous changes that this document has suffered over the years, but considers that it provides extensive and unsustainable cuts in the level of taxes. The efficiency gains in the collection of taxes and public spending are a valid source of fiscal space, but it must be used cautiously and gradually, without jeopardizing the macroeconomic equilibriums whose preservation is a key ingredient for a sustainable process of real convergence.

According to the estimates of the Fiscal Council, the draft revision of the Fiscal Code in its present form involves an extreme risk of a permanent and major deterioration of Romania's public finances. The Fiscal Council estimates indicate headline deficits above the reference value of 3% of GDP in the interval 2016-2019, and the estimated developments in the structural budget balance suggest the reversal of the progresses made so far in terms of fiscal consolidation; at the end of 2019, the structural deficit will come back to a level close to the one recorded in 2010. Such developments are in flagrant contradiction with the principles and rules established by the FRL and with the fiscal governance treaties at the European level at which Romania adhered.

Moreover, the estimates presented by the Fiscal Council do not take into account a number of factors with a potential significant impact in the sense of an increase in the recorded headline deficit:

- The recent political agreement to increase defense expenditures up to a level of 2% of GDP for a period of at least 10 years from 2017 (from a level of about 0.8% at the end of 2013);

- The reaction of the financial markets to a potential permanent and major deterioration of the structural position of public finances in Romania.

Regarding this last point, it should be noted that rating agencies emphasize in their recent reports that their assessments are conditional of the progress’s preservation in terms of public finances structural position[10]. Moreover, the recent experience of Bulgaria indicates a significant probability of occurrence of jumps in the country risk premium, which implies higher funding costs for both the state and the private sector: the considerable widening of the deficit at the end of 2014 (from 1.2% in 2013 to 3.4% of GDP in 2014, according to the European Commission estimates) has generated a jump of about 100 basis points of the risk premium applicable to the neighbor state while it continues to remain significantly above that of Romania.

In addition, it is impossible to reconcile such a projected evolution of the public finances position with the announced target by the Government for adopting the euro in 2019, while the Fiscal Council estimates indicate the existence of an excessive deficit for the coming years in the situation in which the new Fiscal Code will be applied.

Finally, the opportunity of a fiscal stimulus of this magnitude is questionable as the cyclical position of the economy is estimated by the European Commission to be close to equilibrium (output gap close to 0) in 2016. Romania risks falling again into the trap of a pro-cyclical fiscal policy, pressing on the accelerator in the expansion phase of the economic cycle while risking to be forced to implement structural adjustment measures in a future phase of recession. There is a quasi-unanimous consensus in the recent literature regarding identifying a significantly higher levels of fiscal multipliers in recessions and lower values during expansions, which means that the benefits in terms of supplementary economic growth in the short term due to the pro-cyclical fiscal stimulus are outweighed by the costs that an inevitable fiscal consolidation could generate in the downward phase of the economic cycle. Otherwise, the experience of Romania in the last 10 years demonstrates this in full.

Given the extremely high probability that the implementation of the draft revision of the Fiscal Code will lead to major deviations from the medium-term budgetary objectives, the Fiscal Council cannot endorse the legislative proposal.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of the Fiscal Council, according to Article 43, paragraph (2), letter d) of Law no. 69/2010, based on the vote of the Fiscal Council members in the meeting on March 30th, 2015.

30th March 2015

Chairman of the Fiscal Council

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[10] The latest press releases of Fitch, Standard & Poor's and Moody's mentioned among the factors that could cause a negative review of Romania's rating a fiscal relaxation that can affect the stability of public finances.

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	Annex 1		Estimated impact, mil. RON			
	Propopals to amend the Fiscal Code		**2016**	**2017**	**2018**	**2019**
Personal Income Tax	Change of the personal deduction	1	-698,0	-817,0	-877,6	-942,8
	Elimination of the health contribution deduction - employees	2	1089,2	1229,8	1273,7	1319,1
	Reduction of the pension contribution (impact on revenues)	3			666,4	753,0
	Reduction of the single rate - PIT	4				-3304,7
	Credit special deduction (maximum impact) *	5	-1853,5	-2169,3	-2330,4	-2503,4
	Health contribution non-deductibility + Increase of the tax free treshold - pensioners	6	1,4	-149,1	-308,8	-451,1
	Removal of the tax on dividends	7	-2037,2	-2269,7	-2533,5	-2828,0
	Increare of the lump expenditure share **	8	-115,1	-118,2	-121,2	-124,3
	Total impact PIT - Fiscal Council	**9=1+2+3+4+6+7+8**	**-1759,8**	**-2124,2**	**-1901,0**	**-5578,8**
	Total Impact PIT - MPF	**10**	**-1819,5**	**-1390,1**	**-904,6**	**-4056,5**
	Estimated impact difference FC - MPF	**11=9-10**	**59,7**	**-734,1**	**-996,4**	**-1522,3**
Corporate income tax	Revision of the dividend income regime **	12	-59,0	-80,0	-82,0	-84,1
	Modification of the expenditure deduction principle **	13	-14,0	-21,0	-22,0	-23,0
	Reduction of the single rate - CIT	14				-1502,3
	Total impact CIT - Fiscal Council	**15=12+13+14**	**-73,0**	**-101,0**	**-104,0**	**-1609,4**
	Total impact CIT - MPF	**16**	**-73,0**	**-101,0**	**-104,0**	**-1559,0**
	Estimated impact difference FC - MPF	**17=15-16**	**0,0**	**0,0**	**0,0**	**-50,4**
VAT	Reduction of the standard VAT rate (20% in 2016 + 18% in 2018)	18	**-8722,4**	**-10052,9**	**-15124,3**	**-15994,6**
	Reduction of the VAT rate at 9% for meat, fish, vegetables and fruit (from 2016) **	19	**-2700,0**	**-3100,0**	**-2500,0**	**-2900,0**
	Impact of the excise reduction	20	**-699,3**	**-738,8**	**-781,3**	**-826,2**
	Total impact VAT - Fiscal Council	**21=18+19+20**	**-12121,7**	**-13891,7**	**-18405,5**	**-19720,8**
	Total impact VAT - MPF	**22**	**-12295,5**	**-14070,5**	**-19051,7**	**-20880,4**
	Estimated impact difference FC - MPF	**23=22-21**	**173,8**	**178,8**	**646,2**	**1159,6**
Excises	Reduction of the excises for energy products	24	-2660,2	-2810,4	-2972,2	-3143,2
	Reduction of the excises for alcoholic products	25	-178,4	-188,4	-199,3	-210,7
	Removal of tax for oil from domestic production and natural gas	26	-3,8	-4,0	-4,2	-4,5
	Removal of tax for other excisable products	27	-71,3	-75,3	-79,6	-84,2
	Total impact EXCISES - Fiscal Council	**28=24+25+26+27**	**-2913,6**	**-3078,2**	**-3255,3**	**-3442,6**
	Total impact EXCISES - MPF	**29**	**-3013,6**	**-3114,7**	**-3225,4**	**-3346,4**
	Estimated impact difference FC - MPF	**30=28-29**	**100,0**	**36,5**	**-29,9**	**-96,2**
Social security contributions	Capping the health contribution at 5 salaries	31	-281,77	-318,1	-329,5	-341,3
	Net impact of the pension contribution reduction	32			-8047,0	-9.091,7
	Total impact SSC - Fiscal Council	**33=31+32**	**-281,8**	**-318,1**	**-8376,5**	**-9433,0**
	Total impact SSC - MPF	**34**	**-501,6**	**-87,3**	**-8303,5**	**-9627,1**
	Estimated impact difference FC - MPF	**35=33-34**	**219,8**	**-230,8**	**-73,0**	**194,1**
	Impact MICROENTERPRISES INCOME TAX**	**36**	**300,0**	**385,0**	**357,9**	**332,7**
	Impact CONSTRUCTIONS TAX **	**37**	**-1038,0**	**-1066,0**	**-1093,0**	**-1120,7**
	Total impact - Fiscal Council	**38=9+15+21+28+33+36+37**	**-17887,8**	**-20194,2**	**-32777,5**	**-40572,6**
	Total impact - MPF	**39=10+16+22+29+34+36+37**	**-18441,2**	**-19444,6**	**-32324,3**	**-40257,4**
	Estimated impact difference FC and MPF	**40=38-39**	**553,4**	**-749,6**	**-453,2**	**-315,2**

* The impact of the special deduction on loans was not included due to the uncertainties regarding its dimension – the sum from the table represents the maximum impact, but any value between zero and this sum could materialize depending on the attractivity of the scheme.

** Impact according to the MPF's estimates.

Annex 2

Determination of the fiscal multipliers using the methodology described in Battini et al. (2014)

Step 1: Assign scores based on the structural characteristics of the economy:

- **Low trade openness:** The economy is relatively closed, if the ratio of imports to domestic demand is below 30 percent on average over the past five years.
- **High labor market rigidities:** The labor market in the analyzed country is strongly regulated.
- **Small automatic stabilizers**: The automatic stabilizers measured by the ratio of public spending to nominal GDP are "small" (for instance, when the ratio is below 0.4).
- **Fixed or quasi-fixed exchange rate regime:** The exchange rate arrangement of the country is not fully flexible.
- **Low/safe public debt level:** The country's gross government debt is below a level that is generally considered "safe" by financial markets; a threshold of 40% can be used in the case of Emerging Market Economies.
- **Effective public expenditure management and revenue administration.**

In the case of Romania, the assignment of scores according to the criteria above mentioned can be found in the next table:

Scoring based on structural characteristics	
Low trade openness	0
High labor market rigidities	0
Small automatic stabilizers	1
Fixed or quasi-fixed exchange rate regime	0
Low/safe public debt level	1
Effective public expenditure management and revenue administration	0
Total score	**2**

Step 2: Summing the scores in order to determine the likely level of the first – year multiplier (low, medium, or high) in "normal" times.

Framing the fiscal multipliers for the first year based on the scores		
Multiplier type	Score	Multiplier value
Low	< 3	0,1 - 0,3
Medium	3 - 4	0,4 - 0,6
High	4 - 6	0,7 - 1,0

Step 3: Adjusting the fiscal multipliers based on conjunctural factors

- **Adjust the range for the cycle:** If the economy is at the lowest point of the cycle (maximum negative output gap based on historical patterns), increase both the lower and upper bound of the multipliers range by 60 %. If on the other hand, the economy is at a peak (maximum positive output gap), decrease both bounds by 40%. When the output gap is zero, no adjustment should be made.
- **Adjust the range for the monetary stance:** if the monetary policy is perfectly accommodative (The Central Bank does not react to the fiscal changes by increasing the interest rate), then the bounds of the multiplier increase by 30%.

Adjusting the fiscal multipliers based on conjunctural factors, for Romania	
Adjust the range for the cycle	0
Adjust the range for the monetary stance	30%

Given the persistence of a fiscal shock over a period of 4 years, the effect in a particular year is determined based on a matrix whose generic form is shown below:

The effect on GDP relative to the baseline scenario of a fiscal stimulus in amount of 1 RON initiated in each year of the period 2016-2019							
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
2016	0.4	0.4	0.3	0.1	…	…	…
2017	…	0.4	0.4	0.3	0.1	…	…
2018	…	…	0.4	0.4	0.3	0.1	…
2019	…	…	…	0.4	0.4	0.3	0.1

The impact of the measures on GDP (million lei)							
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
2016	6358.6	6994.4	4662.9	2331.5	0.0	0.0	0.0
2017	0.0	58.1	63.9	42.6	21.3	0.0	0.0
2018	0.0	0.0	4512.2	4963.4	3309.0	1654.5	0.0
2019	0.0	0.0	0.0	2245.6	2470.2	1646.8	823.4
Cumulated	6358.6	7052.5	9239.1	9583.2	5800.5	3301.3	823.4

The other inputs required are the elasticities of the budgetary aggregates on GDP (estimated for Romania by Price et al., 2014) and the amount of the first – round effects of the measures introduced in the year when the fiscal impulse takes place (additional fiscal impulse relative to the baseline scenario).

The elasticites of the budgetary aggregates on GDP for Romania	
PIT to GDP Elasticity	1.3
CIT to GDP Elasticity	2.0
SSC to GDP Elasticity	0.6
Indirect taxes to GDP Elasticity	1.0
Unemployment expenses to GDP Elasticity	-3.9

Source: Price et al. (2014)

The fiscal impulse determined by the proposed measures, in the period 2016-2019	
2016	16304
2017	149
2018	11570
2019	5758