Fiscal Responsibility and the New Fiscal Code

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Fiscal Council's Opininon the Draft Revision of the Fiscal Code

- ***Negative endorsement motivated by the existence of an extreme risk of permanent and high deterioration of the public finances position in Romania,*** incosistent with the fiscal rules and with the principles established by the Fiscal Responsibility Law and by the European fiscal governance treaties.

- ***The opportunity of a fiscal loosening of such proportion*** is questionable

  - The cyclical position of the economy is likely to be at equilibrium or even to record the existence of an excess demand starting with 2016

  - Romania risks to remain into ***the trap of a procyclical fiscal policy***, pressing the accelerator in the expansionary phase of the economic cycle and risking to be constraint to implement ***structural adjustment measures in an inevitable future recession phase.***

- ***Reserves in terms of implications on the economic growth in the long run*** given that the composition of the legislative package is focused on reducing consumption taxation.

The Set of Discretionary Measures and the Public Finance (Im)balance

The First Round Effects of the New Fiscal Code Measures

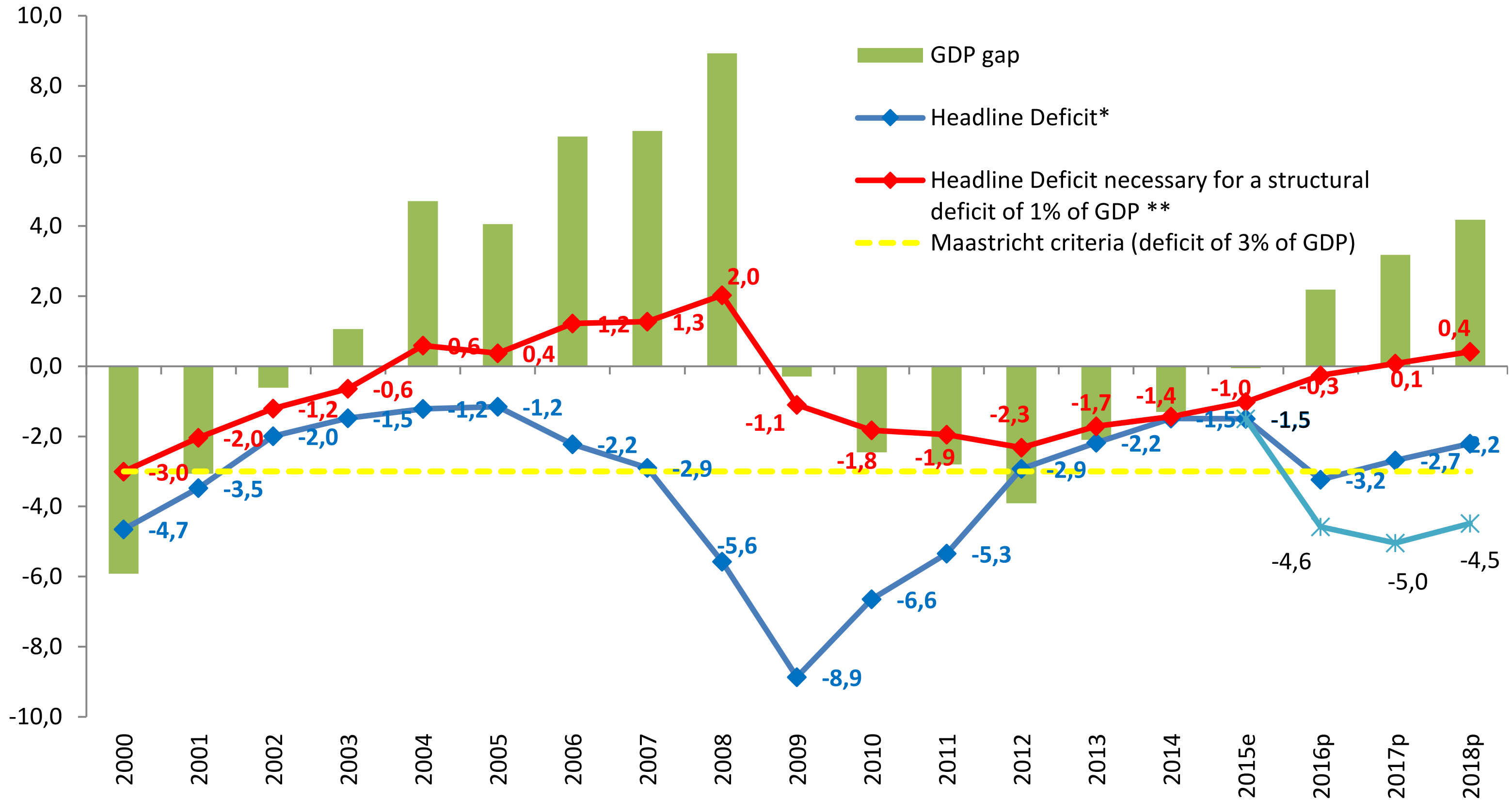
The Main Measures of the Fiscal Code			
No.	Measure	Budgetary Impact	
		Billion lei	% of GDP
1	Reduction of the standard VAT rate from 24% to 19%	-8.9	-1.2
2	Reduction of the tax on dividends from 16% to 5%	-1.3	-0.2
3	Various reductions of the excises (including the impact on VAT)	-3.6	-0.5
4	Changes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

- Other sources of pression upon the budget deficit:
  - 2016 – the increase of salaries in the public sector according to the new Unified Wage Law (according to MPF, the gross budgetary impact is 15.5 bn lei and the net impact is 10 bn lei (1.3% of GDP))
  - 2017 - the increase by at least 1% of GDP of the defence expenses according to the political commitment from the beginning of 2015

Second Round Effects of the Fiscal Code - estimation

- Impact fiscal multiplier calibrated at 0.4 (ac. *Battini et al. , 2014*), with persistent effect for 4 years (a total multiplier of 1.2)
  - The proposed level is at the top of the range of the estimated multipliers for economies similar to Romania
  - Additional economic growth (relative to the baseline scenario) of 1 pp. in 2016 and 2017, respectively 0.6 pp. and 0.3 pp. in 2018 and 2019
- The elasticities of budgetary aggregates to GDP used for the second round effects are taken from the OECD study *Price et al., 2014* which are also used by the European Commission
- The second round effects at the level of budgetary revenues are 0.2% of GDP in 2016, 0.5% of GDP in 2017 and 0.7% of GDP in 2018

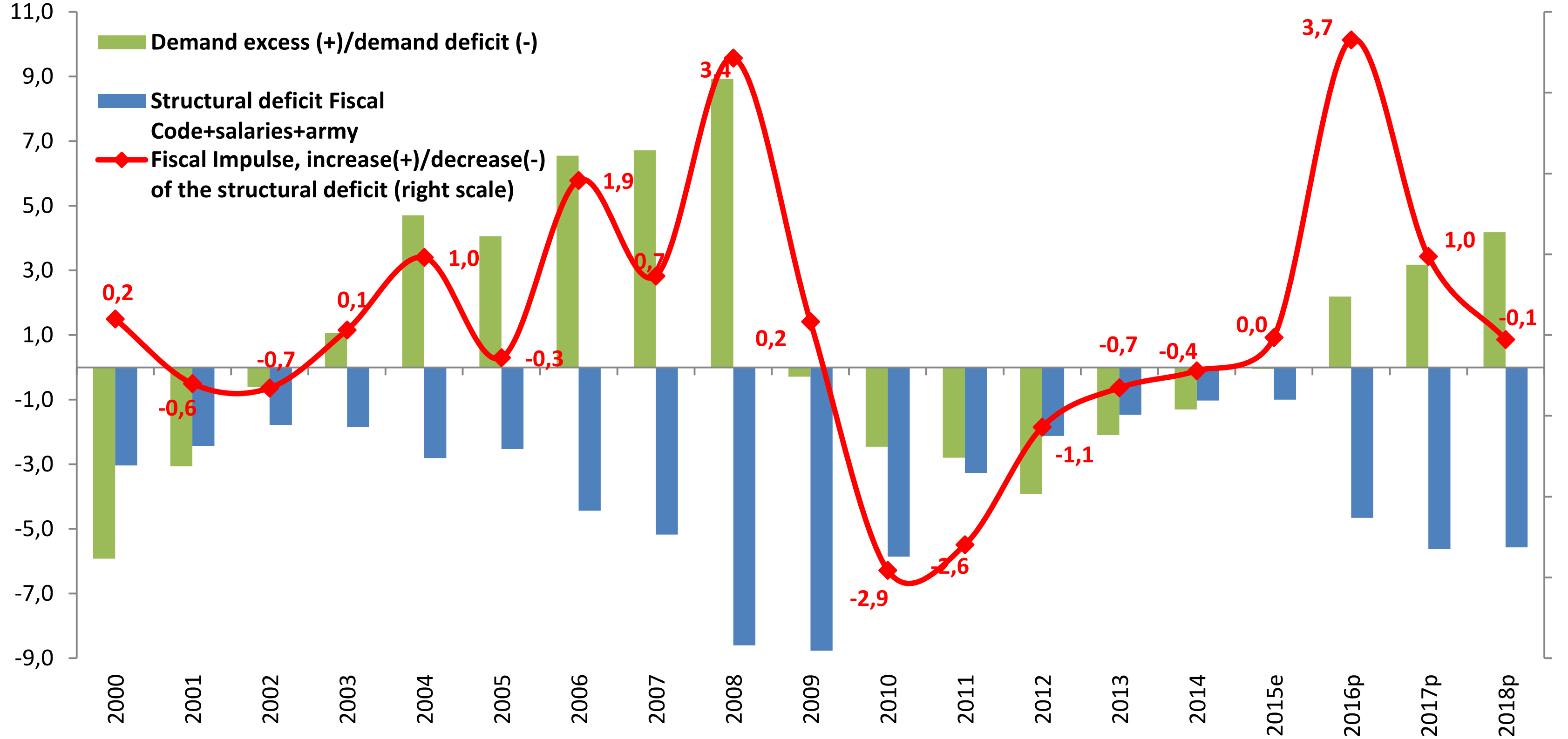
The Impact of the Proposed Measures on the Budget Deficit (% of GDP)



Source: Fiscal Council

- The Fiscal Council estimates that the budget deficit will exceed 3% of the GDP in 2016, with the risk of reentry in the ***excessive deficit procedure***.
- Including the increase of salaries in the public sector and the implementation of political commitment for the defense spending, the budget deficit could reach 5% of GDP in 2017, that ***would emphasize the growing trend of unsustainable public debt (above 45% of GDP most likely since 2017).***

The Recurrent Problem of the Fiscal Policy Procyclicality

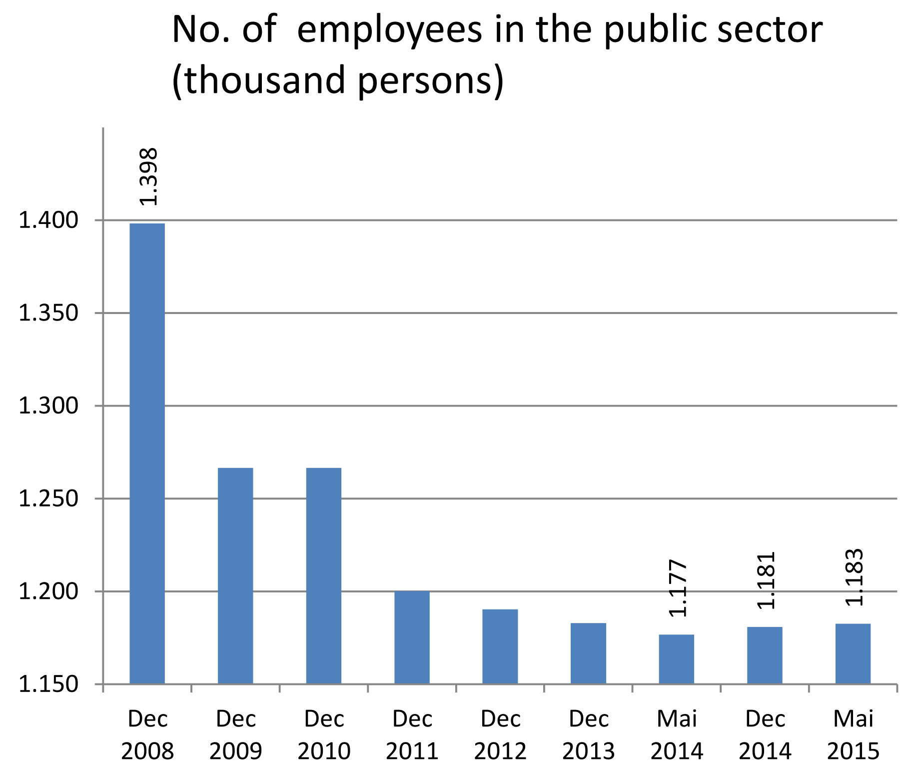


Source: AMECO, Fiscal Council

- In the scenario in which the public sector salaries are also growing, the ***fiscal procyclical stimulus projected for 2016 would be even stronger in magnitude as the one from 2008.***
- România risks entering again ***into the trap of a procyclical fiscal policy***, risking to be constraint to implement major structural adjustment measures in an inevitable future recession phase.
- The benefits in terms of additional short term growth will be outweighed by the costs that an inevitable fiscal consolidation could generate during the downward phase of the economic cycle.

The New Unified Wage Law in the Public Sector has the potential to reverse the wage envelope adjustment made during the crisis

Source: Eurostat, own calculations



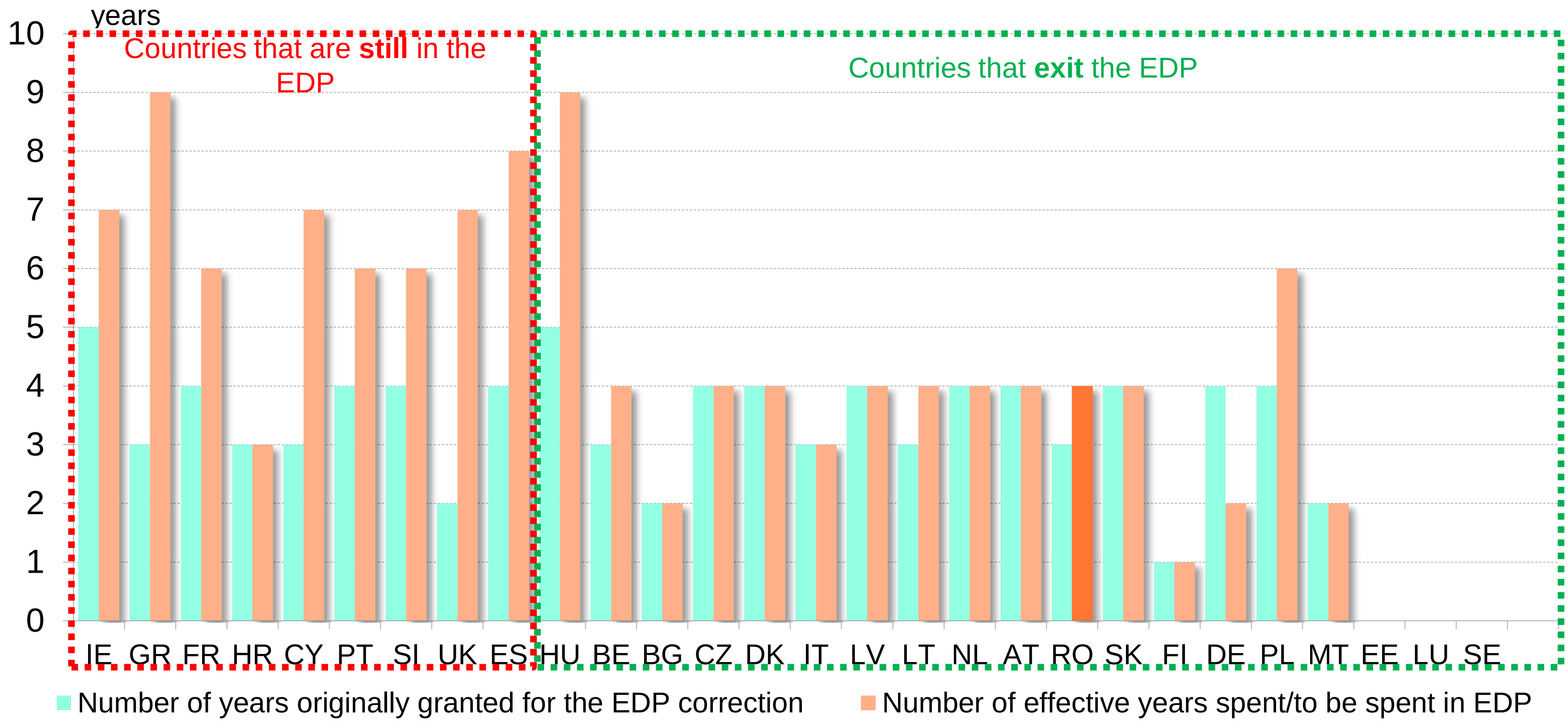
Source: MPF

One look at the Stability and Growth Pact Implications

The Relative Position of the Member States in terms of Stability and Growth Pact (SGP)

- **Under the corrective arm of SGP (în EDP):**
  - ✓ Deadline for correction 2015: PT, SI, FR, IE, UK
  - ✓ Deadline for correction 2016: CY, GR, ES, HR
- **Under the preventive arm of SGP**
  - ✓ Without EDP: EE, SE, LU
  - ✓ Since 2011: FI
  - ✓ Since 2012: BG, DE
  - ✓ Since 2013: HU, IT, LT, LV, RO
  - ✓ Since 2014: AT, BE, CZ, DK, NL, SK
  - ✓ Since 2015: MT, PL

Time Spent in the Excessive Deficit Procedure (EDP) in Relation to the Deadlines Originally Granted



Source: European Commission

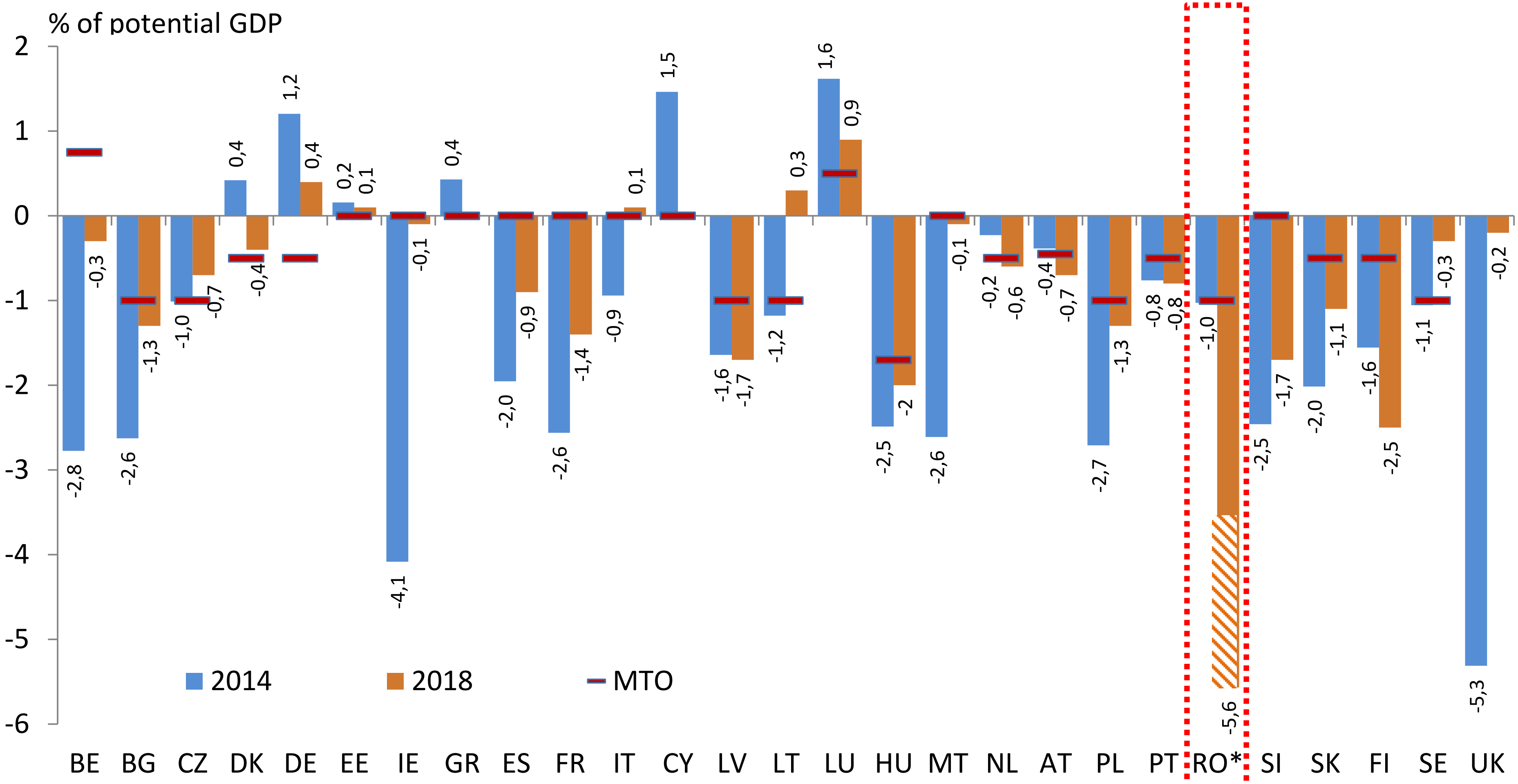
- The major structural adjustment made by Romania (6.7pp of GDP) was done in the context of EDP – similar adjustment time to the majority of the states, exit of EDP at a 2.1% of GDP structural deficit
- The cumulated adjustment under the preventive arm of SGP (2013 & 2014) – 1.1 pp. of GDP

Decision Matrix for Determining the Necessary Adjustment for the Cyclical Position

Status	Conditions	Annual fiscal adjustment required	
		Debt under 60% and without sustainability risk	**Debt over 60% or sustainability risk**
„Horror" Times	ΔGDP(%) < 0 or *output gap* < -4 of GDP	There is no adjustment required	
Very Hard Times	-4 ≤ *output gap* < -3	0	0,25
Hard Times	-3 ≤ *output gap* < -1,5	0 if the *gap* is opening, 0,25 if the *gap* is closing	0,25 if the *gap* is opening, 0,5 if the *gap* is closing
Normal Times	-1,5 ≤ *output gap* < 1,5	0,5	> 0,5
Good Times	*output gap* ≥ 1,5	> 0,5 if the *gap* is opening, ≥ 0,75 if the *gap* is closing	≥ 0,75 if the *gap* is opening, ≥1 if the *gap* is closing

Source: European Commission

The structural deficit widens from the MTO, while the other countries would be on a convergence trajectory

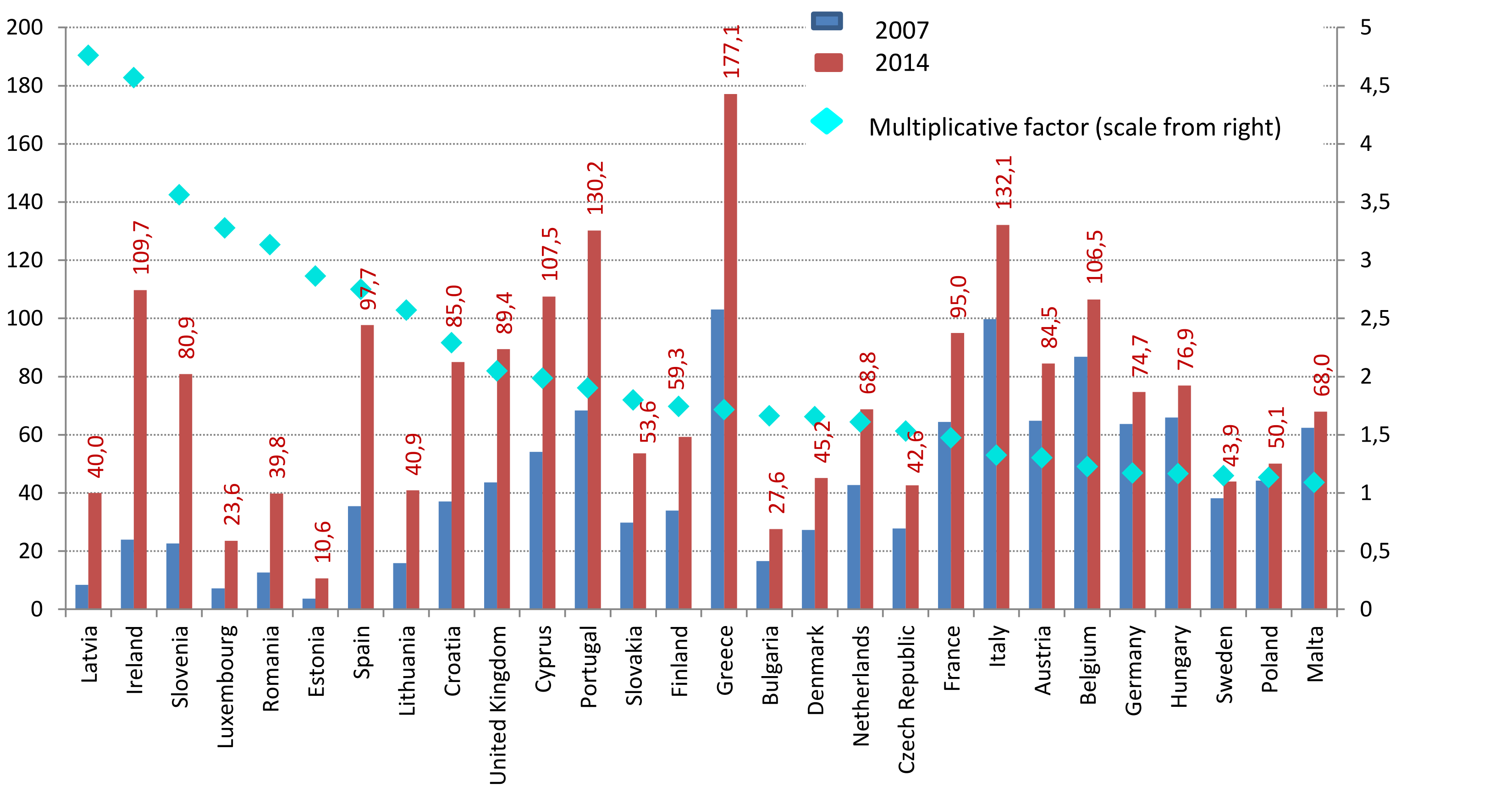


Source AMECO, Stability and Covergence Programme , own calculations

* structural deficit associated to Fiscal Code 3,3% + salaries impact public sector and military expenses 2,3%

Vulnerabilities associated to an upward trajectory of the Public Debt

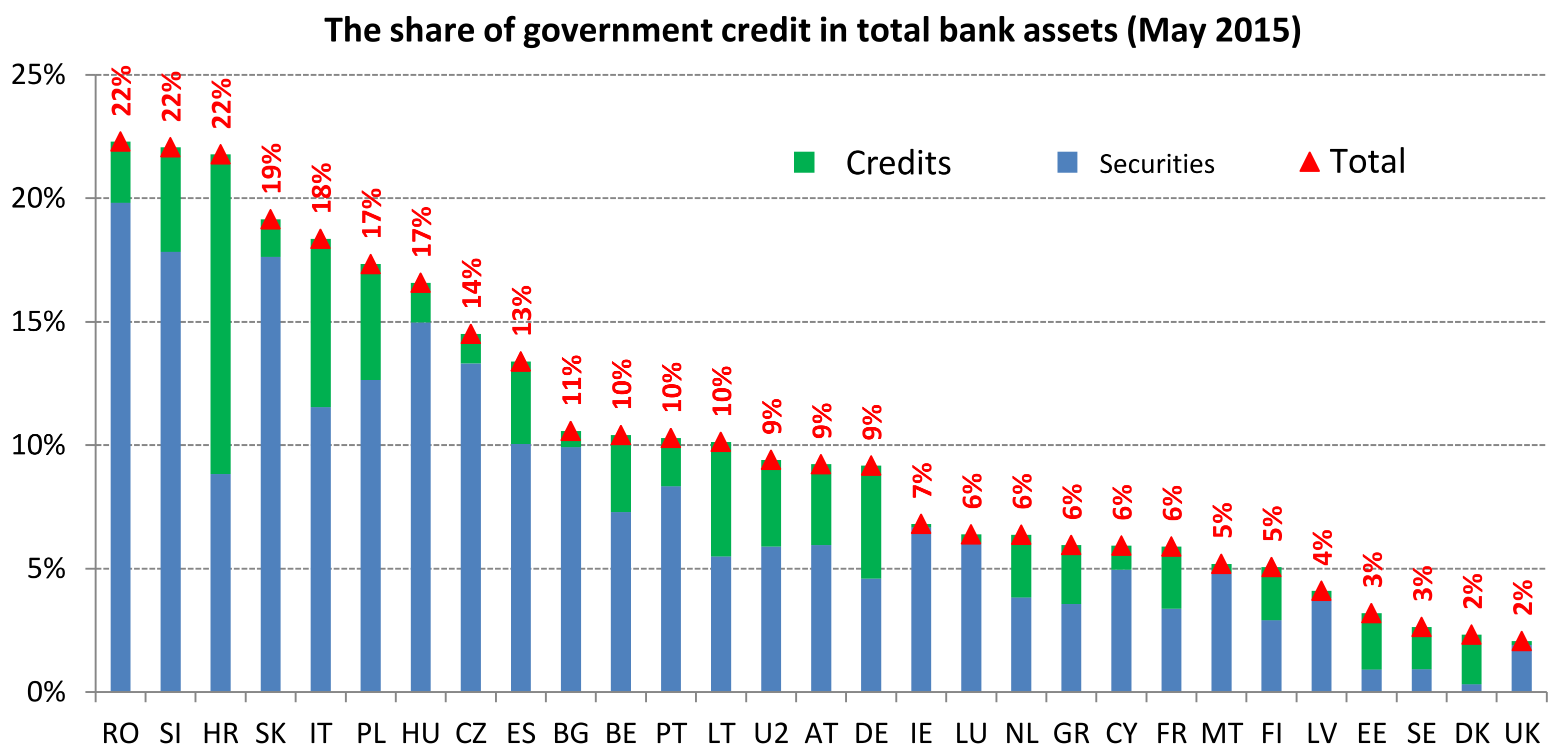
Public debt, 2007-2014 (% of GDP)



Source: Eurostat

- All EU member states registered increases in public debt during the crisis.
- Romania had one of the largest increases in public debt in relative terms during 2007-2014.
- A further increase in public debt would weaken us in the face of future cyclical downturns: public debt can easily grow over 60% of GDP in this situation.
- Law 69/2010 - debt thresholds of 45-50-55% of GDP - freezing wages and social assistance expenditures (including pensions).

Banks' exposure to the government is already high - the main constraint on government debt

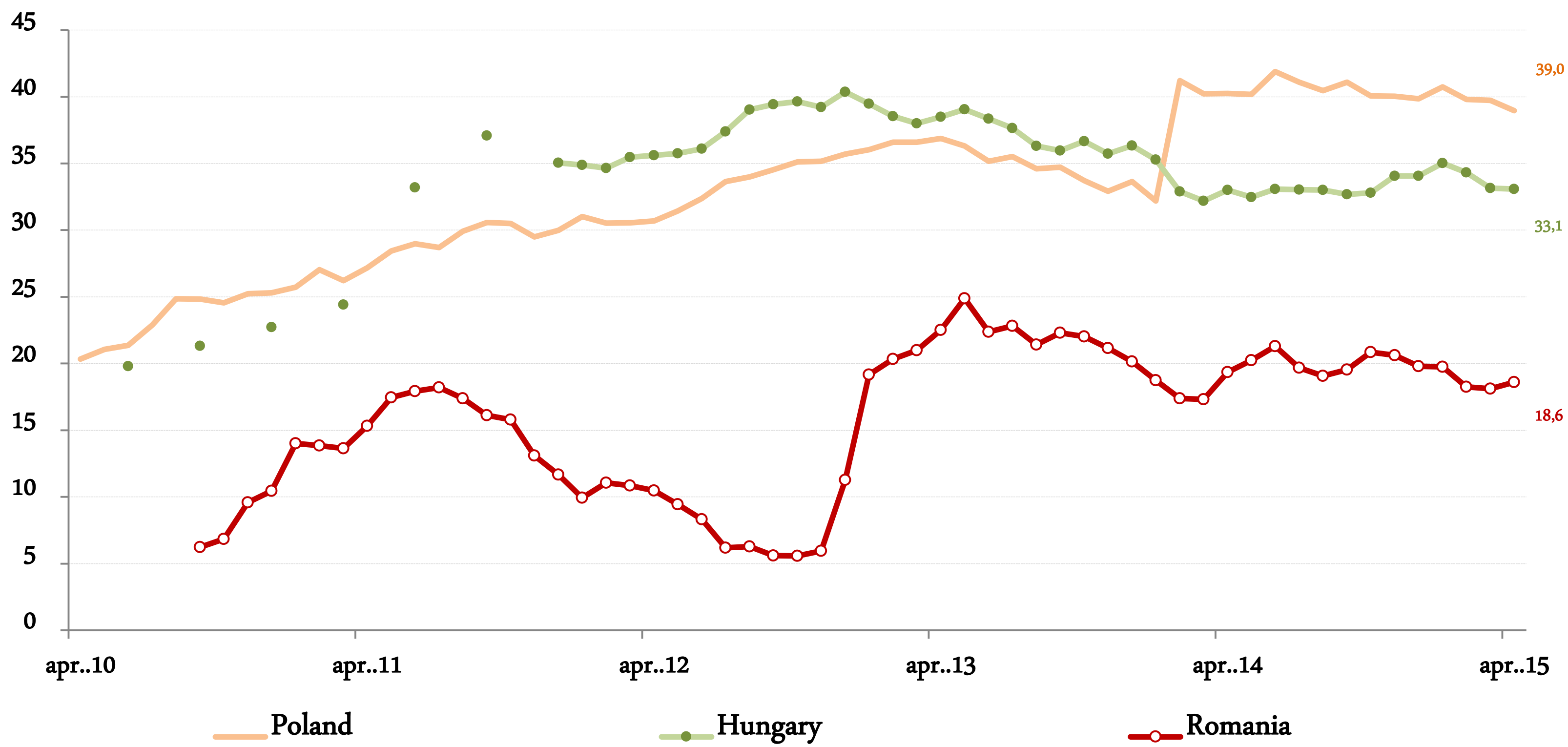


Source: ECB

- At the European level, Romanian banks have the highest exposure to the state as a % of total assets - major constraint for further expansion of public debt.
- The ability to absorb additional debt is very limited at the current level of development of the domestic financial system.

Non-residents' holdings of government securities in RON are relatively small, but an additional increase involves risks

LCY T-securities held by non-residents (% of total)



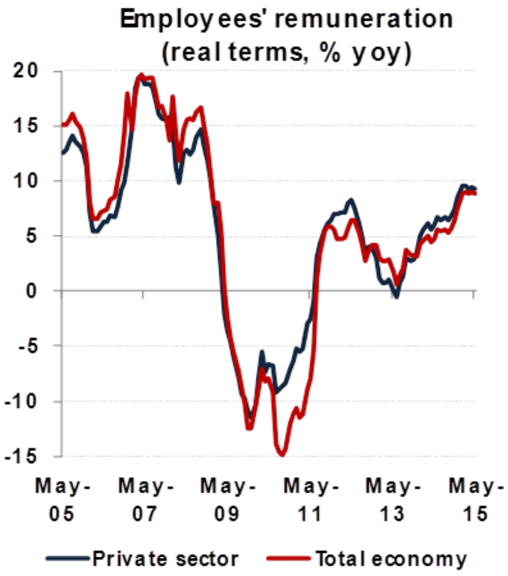
Source: Ministry of Public Finance from each state

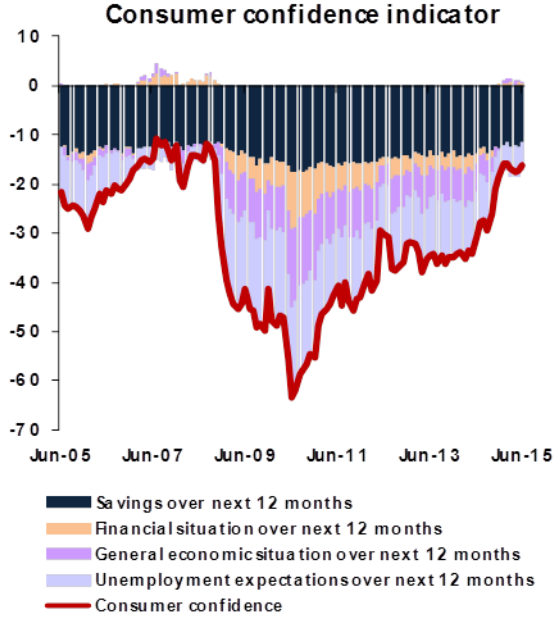
- ❑ Romania has a smaller share of non-residents' holdings of securities denominated in local currency, but these are majority holdings in the case of longer maturities

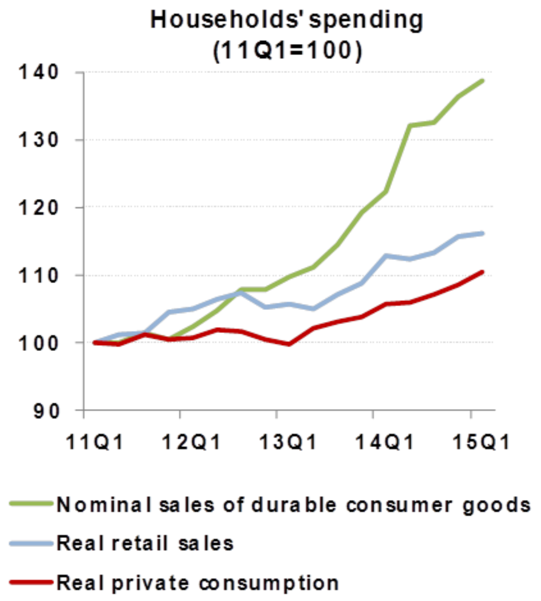
Is it appropriate an aggressive stimulus package for consumption?

The main engine of GDP growth is consumption - very aggressive package to stimulate its appears as inappropriate

- Consumer appetite substantially increased from 2014.
- Labour market conditions have improved significantly - wages rise by about 7% in nominal terms, the employees’ remuneration increases by about 9% in real terms.
- Major improvement in consumer confidence since Oct.-Nov. 2014.
- Consumption already grows faster than domestic supply - medium-term risk of recurrence of macroeconomic imbalances (current account deficit and inflation)



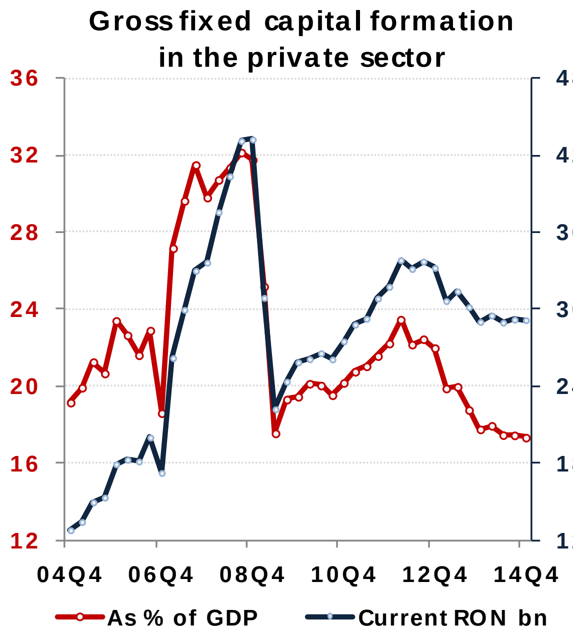


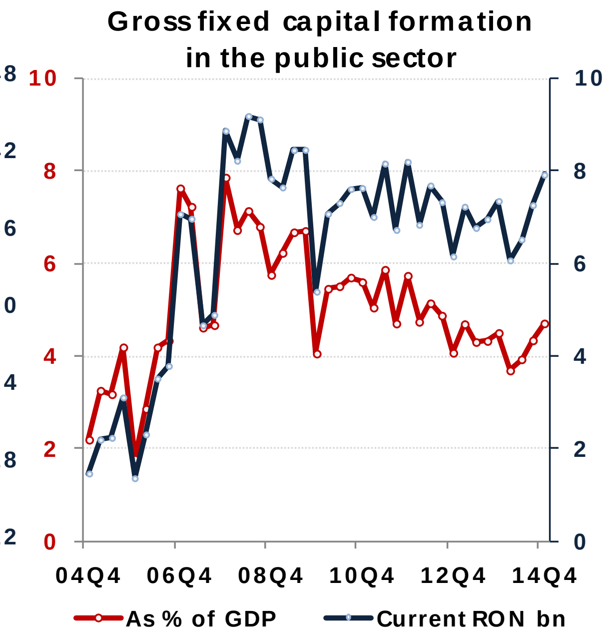


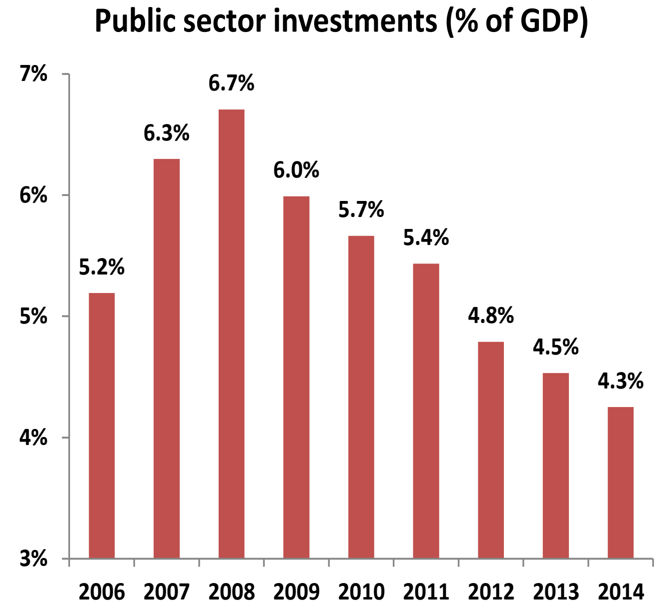
Note: The employees’ remuneration = (number of employees * net salary)
Source: National Institute of Statistics, European Commission, GfK

Investments are poorly evolving

- Private investments evolve weakly from 2012, while public investments fell steadily (as % of GDP) from 2009, reaching the last nine years minimum in 2014.

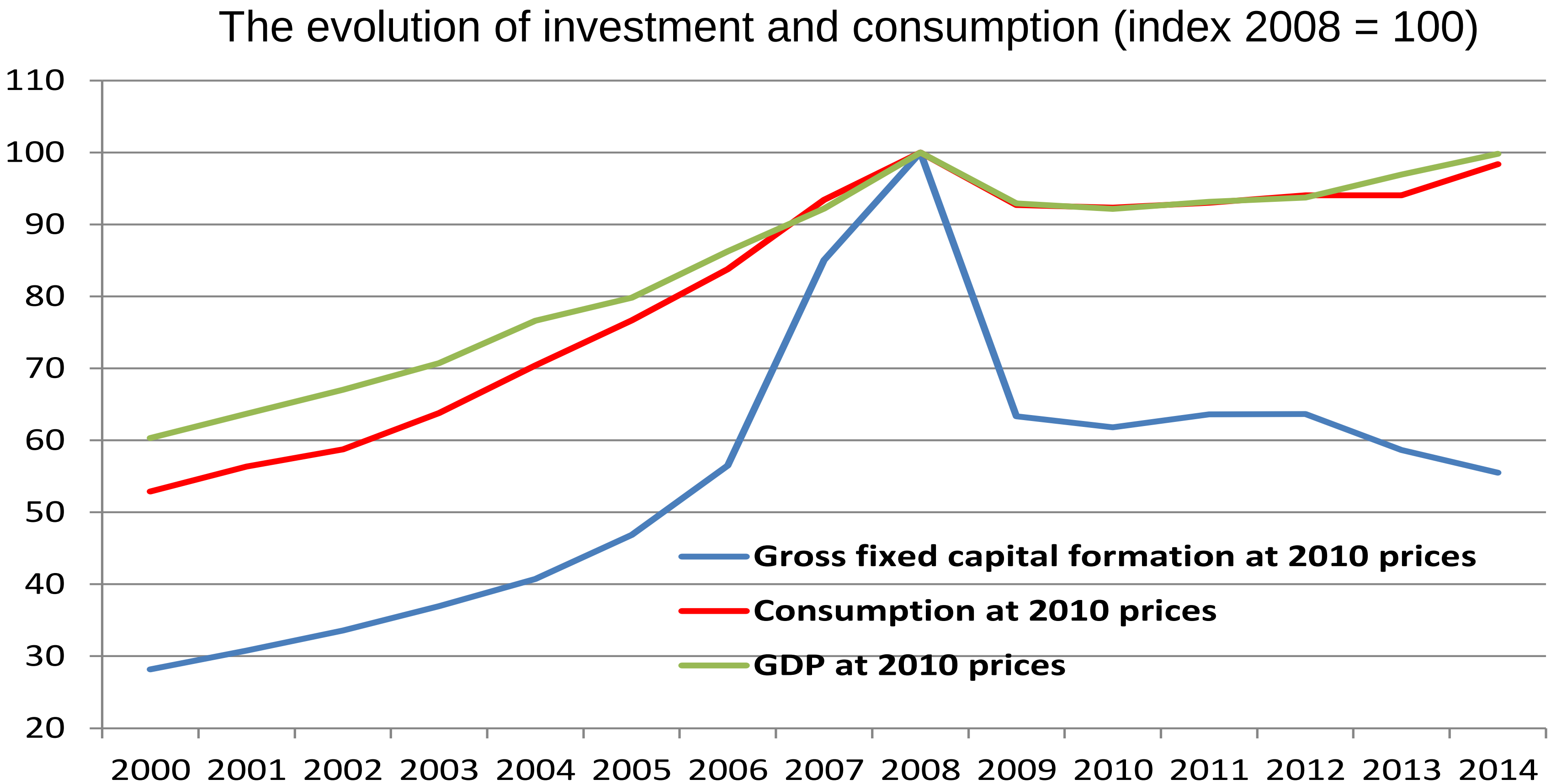






Source: Eurostat, National Institute of Statistics, Ministry of Public Finance

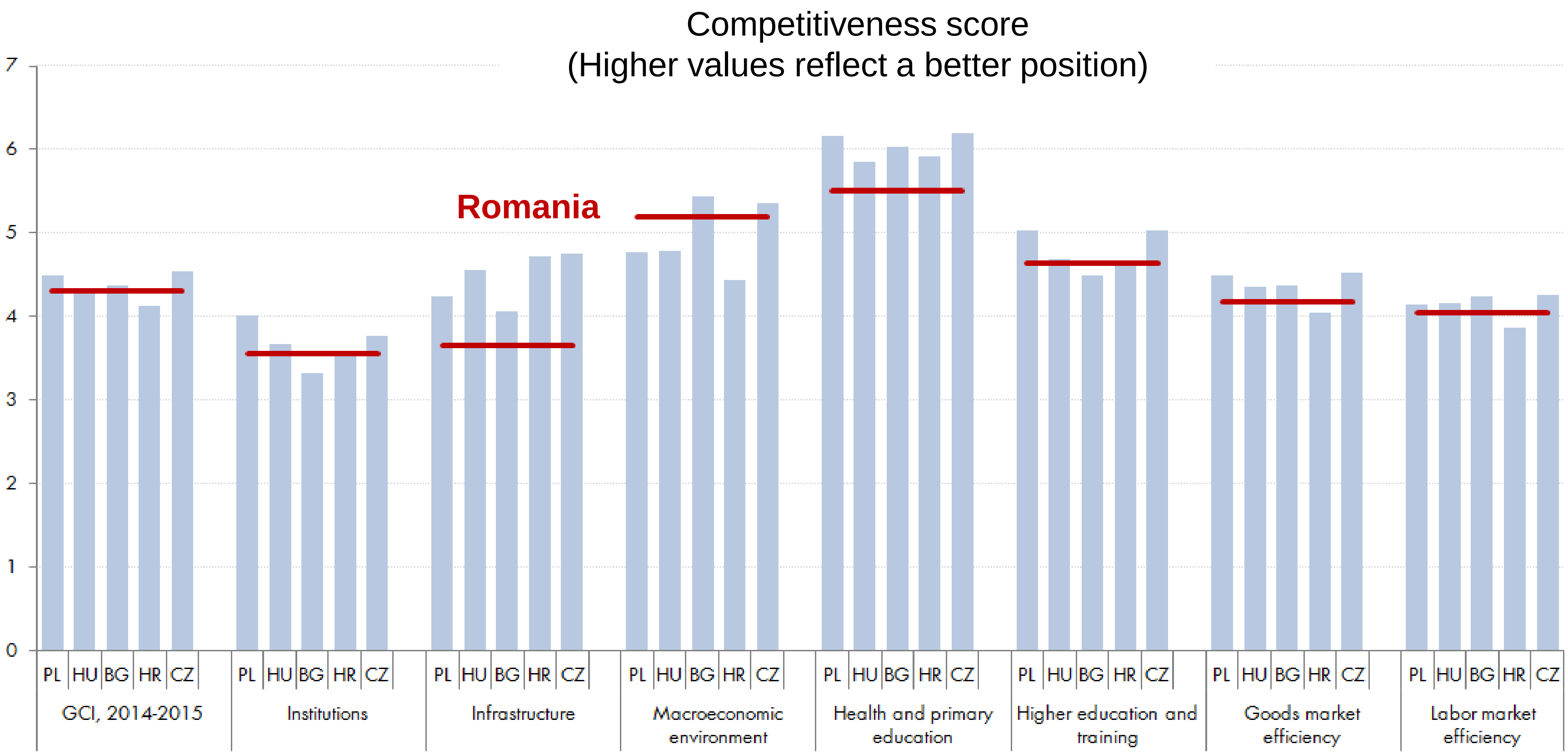
Investments are still well below pre-crisis levels



Source: EUROSTAT

- ❑ Consumption has already recovered the fall during the crisis, while investments are in real terms by about 45% lower than the 2008 level.
  - ✓ Even excluding the pre-crisis speculative bubble in the real estate / construction, investments are still far below their medium-term trend.

Infrastructure, education and health – Romania's weaknesses regarding competitiveness



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

- The quality of infrastructure is clearly the Achilles' heel for economic competitiveness compared to the countries of Central and Eastern Europe.
- Investments in education, health and physical infrastructure - incentives for economic growth in the long run.

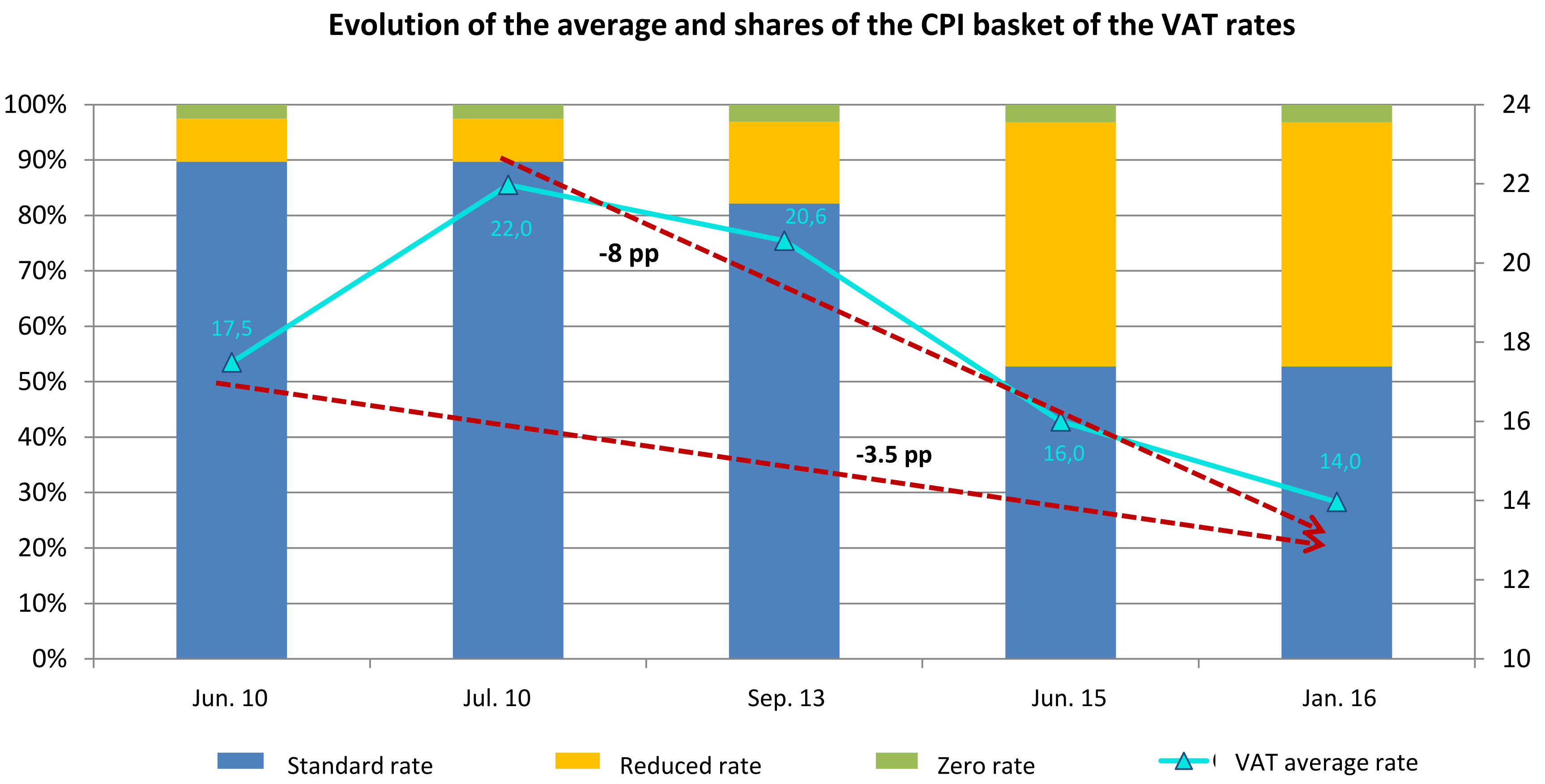
Summary assessment of growth and equity effects of fiscal consolidation instruments

	Growth		Equity		Current account[a]
	Short-term	Long-term	Short-term	Long-term	Short-to medium-term
Expenditure increases					
Education	++	++	+	++	-
Health services provided in kind	++	+	+	+	--
Other government consumption (excluding family policy)	++	-	+		-
Pensions		--			--
Sickness and disability payments	+	-	++	+	--
Unemployment benefits	+	-	+		--
Family	+	+	++	++	-
Subsidies	+	--	-	-	-
Public investment	++	++			--
Revenue decreases					
Personal income taxes	+	++	-	-	-
Social security contributions	+	++	+	+	
Corporate income taxes	+	++	-	-	--
Environmental taxes	+	-[b]	+		-
Consumption taxes (other than environmental)	+	+	+		--
Recurrent taxes on immovable property	+				-
Other property taxes	+		--	-	-
Sales of goods and services	+	-	+	+	-

Source: Cournède B. et al. - *Choosing fiscal consolidation instruments compatible with growth and equity, 2013*

Note: (a) Current-account effects refer to a deficit country, and would switch sign in the case of a surplus country

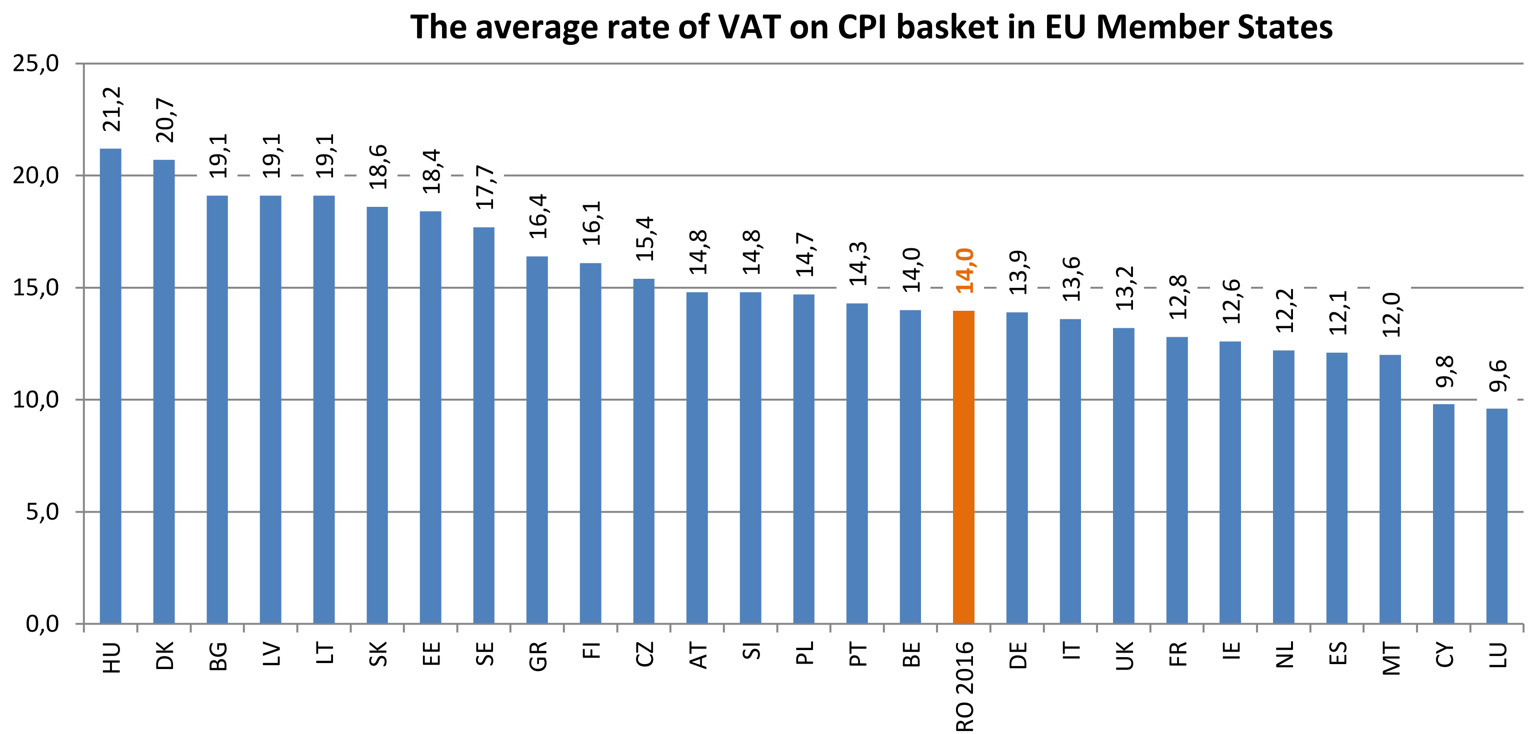
Very large decreases of the average rate of VAT ...



Source: the Fiscal Council's calculations

- The reduction of the average rate of VAT is one of the very large and unprecedented in Europe (-8 pp compared to 2010 and -3.5 pp compared to pre-crisis period).
- Almost half of the CPI basket has reduced or zero VAT rate, compared to about one-third in the case of EU average.

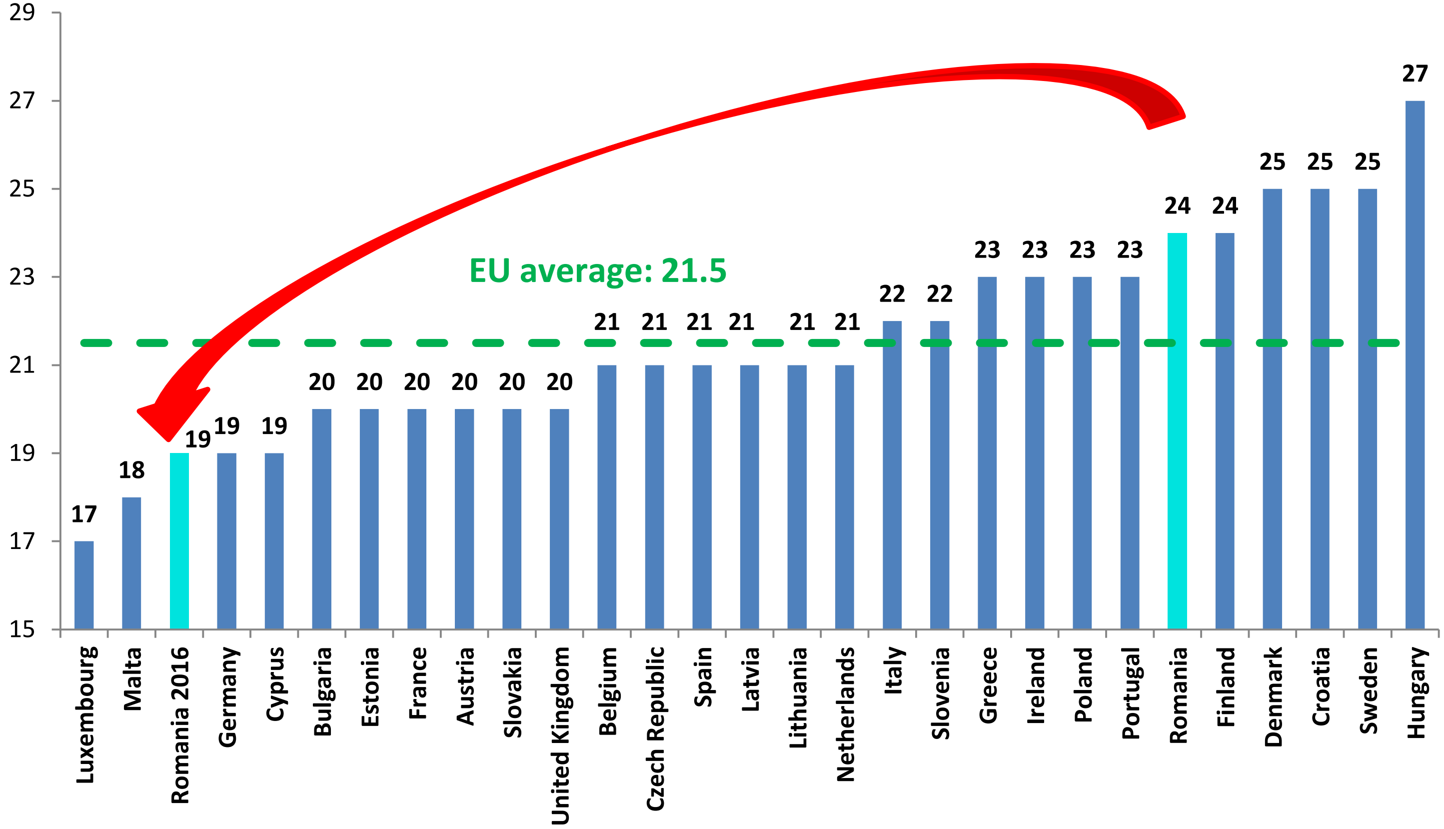
... that would make RO to have a VAT rate below the EU average and below the new member states from CEE



Source: Fabrizio Borselli, Salvatore Chiri & Ettore Romagnano (2012)

- ❑ Very large share of products with reduced or zero rate will **increase the cost of administration and create distortions of the competition.**
- ❑ ***For instance, a better designed system of income tax deductions would have more targeted effects on vulnerable social groups than the reduced VAT to food.***

The standard rate of VAT in EU countries (2015)



Source: European Commission

- Romania currently has the 3rd highest standard rate of VAT in Europe.
- Reducing to 19%, Romania would have the 3rd lowest standard rate of VAT, after Luxembourg and Malta.