Fiscal Council opinion on the state budget and social insurance

Budget laws for 2012

On November 11th 2011, the Fiscal Council received from the Ministry of Finance a letter requesting, under Art. 40, paragraph (2) of Law no. 69/2010, opinions on: *the draft budget law for 2012, the report on the macroeconomic situation in 2012 and the projection for 2013-2015, and the draft social security budget law for 2012*.

Under article 40, paragraph (2), letter d) of the fiscal responsibility law, the Council has the legal attribution to "analyze and issue opinions and recommendations, both before Government approval, and before submission to Parliament, on the annual budget laws."

Thus, given its mandate in accordance with the law 69/2010, the Fiscal Council issues the following opinions and recommendations on the budget projection for 2012:

Significant downward revision of the initial projection of economic growth for 2012; the balance of risks is more inclined towards a lower growth

The general consolidated budget for 2012 (and therefore the medium term budget projection) is built on a significantly worse macroeconomic scenario than the approved 2012-2014 Fiscal Strategy, given that economic growth forecast was reassessed for 2012 at 1.8% - 2.3%, compared with an initial estimate of 3.9%. The midpoint estimate for GDP growth (2.1%) corresponds with the latest forecast of the European Commission. It should be noted however that the latter does not include the impact of additional fiscal consolidation measures mentioned in the 2012 budget draft (mainly freezing public wages and pensions): the budget deficit projection of the European Commission is 3.7% of GDP (ESA95). Compared with the European Commission forecast, the draft budget includes an additional effort to adjust the structural deficit[1] (additional negative fiscal impulse) of at least 1.1% of GDP, which should reflect by default in a lower growth forecast (a quantitative estimate of short-term impact of fiscal consolidation on economic growth, made by the IMF, can be found in World Economic Outlook October 2010[2]). Even if the information available at this time does not invalidate the basic

[1] The budget deficit adjusted for the economy's position on the business cycle. 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.

[2] http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf

scenario of the macroeconomic projection underlying the draft budget, the Fiscal Council considers that the balance of risks points towards a significantly lower than expected economic growth in 2012, especially given the persistent uncertainty in the euro area, with negative impact on external demand (exports) and on external financing availability and cost.

The Fiscal Strategy adopted by the government is no longer portraying the current situation and should be reviewed.

The 2012-2014 Fiscal Strategy, as adopted in August 2011 by the Government, becomes obsolete due to the review of the macroeconomic framework and the new fiscal policy measures. The Fiscal Council recommends that it should be updated properly, considering art. 23 of the fiscal responsibility law, so that the fiscal strategy subject to Parliament debate to be consistent with the new macroeconomic framework and fiscal policy objectives over the medium term. In the absence of such update, the respective benchmarks (in particular, total expenditure and personnel expenditure ceilings for 2012 and 2013) are no longer relevant for assessing the compliance with the tax rules provided by the law.

Lack of commitment towards the announced ambitious deficit target; ambiguity in the formulation of budgetary policy

The draft budget for 2012 sets a target deficit of 1.9% of GDP (cash standards), significantly more ambitious than the 3% level assumed in the fiscal strategy approved by the Government in August 2011, despite the significant downward revision of the macroeconomic framework. According to the Fiscal Council, the increased caution reflected in establishing a more ambitious deficit target is justified in the light of internal and external financing constraints. In addition, setting a target for cash-based budget deficit less than 3% of GDP is welcomed considering the persistence of a significant gap between cash and ESA95 deficit, especially taking into account the potential impact on the ESA95 budget execution generated by the National Infrastructure Development Program.

However, the Fiscal Council noted the lack of commitment to this new target, given that the text of the report accompanying the draft budget explicitly mentions the possibility of a deficit increase during the year. This contradicts the principles of transparency and stability stated by the fiscal responsibility law.

Furthermore, a possible upward revision of the deficit target during 2012, even at a level that would ensure the objective of eliminating the excessive deficit, would undermine the credibility of the rule-based fiscal framework stated by the fiscal responsibility law. Additionally, a higher budget deficit target may have the potential to be perceived as a slippage (and penalized as such) by the financial markets, especially given that the upward revision would be due to higher social and personnel spending in an election year, thus canceling the benefits of establishing a more ambitious original goal of fiscal consolidation.

The same ambiguity is also found in formulating the main budgetary policy parameters. Thus, the draft budget report mentions the possibility of raising the personnel spending during the year up to a ceiling of 7.2% of GDP (currently 6.9% of GDP). It also indicates the possibility of pension indexation during 2012 according to the new pension law, with a negative impact on the budget deficit (for example, if the indexation would be effective starting July 2012, the estimated additional impact on the expenditure side would be about 0.3% of GDP).

The increase in personnel and social spending during the year 2012, if materialized, would breach the rules of the Fiscal Responsibility Law

The Fiscal Council warns that, if materialized, the increase in personnel and social spending in 2012 (by increasing total expenditure of general government) would breach:

- Article 8 of the fiscal responsibility law which provides that "the Government, ministers and any entity responsible for public service pay policies and wage agreements must ensure that such policies and agreements comply with the objectives of fiscal responsibility, the fiscal rules and the objectives and ceilings established under the fiscal and budgetary strategy".
- Article 9, paragraph 2 of the fiscal responsibility law which provides that "Personnel expenditures cannot be increased during the budget year or by the supplementary

budget".

- Article 16 "The total expenditure of the consolidated general budget, excluding the financial assistance from the EU, shall not be increased during budgetary revisions, except for the payment of debt service or Romania's contribution to the EU budget".
- Article 17 "If the half-yearly report on the economic and budgetary situation, finds that the forecast for the consolidated general budget balance deteriorates by more than 0.5% of gross domestic product compared with the forecast contained in the Annual Budget, and such deterioration is not the result of the worsening in the macroeconomic framework, the Government is required to implement necessary measures in order to reach the target for the consolidated general budget balance".

Moreover, an increase in wages and pensions initiated with less than 180 days before termination of the mandate of the Government, in accordance with article 110, paragraph (1) of the Romanian Constitution, would also violate the provisions of Article 9, paragraph 1, of the fiscal responsibility law.

Using yet another waiver to circumvent the rules stated in the fiscal responsibility law (exempting from the FRL provisions has already been used for the first budget revision in August 2011) would raise serious questions regarding their relevance and would cancel the long-term benefits of a rule-based fiscal framework.

The fiscal revenue projections are consistent with the new macroeconomic framework

Based on the new macroeconomic framework, the draft 2012 budget reduces the revenue projection by 4.39 billion RON as compared with the level in the 2012-2014 Fiscal Strategy. Excluding revenues from EU funds and adjusted with the impact of announced discretionary measures and the impact of SWAP schemes for arrears repayment (two SWAP schemes were implemented in 2011[3] and another one is envisaged for 2012[4]), the overall revenues increase by 5.6 percent compared to 2011 level. A list of the discretionary measures and the impact of the SWAP schemes is presented in ***Appendix 1***.

Overall, the Fiscal Council considers the tax revenues projections for 2012 as being consistent with the macroeconomic assumptions used. However, the risks of these assumptions are rather negative.

The excise duty revenues adjusted with the impact of the announced discretionary measures (increased rate for cigarettes and diesel) are projected to grow more rapidly than the appropriate macroeconomic base would indicate (proxy: real households final consumption expenditure, excluding self-consumption); a better performance could be possible due to efforts to fight tax evasion, efforts that already showed results in the current year.

There are still deficiencies in the transparent substantiation of the revenue forecast

However, the Fiscal Council has to reiterate the recommendations to improve the transparency in substantiating the budgetary revenues by presenting- for each revenue item - the appropriate macroeconomic base as well as the impact of any legislative measures. For more transparency, an assessment of the revenue forecasts consistency together with relevant assumptions is shown in ***Appendix 2***.

Expenditure cuts on personnel, social assistance and investments expenditure

The overall expenditure level in the 2012 draft budget needed to achieve a 1.9% budget deficit is 206.6 billion RON (35.6% of GDP), 10.8 billion less than the 2012-2014 Fiscal Strategy level due to downward revisions in personnel expenditure(2.8 billion RON) and pension spending(3.6 billion RON) based on freezing wages and pensions in 2012. Moreover, the 2012 draft budget cuts investment spending by almost 5 billion RON.

In 2012, the general government spending, adjusted by the

[3]The SWAP schemes (with symmetric impact on both revenue and expenditure side) were used on both budgetary revisions, amounting 1.44 billion RON and 1.07 billion RON respectively.

[4] For 2012 a similar mechanism amounting 1.56 billion RON is envisaged in order to settle the railway company CFR Infrastructure outstanding obligations toward the state budget (850 million RON) as well as the outstanding obligations of some local authorities related to ISPA projects(712 million RON)

impact of SWAP schemes, is 0.6% higher than the 2011 level.

More ambitious assumptions on European funds absorption

The draft 2012 budget assumes a level of revenues from EU post-accession funds of 12.5 billion RON (3 billion Euro), 60% higher than in 2011.

The Fiscal Council acknowledges the Government's commitment to improve EU funds absorption, especially in a more difficult international financial framework that constrains the investment financing. Better European funds absorption is essential to offset the negative effects of the sovereign debt crisis on capital flows. Consequently, the Fiscal Council recommends setting strictly monitored quarterly targets for European funds absorption, by line ministries, in order to allow for the rapid correction of any deficiencies.

More transparency required in substantiating some expenditure items

The draft budget report does not explicitly state the number of employees and average wage in the public sector underlying the medium-term personnel expenditure path. Lacking these assumptions, it is difficult to asses the consistency of the personnel expenditure projection.

Social assistance spending is projected to decrease by 593 million RON (0.1% of GDP)-compared to the 2011 level, due to 400 million RON cut in "social benefits in kind". The reasons for such a reduction are not presented and, moreover, this spending item increases again in 2013 to the initial higher level.

The decision of recalculating special pension proved to be, contrary to expectations, very expensive for the budget.

Although, according with the initial calculations of the Ministry of Labor, the special pensions recalculation anticipated substantial budgetary savings, in the end, this decision has materialized in additional pension expenditure of around 1 billion lei per year corresponding to 159,000 persons retirees, given that the corresponding average pension increased following the recalculation exercise from RON 1755 (the level used in the 2011 social insurance budget of for) to RON 2289 in 2012 (an average increase of 30.4%).

It is necessary to clarify the impact of the National Program for Infrastructure Development on the budget execution according to ESA95

The Government Emergency Ordinance no. 105/2010 approving the National Program for Infrastructure Development commits budgetary expenditures of about RON 20 billion (around 4% of GDP) for investment projects to be executed in the following years. According to the ordinance, the budgetary commitments are allowed during 2010-2013, while the effective payment will be made gradually at a later stage and therefore being reflected in the cash deficit only starting 2013.

In this context, although effective payments under these investment projects are not foreseen during 2011-2012, thus not influencing the cash budget deficit in these years, it is very likely that the undertaken budgetary commitments (which would be almost completed by end 2012) will have a significant impact on the ESA95 based deficit starting with 2011-2012.

Considering the objective of eliminating the excessive deficit by end of 2012, the Fiscal Council considers necessary to clarify the potential impact on the ESA95 budget deficit of the PNDI, namely the current stage of the budgetary commitments under this program as well as the estimated amounts for 2012.

Additionally, the Fiscal Council considers that investment objectives under PNDI should be mainly financed by European funds, thus avoiding a potential negative effect on the budget deficit on the medium-term.

The Fiscal Council considers that a cash deficit target smaller than initially planned for 2012 appears to be a prudent approach, especially in the context of Government's commitment to correct the excessive budget deficit (according to ESA95) by end 2012. Although it emphasizes the pro-cyclicality of the fiscal policy, setting a more ambitious fiscal consolidation objective is correct considering the significant internal and external financing constrains generated by a turbulent and unpredictable international framework. Nevertheless, the Fiscal Council considers necessary a stronger commitment towards the new deficit target. Any increase during the year might have the potential, on adverse market conditions, to be perceived by financial markets rather as a slippage as it would undermine the credibility of a rule-based fiscal framework. In addition, a possible increase of the budget deficit target during 2012 based on higher pensions and public sector wages would breach several fiscal rules established by the FRL; rules that were meant to increase the predictability and transparency of the fiscal policy and to improve the public finances sustainability on the medium and long run.

The above opinions and recommendations of the Fiscal Council were approved by the President of the Fiscal Council, according to Art. 43, paragraph (2), letter d) of FRL, based on the vote of the Fiscal Council members in the meeting on November 24, 2011.

November 24, 2011

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Annex 1

Fiscal policy measures and the impact of temporary mechanism of extinguishing outstanding payments in 2012

	Budgetary impact	Revenue category
I. Fiscal policy measures	779.3	
The increase of excise duty on diesel fuel from 358 Euro / ton to 374 Euro / ton	289	Excise
The increase of excise duty on cigarettes from 76.6 Euro/1000 cigarettes to 79.10 Euro/1000 cigarettes	137	Excise
The limited deduction, of 50%, for fuel expenditure of motor vehicles exclusively intended for the carriage of passengers (replaces the previous measure that temporarily eliminated this deductibility)	-228.7	VAT
The increase of royalties	282	Non-tax revenues
Supplementary transfer to the second pillar of pension (+0.5 pp. of CAS paid by employee)	-400	Social contributions
Additional revenue from sale of goods belonging to the private domain of the state or to the territorial administration units	700	Capital revenues
II. The impact of SWAP schemes for settling outstanding payments*	1562	VAT
Outstanding obligations of CFR Infrastructure	850	VAT
Outstanding obligations of territorial administrative units for ISPA projects	712	VAT

* This amount is also reflected in the budget expenditure under "other transfers"

Annex 2

	2011			2012					
	CGB revenues after the second revision	The influence of the two compensation schemes	CGB revenues after budget revisions without the impact of compensation	The influence of compensation scheme in 2012	Fiscal policy measures in 2012	Relevant macroeconomic bases	Revenues projection 2012 FC	CGB revenues states by the budget draft 2012	Differences
	1	2	3=1-2	4	5	6	7=3*6+4+5	8	9=7-8
Total revenue	182,359.0	2,514.3	179,844.7	1,562.0	779.3		194,750.8	195,350.9	-600.1
Current revenue	172,453.4	2,514.3	169,939.1	1,562.0	79.3		179,756.6	180,361.2	-604.6
Tax revenue	105,011.5	1,788.3	103,223.2	1,562.0	197.3		110,019.1	110,398.9	-379.8
Corporate income tax	11,077.0	7.5	11,069.5				11,711.1	11,747.4	-36.3
Profit	10,438.0	7.5	10,430.5			Nominal GDP (+5.79%)	11,035.1	11075.9	-40.8
Capital gains and other taxes	639.0		639.0			Nominal GDP (+5.79%)	676.0	671.5	4.5
Personal income tax	19,009.8		19,009.8				19,997.2	19,970.6	26.6
Salaries, dividends, capital gains, rent	18,732.8		18,732.8			The average number of employees (+0.7%) Average gross earning (+4.5%)	19,704.1	19672.9	31.2
Other (local) taxes	277.0		277.0			Nominal GDP (+5.79%)	293.1	297.7	-4.6
Property tax	3,997.6		3,997.6			The average rate of inflation (3.4%)	4,133.5	4203.5	-70.0
Taxes on goods and services	69,923.5	1,780.7	68,142.8	1,562.0	197.3		73,081.7	73,405.2	-323.5
VAT	47,689.1	1,709.0	45,980.1	1,562.0	-228.7	Household's final consumption expenditure excluding own account consumption and the related market (+5.5%)	49,832.2	49652.0	180.2
Excises	19,671.7	71.7	19,600.0		426.0	Household's final consumption expenditure excluding own account consumption and the related market, in real terms (+1.9%). Variation of the reference exchange rate for excise ** (0.7%)	20,545.7	21179.5	-633.8
Other taxes on goods and services	69.2		69.2			Household's final consumption expenditure excluding own account consumption and the related market (+5.5%)	73.0	124.6	-51.6
Taxes on using goods, authorizing the use of goods or on carrying activities	2,493.5		2,493.5			Household's final consumption expenditure excluding own account consumption and the related market(+5.5%)	2,630.8	2449.1	181.7
Tax on foreign trade and international transactions	641.6		641.6			Imports of goods and services (11%)	712.6	685.7	26.9
Other tax revenue	362.0		362.0			Nominal GDP (+5.79%)	383.0	386.5	-3.5
Social security contributions	49,530.7	726.0	48,804.7		-400.0	Average gross earning (+4.5%)	50,935.3	50945.3	-10.0
Nontax revenue	17,911.2		17,911.2		282.0	The average rate of inflation (3.4%)	18,802.2	19017.0	-214.8
Capital revenues	764.5		764.5		700.0	The average rate of inflation (3.4%)	1,490.5	1486.0	4.5
Grants	1,331.1		1,331.1				971.7	971.7	0.0
EU funds	7,810.0		7,810.0				12,532.0	12532.0	0.0