Fiscal Council of Romania

Fiscal Council's preliminary Opinion on the draft of the second budget revision for 2022

On November 15th, 2022, the Ministry of Finance (MF) sent to the Fiscal Council (FC), by address no. 467238/14.11.2022, the draft revision of the general consolidated budget for 2022, the explanatory note and the draft of the Government Emergency Ordinance on the revision of the state budget for 2022, as well as the explanatory note and the draft of the Government Emergency Ordinance for the revision of the social security budget for 2022, requesting, under art. 53, para. (2) of the Fiscal Responsibility Law (no. 69/2010, republished, hereafter referred to as FRL), the opinion of the Fiscal Council.

According to art. 53, para. (4) of the FRL, the Government and the Parliament have the obligation to analyze the opinions and recommendations of the Fiscal Council when they elaborate the Fiscal Strategy, the annual budgetary laws, as well as other measures determined by the application of the law and, respectively, upon their appropriation/approval.

Given the Government's intention to approve the above-mentioned documents at the meeting announced for Thursday, November 17th 2022 – which is a very short time frame for drafting an extended opinion, the Fiscal Council decided to elaborate a preliminary opinion.

The preliminary opinion makes a brief assessment of the macroeconomic framework underlying the second budget revision in 2022, of the updated coordinates of budget revenues and expenditures proposed in the draft revision, of the compliance with fiscal rules, while the extended opinion will be drafted in the coming period.

The general context of the current budget revision

As stated in the previous opinion (regarding the first budget revision of 2022), never the Fiscal Council had to issue an opinion on budget execution under such unfavorable circumstances in the European economy, with such severe implications on the Romanian economy. We are considering the energy crisis, which is intertwined with a very complicated green energy transition, disruption of production and supply chains, quasi-pervasive high inflation, exacerbated effects of climate change, the pandemic and, not least, the war in Ukraine. These adverse shocks put tremendous pressure on the economies of the member states of the EU, on public budgets, is affecting people's livelihoods.

The ability of economies to recover with minor frictions has been overestimated. Imbalances between supply and demand, the impact of the energy transition and the energy crisis, have led to massive increase in the relative price of energy, to the strong increase in inflation (to unprecedented levels recorded in many developed countries in the last four decades).

This change in relative prices has distributional consequences between and within economies, implies a major rise in the cost of living, a deterioration of the quality of life for the most citizens.

The energy transition in the EU is also hampered because the common energy market has important obstacles: the way of linking electricity tariffs to hydrocarbon quotations, insufficient strategic reserves, dependence on the Russian Federation, poor interconnection given that the member states resort to different energy resources in use, etc. And the regulations on this market are not adequate.

The adverse shocks mentioned above, by consequence, put a great strain on national budgets. The economies of the EU countries present specific features of quasi-war conditions, which are materializing in more expensive access to resources, rationing, other reductions of administratively consumption (e.g.: 15% reduction of gas consumption in the EU over a period of time), exhortations addressed to the population and companies to reduce energy consumption, mobilization of resources and redirection to priority uses through direct intervention (including special orders of the state), nationalizations of some enterprises in strategic sectors, etc.

Macroeconomic data speaks eloquently about economic shocks and strain. Inflation, which increased to levels not seen for many years (in the euro area an average of about 11% in October compared to the previous year, in the Baltic countries and in Central and Eastern Europe from approx. 16 to over 20 percent in the same month), drastically amputates purchasing power and saving reserves of citizens. High inflation, even if falling, is also forecasted for 2023. Economic recovery is slowed by the inflationary shock and the effects of the War.

Central banks are tightening monetary policies in the fight against high and persistent inflation, with the danger of inflationary expectations getting out of control. Strengthening monetary policies in the US and other developed countries, through effects on international financial markets, can cause major troubles in emerging economies that have large internal and especially large external imbalances.

The tightening of monetary policies can generate new financing syncopes (sudden stops) on the markets, company failures and even countries in default. Governments seek through targeted programs to mitigate such effects, which however involve increases in budget expenditures.

Not infrequently the decisions are to limit damage, to choose between options, all with important imperfections. A lucid approach is to try to share the burden of shocks in society as fair as possible. Considerable windfall gains (e.g.: power producers) can be taxed and used for feeding national budgets, protecting the most vulnerable citizens.

In a world characterized by a new "cold war" and de-globalization (regionalization of economic and commercial ties), public budgets must be more robust. This desideratum will be harder and harder to achieve given that the requirements induced by out-of-the-ordinary challenges can generate deeper deficits, when public and private debts exceed sustainable levels.

A particular vulnerability of Romania is the external balance, where the current account deficit will reach probably approx. 9% of GDP (in 2021 was 7%), and the degree of coverage by non-debt generating flows will probably be below 50%.

Romania has been in the excessive deficit procedure since the beginning of 2020. It has to do fiscal consolidation in a very unfavorable international environment, when its fiscal revenues (including social security contributions) are among the lowest in the EU – about 27% of GDP compared to the average of about 41% of GDP in the EU. Tax revenues must increase substantially, which is a leitmotif of FC documents. The very low level of fiscal/budgetary revenues is unacceptable in relation to Romania's current and future needs.

As other FC documents point out, the only counter-cyclical force that can counteract the contractionary effects of the fiscal consolidation, are the European resources – NRRP (National Recovery and Resilience Plan) and the MFF (Multiannual Financial Framework). These resources are vital to Romania considering the state of the public budget and the vulnerabilities of the external balance, the extremely unfavorable international environment.

The macroeconomic framework underlying the second budget revision for 2022

In the evaluation of the second budget revision of this year, as in previous opinions, the Fiscal Council starts in its considerations from the general economic coordinates of Romania, as well as from the international context.

These considerations are based on the updated forecast – from October 2022 – of the National Commission for Strategy and Forecast (NCSF) and the accompanying note related to this forecast, as well as previous forecasts, including the one related to the first budget revision for 2022, published by NCSF in July 2022. It is worth noting that all recent forecasts (both by domestic institutions and international ones) start, on the one hand, from the important modification of the real economic growth pattern in 2022, revealed by data published by the National Institute of Statistics (NIS) related to the first two quarters of this year[1], which places a significant part of

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[1] NIS announcement regarding the gross domestic product (provisional 2) for the second quarter of October 12, 2022.

this year's economic growth in its first half and also indicates a high level of it; the second quarter data also brings clarifications and corrections regarding rate of growth contributions. On the other hand, the signal data for the third quarter, published on November 15 c.y., significantly changes historical GDP data – only the seasonally adjusted data series – which changes, implicitly, the prospects of economic growth for this year. The data on the first semester indicated, in the absence of a contraction (not indicated by other data – such as those with a larger frequency) in the III and/or IV quarter, and, at the same time, in the absence of historical data revision, the possibility of a real economic growth slightly lower than 7%. Review of historical data, conducted in the "signal" estimates related to the third quarter, brings (in the sense of a high probability) the economic growth pace below the 5% threshold. In this context, the review carried out by the NCSF on real growth for 2022, from 3.5% in this year's first revision to 4.6% in the macroeconomic projection related to the second revision, brings an extra touch of realism to the projection and makes it compatible with the latest published statistical data.

Regarding the structure of economic growth – with a particularly important effect on the macroeconomic bases that measure taxes– the one from the NCSF projection, which has the center of its weight located on private consumption and gross fixed capital formation, seems to be consistent with recent statistical developments. However, it can be noted that some contributing factors to current economic growth – such as the use of savings (including currency) from the pandemic period, government support measures, the return of confidence in the economy, the internal absorption stimulus by the fiscal policy - will exhaust its potential during the next period, which equates to a downside risk of economic growth. Internally, there are already indications of slower real economic development in the coming period, such as: (i) the evolution of industrial production, (ii) the dynamics of the real average salary and the real pension, (iii) the evolution of primary energy resources, (iv) the high level of prices on the chains of production, etc. To these is added the restrictive monetary policy at the domestic and international level aimed to combat high inflation but having effects on economic growth, the higher risk aversion of the markets, developments on the markets of raw materials and energy, changes in the fluency of production and value-added chains, as well as geopolitical tensions.

The real economic growth projection is accompanied by an increase in the GDP deflator of 13% in 2022, revised upwards from 12.2% in the NCSF's previous macroeconomic projection. In the context of a CPI inflation rate of 15.3%[2] for October 2022 (year on year), published by NIS, and a industrial production price inflation of 46.7% for September 2022 (year on year), as well as the evolution of other indicators in the economy, it can be appreciated that the forecast of the dynamics of the GDP deflator is prudent, and, it can be, in plausible scenarios, even slightly

[2] Almost half of it (15.3%) being determined by the evolution of exogenous prices (7.4 p.p.) and, from it, the evolution of energy prices has a consistent contribution (4.2 p.p. – almost a third of the total CPI inflation rate). Directly and indirectly, energy prices affect the dynamics of all other prices.

higher. The forecast of CPI inflation (year-on-year, end of period), at 15.2% (in upward revision from 12.2% in the previous NCSF projection), is relatively prudent – from the perspective of the fiscal bases – the last Inflation Report (from November this year) of the NBR indicating forecasts of 16.3% for CPI inflation in December 2022. In all price projections, compensation legislation details and capping the prices of gas and electricity have a significant impact – also implied in the NCSF forecast and that of the NBR.

Putting all this information together – a plausible real GDP growth forecast and a prudent deflator forecast – it justifies the assertion of a high level of plausibility of the nominal GDP forecast, expected to grow by 18.2%.

The dynamics of the national economy and its structure (with an emphasis on domestic absorption) are illustrated in the size of rapidly growing external imbalances – the trade balance deficit, according to the latest data of NIS, from September 2022, showing a widening of it, in euros, cumulatively for the first 9 months of the year compared to the similar period last year, with 8.3 billion euros, equivalent with a rate of +49.6%. Similarly, the balance of payments data, published by NBR on November 14 c.y., shows an increase in the current account deficit for the cumulative first 9 months of the year compared to the similar period of last year, with 7.5 billion euros, equivalent to an increase of 59.7% (the main determinants being the deficit in trade in goods as well as the deficit related to primary incomes). It should be noted, however, that the widening of external deficits is significantly caused by the terms of trade deterioration, as found in many EU countries. This evolution it is to be judged given that the financing of this deficit is done to a smaller and smaller extent by non-debt generating flows (these being considered to be the balance of the capital account and, from the financial account, only "equity participations"), for the cumulative first 9 months of this year their share being only 40.6% in the total current account deficit (8.2 billion euros out of 20.2 billion euros), compared to 56.2% in the similar period of 2021 (7.1 billion euros out of 12.6 billion euros).

The labor market[3] is predicted by the NCSF to record an increase in the average number of employees with 1.6% (from 1.4% in the forecast underlying the first revision) and an increase in average gross wage earnings of 10.6% (vs. 10.4% previously). The unemployment rate remains close to previously forecast values, being 5.4% – the BIM unemployment rate (identical to the previous projection round of NCSF) and 2.9% – the unemployment rate registered at the end of the year[4] (from 2.5% in the previous forecast). These new coordinates, slightly more favorable

[3] Important through the related macroeconomic bases, payroll tax, social security contributions, some expenditure items such as unemployment benefits and social transfers, all with a significant impact on the value of the deficit.
[4] According to ANOFM data.

overall from the point of view of the fiscal macroeconomics bases, indicates, similar to the assessment from the first revision, a plausible projection of labor market aggregates.

Corroboration of economic information and data with the dynamics of relevant macroeconomic variables designed by the NCSF and for the second budget revision leads to the conclusion of a plausible trajectories of these aggregates for 2022. It is possible, similarly to the assessment since the first revision, a slightly faster evolution of prices/GDP deflator, while the risks regarding the real dynamics, this time they appear to be relatively balanced.

As with the first revision, we believe that the macroeconomic evolution in the coming years depends, between other, on: (i) keeping the fiscal adjustment commitments agreed with the European Commission, which involves a timetable for reforms (including fiscal/collection) and a substantially volume of funding, under particularly favorable conditions, both through the multiannual European budget framework and through NRRP, (ii) reaching the targets conditions access to international capital markets[5] also emphasizing the issue of public debt sustainability in the broader context of securing financing of Romania's total external debt (public and private).

Deviations from conditions such as those stated above can lead to less favorable dynamics from a macroeconomic point of view and even towards a precarious balancing area of the economy, which will not ensure the stability pursued through fiscal consolidation[6] and through the rest of the economic policies, culminating even with non-linear evolutions of the economic-financial indicators. FC believes that these important risks must guide and discipline public policy in the sense of compliance commitments, in the interest of achieving national macroeconomic objectives.

Updated coordinates of budget revenues and expenditures

Compared to previously approved budget parameters[7], the draft of the second budget revision includes a small increase in both revenues and total expenditure of the GCB (+0.8 billion lei), the budget deficit thus remaining unchanged in nominal terms. Expressed as a percentage of GDP, the level of the budget deficit is expected to decrease to 5.74% of GDP from 5.84% of GDP previously, against the background of the increase in nominal GDP projection by 23.7 billion lei.

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[5] Essential for financing and refinancing the deficit and debt.

[6] This area of precarious balance would amount to a fragile equilibrium, as such a state is encountered in the specialized literature.

[7] The comparisons will have as reference the budget revision approved by the Government in August of this year. and not the revision draft on which the FC issued an opinion. Between the two there are some minor differences, namely total revenues and expenses higher by about 0.4 billion lei in the version of revision adopted by the Government.

FC welcomes the Government's intention to target a lower budget deficit for this year.

In the structure of budget revenues and expenses, however, there are important changes, as will be detailed below.

By categories of budget revenues, more important positive revisions of the initial estimates occur for non-tax revenues (+6.7 billion lei), corporate income tax (+1.6 billion lei), amounts received from the EU on account of payments made and pre-financing related to the 2014-2020 financial framework (+1.5 billion lei), while more significant negative revisions occur at the level of the amounts related to non-refundable financial assistance allocated for NRRP (-5.8 billion lei), VAT revenues (-2 billion lei), the amounts related to the rental of 5G frequency bands (-1.3 billion lei), the receipts from excise duties (-0.7 billion lei).

It should be mentioned that the first budget revision operated in August last year. provided for a substantial nominal increase in total budget revenues (+32.1 billion lei, respectively +7.3%), its size being unprecedented in the history of the revisions assessed by the FC from 2010 to the present. In essence, the large-scale revision of budget revenues had two main sources: the upward revision of nominal GDP dynamics due to higher inflation (+4.2%, respectively 55.2 billion lei); the additional revenues from the overtaxing of electricity and natural gas producers. In the opinion regarding the draft of the first budget revision, the FC considers as probable the materialization of a revenue gap compared to the targets assumed at that time of about 9 billion lei (representing about 0.65% of GDP), the non-achievements being expected at the level of revenues from VAT, social security contributions, excise taxes.

The second budget revision is based on a nominal GDP forecast that is even higher compared to the value considered in August last year (+1.7%, respectively 23.7 billion lei), which would lead to higher tax revenues (including social security contributions). In the draft of the second revision, however, these are reduced by approximately 2.4 billion lei, which is likely to validate the FC projection from the opinion on the first budget revision regarding the likely materialization of a revenue gap compared to the assumed targets at that time. Also, in the context of the increase in the nominal GDP projection, as well as the up-to-date budget execution, at this point in the analysis, the FC lowers its projection regarding the anticipated gap in tax revenues (including social security contributions) in relation to the new proposed targets to about 3 billion lei.

More precisely, the revenue aggregates on which FC has reserves from the perspective of reaching the proposed targets are represented by VAT, social security contributions, corporate income tax and excise duties.

It should be noted with regard to the new budget revenue targets, the significant overperformance of non-tax revenues, but also the non-realization of some projects financed through the NRRP provided for the year 2022.

By categories of budget expenses, more important additions are found in interest expenses (+4.5 billion lei), social assistance (+1.6 billion lei), goods and services (+1 billion lei), capital expenditure (+0.5 billion lei), while significant reductions in allocations occur at the level of projects financed from NRRP, including the loan component (-7.6 billion lei).

It should be mentioned that the first budget revision operated in August c.y. provided a substantial nominal increase in total budget expenditures (+35.3 billion lei, respectively +6.8%), its size also being unprecedented in the history of corrections assessed by the FC from 2010 to the present. Following the analysis of the budget expenditures proposed by the draft of the first budget revision, the FC considers it probable that the budget allocations will be exceeded by about 6 billion lei (representing about 0.45% of GDP), the proposed levels being considered insufficient in the case of goods and services expenditures and those of social assistance.

The second budget revision confirms the FC assessments regarding the insufficiency of allocations for the two categories mentioned above, with the mention that the additional allocations proposed by the second budget revision amount to 2.6 billion lei. The FC maintains its previous assessment of the need for even higher additional allocations to goods and services and social assistance spending. At this moment of the analysis, the FC considers this necessary at around 3 billion lei compared to the levels proposed by the draft of the second budget revision.

With regard to budget expenditures, FC emphasizes that the budget execution at 9 months showed a significant under-execution of capital expenditures (difference from the target proposed by the first revision of about 20.6 billion lei, the amounts spent in the first 9 months representing approximately 48.3% of the allocations for the whole year), as well as the projects financed from EU funds related to the financial framework 2014-2020 (difference from the target proposed by the first revision of approximately 25.3 billion lei, the amounts spent in the first 9 months representing approximately 51.7% of the allocations for the whole year). Under these conditions, even assuming a significant acceleration of these expenses in the last 3 months of the current year, it is possible and even probable that the amounts actually spent will be lower than the budgeted ones, which will favorably affect the budget balance.

It should also be noted that at the level of spending on goods and services, traditionally, in the last 2 months of the year, the monthly average of the amounts spent is higher compared to the average recorded in the first 10 months of the year.

The elements described above contributed significantly to the recording of a cash budget deficit of 3.04% of GDP at the level of September 2022, under the conditions of a level proposed at that time of 5.84% of GDP for the entire year. Given the concentration of a significant part of investment spending and higher flows of spending on goods and services in the last part of the year, a significant increase in cumulative monthly budget deficits is expected in the last quarter of 2022.

An important source of uncertainty regarding the budget deficit for 2022 according to the cash methodology and, especially, through the lens of the European ESA 2010 methodology is represented by the budgetary impact of the energy compensation schemes (GO no. 118/2021 for the period November 2021 - March 2022 and GEO No. 27/2022 for the period April 2022 - August 2022). The final cost of GEO no. 118/2021 was about 2.4 billion lei, while the amounts related to settlement requests validated by NERA based on the provisions of GEO no. 27/2022 until 10.11.2022 are in the amount of 5.3 billion lei. Thus, the sums provided for this purpose at the first revision, of around 7.4 billion lei, have already been exhausted, given that the size of the sums remaining to be requested by the energy suppliers / to be validated by NERA is not known. In addition, there are still uncertainties regarding the budgetary impact of the new energy compensation scheme (provided by GEO no. 119/2022[8]). In the absence of sufficient information to resolve these issues, the FC will not assume at this point in the analysis a budgetary impact of the schemes different from what is found in the current budget construction. However, the FC considers that the balance of risks regarding the budgetary impact of the compensation schemes is inclined towards a more unfavorable impact compared to the one included in the current budgetary allocations.

In conclusion, FC welcomes the Government's intention to target a lower budget deficit for this year. At this point in the analysis, considering the values of the budget aggregates proposed by the draft of the second budget revision, the FC assesses as probable the registration of a gap in fiscal revenues (including social security contributions) of about 3 billion lei (representing about 0.2% of GDP), as well as the materialization of exceeding the envelope of budget expenditures on goods and services and those on social assistance by about 3 billion lei (representing about 0.2% of GDP).

However, falling within the proposed new target for the cash budget deficit of 5.74% of GDP is possible given the significant under-execution of total investment expenditure (capital expenditure and European projects) in the first 9 months of the year, which makes it improbable to reach the proposed targets for these expenses, but which has a favorable impact on the budget balance. Uncertainties also persist regarding the budgetary impact of energy compensation schemes.

FC emphasizes the improvement of the fiscal outlook for the current year. This improvement is underpinned by both the higher-than-anticipated dynamics of nominal GDP, which implies higher

[8] It is worth noting that GEO no. 153/2022 comes with changes in the construction and application of the compensation scheme.

tax revenues (including social security contributions), and the very large increase (compared to budgeted levels) of non-tax revenues, particularly as a result of developments in the energy sector.

Compliance with fiscal rules

The project of the second budget revision provides for the modification of the ceilings in nominal terms for some of the indicators specified in the fiscal-budgetary framework for the year 2022 (established initially by Law no. 312/2021 and then amended on the occasion of the first budget revision by GO no. 19/ 2022) as follows:

- the nominal ceiling of the GCB's primary deficit is reduced by 5.7 billion lei to the level of 51.4 billion lei, based on the successive upward revision of interest expenses (+4.4 billion lei at the first revision; + 4.5 billion lei for the second revision);
- the nominal ceiling of GCB personnel expenses is increased by 0.2 billion lei to the level of 118.4 billion lei;
- the nominal ceiling of total GCB expenses, excluding financial assistance from the EU and other donors, is increased by 4.4 billion lei to the level of 496.2 billion lei.

As for the nominal deficit of the GCB, it remained within the limit provided by GO no. 19/2022, on the basis of the revision with the same amount of the BGC's revenues and expenses respectively in the second revision in relation to the values from the first revision (+0.8 billion lei on both revenues and expenses). Also, the indicators expressed as share in GDP have remained within the limits provided by Law no. 312/2021 (5.8% of GDP in the case of the GCB deficit, respectively 8.8% of GDP in the case of GCB personnel expenses), and against the background of the increase in the nominal GDP projection by 23.7 billion lei compared to the estimate from first correction.

The Government Ordinance draft on the state budget revision for 2022 stipulates the necessary derogations from the fiscal rules established by the FRL and redefines the ceilings of the budgetary aggregates in accordance with the levels provided in the revision proposal.

The opinions and recommendations formulated above by the FC were approved by the President of the Fiscal Council, according to the provisions of art. 56, para. (2), lit. d) of Law no. 69/2010 republished, following their approval by the Council members, through vote, in the meeting of November 17th, 2022.

17th November 2022

Chairman of the Fiscal Council
Professor Daniel Dăianu