Fiscal Council's preliminary opinion on the State Budget Law and Social Insurance Budget Law for 2018

On November 29th, 2017, the Fiscal Council received from the Ministry of Public Finances (MPF) the letter no. 446157 dated November 28, 2017, requesting under art. 53, paragraph (2) of the Fiscal Responsibility Law no. 69/2010 republished (FRL), the opinion on the Report on the macroeconomic situation for 2018 and the projection for the period 2019-2021, the draft of the Budget Law for 2018, the draft of the Social Insurance Budget Law for 2018, the Fiscal Strategy for 2018-2020 and the corresponding explanatory note and the draft of the ceilings law of certain indicators specified in the fiscal framework for the year 2018. The Fiscal Council notes that it has received the set of documents necessary for the elaboration of its opinion in the second half of Wednesday, November 29th.

Under article 53, paragraph (4) of the FRL, the Government and Parliament are required to consider the opinions and recommendation of the Fiscal Council when **elaborating and approving the Fiscal Strategy and the annual budgets, as well as in the preparation of other measures triggered by the implementation of this law.** Given the Government's intention to approve the above documents at the meeting from 6.12.2017, while November 30th and December 1st are public holidays, the Fiscal Council does not dispose of sufficient time for analysis and writing a complete opinion. However, in order to avoid the delaying of budget adoption in the Government meeting and submission to Parliament, the Fiscal Council decided to write a preliminary opinion, making some general considerations and identifying some major visible aspects at a first evaluation, which will be followed by a complete opinion in the week December 11-15th, 2017. After its completion, the Fiscal Council will notify the Parliament and publish the opinion on the website of the institution (www.fiscalcouncil.ro).

Therefore, the Fiscal Council considers as appropriate the following preliminary general considerations:

Procyclical fiscal policy, larger deviation from the medium-term objective, in contradiction with FRL's fiscal rules

The budget construction targets a deficit slightly below the 3% of GDP reference value of the Stability and Growth Pact (SGP) corrective arm. Irrespective of the expected excess demand (it should be noted that there are still significant differences between the National Commission for Economic Forecasting - NCEF assessments and the most recent evaluations available from the European Commission - EC on the potential and effective growth rate of GDP, the NCEF being substantially more optimistic[1]), the budget construction states a massive slippage

[1] The European Commission assesses the growth rate of potential GDP to 3.7% in 2017, then rising to 4% in 2018 and 2019, while the NCEF assesses it at 4.6% in 2017, 5.2% in 2018 and 5.3% in 2019. The

which continues to widen in 2018 compared to the requirements of the SGP's preventive arm, also embedded in national legislation through the FRL. Convergence towards the medium-term objective (defined as a structural deficit of 1% of GDP) is expected to start only in 2019, but the assumed budget deficit targets imply a structural effort below the minimum target of 0.5 pp of GDP stated by european regulations in 2019 and just equal to it in 2020.

A rather optimistic macroeconomic scenario with parameters that appear to be at the top of the posibility range. Risks inclined to less favorable developments compared to the ones taken into account.

The medium-term macroeconomic scenario underpinning the budget construction is in line with previous NCEF assessments, but remains significantly more optimistic than other institutions' forecasts, although developments in the current year made the projected increases for the coming years plausible. In the opinion of the Fiscal Council, this scenario is rather inappropriate from the point of view of a prudent budgetary construction, with the balance of risks is tilted towards less favorable macroeconomic developments than those taken into account. The Fiscal Council identifies unusually high risks related mainly to the future behavior of the private sector in response to the recent amendments to the Fiscal Code (in particular the transfer of social contributions from the employer's burden to that of the employee)[2], a scenario where the growth of the gross salary to be lower than the one envisaged in the projected budget revenues having a high probability, with implications for the evolution of private consumption and economic growth in general. To those are added the risks of introducing room for fiscal arbitrage by capping the social contributions calculation base to the minimum wage for self-employed income and a more favorable tax regime for micro-enterprises (with reference to the applicability of the taxation of the turnover for firms that earn income from consultancy and management activities), which could encourage the sub-declaration of wage income (especially for high wages).

VAT revenues projected for 2018 appear to be significantly

The Fiscal Council has concerns about the projected evolution of VAT revenues in the draft budget, with a preliminary analysis indicating a potential overvaluation of these even in the context of using the NCEF's macroeconomic scenario. Thus, VAT

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differences are also significant in the case of the projected real GDP growth rate, with the European Commission assessing it at 4.4% and 4.1% in 2018 and 2019 respectively, while NCEF anticipates increases of 5.5% and 5.7%. The differences offset each other in the excess demand assessment, with differences between EC and NCEF figures being only 0.4 percentage points of potential GDP in 2017 and 2018 and 0.2 percentage points of potential GDP in 2019.

[2] See the November 3th opinion of the Fiscal Council on the draft amendment to the Fiscal Code.

overvalued, even under the macroeconomic scenario of the NCEF, with implications for ensuring the financing of local authorities.

revenues are projected to increase (after adjusting the corresponding 2017 and 2018 figures with the temporary compensation schemes chain of budget arrears) by 16.3% (or 8.6 billion lei) compared to the estimated level for 2017 in the second budget revision. The advanced dynamics surpasses substantially that of the private consumption (net of self-consumption) forecast by the NCEF, the text of the Macroeconomic Situation Report indicating on page 81 as an explanation for this evolution the impact of the introduction of the VAT split mechanism and measures to improve the VAT collection taken by NAFA, estimated at 4.9 billion lei. The Fiscal Council is skeptical of the validity of such an assessment: beyond the objection of principle to the lack of caution of including *ex ante* in the revenue projection the impact of measures aimed to improve collection, which is difficult or impossible to assess, the additional revenue estimated in the text of the report appears to be inconsistent with the MPF's previous assessments regarding the introduction of the mandatory and generalized VAT split-payment mechanism, which indicated additional revenues of only 2 billion lei in 2018[3]; given that, subsequently, the scope of the VAT split-payment was considerably narrowed (to a level that makes possible the scenario of avoiding entering into business relations with those enrolled in this payment mechanism by the other economic agents). Considering the above, the Fiscal Council considers that VAT revenues for 2018 are most likely overvalued by about 3-4 billion lei, beyond the possible impact of a less favorable cyclical developments than those taken into account in the budget construction.

Furthermore, as additional VAT revenue is the main source of compensation for local government revenue loss as a result of the personal income tax reduction from 16% to 10% while maintaining the split rate transferred, their (probable) non-realization is likely to create them budgetary difficulties.

The positioning of the deficit below the 3% ceiling depends significantly on exceptional revenues

The budget construction includes exceptional revenues from the sale of heavy water out of the state reserve (+1 billion lei for capital revenues) and from renting the 5G frequency bands (+1.3 billion lei for revenues from taxes on using goods, authorizing the use of goods or on carrying activities). In the first

[3] The explanatory note accompanying GO no. 23/2017 http://gov.ro/fisiere/subpagini_fisiere/NF_OG_23-2017.pdf.

case, there is a significant risk of failure to achieve the forecasted level - worldwide heavy water exports amounted to only 62.4 million USD in 2016[4], and domestically Nuclearelectrica S.A.'s total expenditure on goods and services was, according to the company's income and expenditure budget for 2017, 617.5 million lei[5]. In the second case, the concerned revenues will not be reflected in an equivalent manner in the budget execution according to ESA 2010 methodology, where they would be distributed linearly over the duration of the concession, thus contributing to a negative difference between the budget balance according to ESA 2010 and cash methodology and, therefore, *ceteris paribus*, to an ESA 2010 deficit higher than the one according to the national methodology.

Social assistance expenditure appears to be significantly underestimated

Similar to the situation that the Fiscal Council identified on the occasion of approving the 2017 budget law, the social assistance expenditure for 2018 appears to be significantly underestimated in relation to the already apparent trends in the preliminary execution for 2017[6] (relevant given that it represents a permanent expenditure) and the pension point dynamics. Thus, the extrapolation in 2018 of the implicit flow of social assistance expenditure related to the state budget in the fourth quarter of 2017 (determined as the difference between the amount budgeted in the second budget revision and the nine-month execution) would indicate a level of at least 30.9 billion lei which, given that the budget allocation according to the draft budget is 28.4 billion lei, indicates a need of about 2.5 billion lei higher than the budgeted level. Adding to this figure the impact of raising the minimum social allowance from 520 lei to 640 lei (which would generate additional expenses of 600 million lei expenses for the 6 months of application in 2018[7]) and inflation indexation of the special pensions, the social assistance expenditure underestimation for the state budget is, probably, at least 3.1 billion lei. The social assistance expenditure of the social security budget is projected to increase by 8.7% compared to the level recorded in 2017 – given that the weighted value of

[4]According to the Observatory of Economic Complexity, https://atlas.media.mit.edu/en/profile/hs92/284510/.
[5] http://www.nuclearelectrica.ro/wp-content/uploads/2017/02/A1.pdf.
[6] We remind that the Fiscal Council's concerns regarding the insufficient amount of social assistance expenditure budgeted at the level of 2017 were validated on the occasion of budget revisions (higher than the originally assessed difference), the first budget revision increasing the social assistance expenditure by 3.3 billion lei and the second one with another 1.4 billion lei.
[7] http://gov.ro/fisiere/subpagini_fisiere/NF_OUG_82-2017.pdf.

the pension point is by 9.5% higher in 2018 compared to the previous year, they appear underestimated in relation to the needs of at least 500 million lei. Finally, the Fiscal Council considers as inexplicable the decrease in the social assistance expenditure by 370 million lei compared to the level budgeted for 2017 at the local authorities level. Together, the elements described above seem to indicate an underestimation of social assistance expenditure by about 4 billion lei.

The Fiscal Council's preliminary assessment indicates, therefore, a significant overvaluation of VAT revenues, beyond the risks of the optimistic macroeconomic scenario taken into account in the budgetary construction, by about 3-4 billion lei, which adds to the underestimation of the needs for social assistance expenditure of about 4 billion lei. These elements are supplemented by the risks associated with the macroeconomic scenario used in the budgetary construction, whose balance is assessed by the Fiscal Council as inclined towards less favorable developments than those envisaged, as well as the risks of non-realization of the exceptional capital revenues taken into account. All this indicates as highly probable the event of a deficit significantly beyond the assumed target and thus the 3% of GDP reference value corresponding to the corrective arm of the Stability and Growth Pact and, as a consequence, the need for additional discretionary revenue measures and / or expenditure cuts to maintain the budget deficit at the level of the assumed target, already inappropriate from the perspective of national and European fiscal rules. The experience of the 2017 budget exercise is eloquent in this respect: given that the budget execution revealed a strong underestimation of (permanent expenditure) personnel expenditure and social assistance expenditure (the risks in this sense being signaled by the Fiscal Council in the opinion on initial budget construction), and the execution of budget revenues was below expectations (despite more favorable macroeconomic developments than the initial expectations), the compliance with the deficit target implied a massive reduction in investment expenditure in the context of budget revisions, the reintroduction of the additional excise duty on fuels and the (unrepeatable) drawing of super-dividends from state-owned companies.

The opinions and the recommendations above mentioned by the Fiscal Council were approved by the Chairman of the Fiscal Council, according to Art. 56, para (2) letter d) of the Law no. 69/2010 republished, after being approved by the Council members through vote, on 6^{th} of December 2017.

6^{th} of December 2017 **Chairman of the Fiscal Council,**

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