Romania

Fiscal Council

Annual Report

2012

Note:

The Annual report for 2012 was approved by the Chairman of the Fiscal Council, according to article 43, paragraph (2), letter d) of Law no. 69/2010, after being adopted by the members of the Council through vote, on September 12th, 2013.

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List of abbreviations

CABB	*Cyclically adjusted budget balance*
CEE	*Central and Eastern Europe*
EBA	*European Banking Authority*
EBRD	*European Bank for Reconstruction and Development*
EC	*European Commission*
ECB	*European Central Bank*
ERM II	*European Exchange Rate Mechanism II*
ESA95	*European System of Accounts 1995*
EU	*European Union*
FRL	*Fiscal Responsibility Law*
FS	*Fiscal Strategy*
GCB	*General Consolidated Budget*
GDP	*Gross Domestic Product*
IMF	*International Monetary Fund*
MPF	*Ministry of Public Finance*
MTO	*Medium-term objective*
NA	*Not Available*
NAE	*National Agency for Employment*
NBR	*National Bank of Romania*
NMS	*New Member States*
NCP	*National Commission of Prognosis*
NPISH	*Non-profit institutions serving households*
OECD	*Organization for Economic Co-operation and Development*
SGP	*Stability and Growth Pact*
VAT	*Value added tax*

I. Summary

The Fiscal Council is an independent authority established by the Fiscal Responsibility Law no 69/2010, which aims to support the Government and the Parliament in designing and implementing the fiscal policy and to promote the transparency and sustainability of public finance.

According to the Fiscal Responsibility Law, the Fiscal Council has among its prerogatives to issue an annual report to analyze the conduct of fiscal policy during the previous year against the framework set out in the Fiscal Strategy and Annual Budget, to assess the macroeconomic and fiscal developments as well as the objectives, targets and indicators included in the Fiscal Strategy and Annual Budget.

In 2012, Romania recorded the second consecutive year of economic growth as the GDP advanced by 0.7% in real terms, a significantly lower dynamic compared to 2.2% reached in 2011, mainly due to an unfavorable supply shock in agriculture, reflected in the demand components of the GDP at the level of private consumption and change in inventories. On the other hand, for 2013 it is anticipated an economic growth of 2% sustained by the external demand on the GDP utilization side, respectively by agriculture and industry for the GDP formation side.

The initial budget for the year 2012 was elaborated considering a budget deficit target of 1.9% of GDP (in cash terms), 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 and in the context of introducing an explicitly provision regarding the increase in personnel expenditures due to the public sector wages recovery. Subsequently, the first budget revision in August 2012 set the new deficit target at 2.25% of GDP. The budget deficit target according to ESA95 remained unchanged, respectively a target below 3% of GDP in order to ensure the exit from the excessive deficit procedure.

In the case of the cash budget execution, the budget deficit stood at a level of 2.5% of GDP, the exceeding of the initial target occurring mainly due to the underperformance of revenues from EU funds, while continuing funding the already started projects but also as a result of expenditures on goods and services significantly higher than the initial projection. As for the general government balance according to ESA95 methodology, the final budget execution noted the achievement of the deficit target, creating the premises for Romania's exit from the excessive deficit procedure initiated in 2009.

In the Fiscal Council's opinion, the risks associated to the macroeconomic indicators in 2013 are tilted on the upside, respectively a higher than projected economic growth as a result of higher foreign demand and a better agricultural production. On the other hand, the balance of risks regarding the budget execution seems to be tilted on the downside (a higher effective deficit compared to estimations) as the better than expected economic advance is unlikely to generate significant additional revenue to the state budget, given that tax revenues are lower for exported goods and the agricultural sector remains poorly taxed.

The main domestic risks could materialize if the political commitment for the fiscal consolidation process become weaker. The fiscal policy slippages (like reversing some of the austerity measures implemented in the last years) have the potential to worsen the risk perception regarding Romania and contribute to a high volatility of interest rates and exchange rate, especially given that the share of Romanian sovereign bonds held by nonresidents increased significantly.

On the positive side, an improvement in EU funds absorption and an increased confidence in the Romanian economy could lead to a better than expected economic performance that expectations, supported by possible increased foreign investments as a result of a higher pace of structural reforms.

In the agreements with the IMF and European Commission, the Government committed to a reduction of the consolidated budget deficit for 2013 to 2.15% of GDP according to cash methodology, respectively to 2.4% of GDP according to ESA95 methodology. At the moment of drafting this report, the available information shows that the IMF mission reached an agreement at a technical level for a new economic program that could take the form of a Stand-by Agreement for 24 months, setting a new deficit target for 2013 at 2.3% of GDP in cash terms (2.4% of GDP according to ESA95 methodology). In the Fiscal Council's opinion, even if the magnitude of the adjustment process is significantly lower than in the previous years, the fiscal targets appear as quite ambitious considering that the budget for 2013 includes on the expenditure side the full recovery of wage cuts implemented in 2010, the increase in pensions according to the legal indexation scheme, the gradual reduction of the payment period for invoices below 60 days and considering that revenues are negatively affected by a more unfavorable structure of economic growth than initially estimated. Moreover, the impact of the recently announced revenue measures is not clearly quantified, including some one-off measures.

However, the Government's commitment to keep the budget deficit below 3% of GDP seems to be strong and a possible underperformance of revenues will probably generate some supplementary adjustments on the expenditure side as there is some room for maneuver in this regard.

The need to improve EU funds absorption becomes critical in the context of the fiscal compact's provisions that will limit the room for maneuver for the fiscal policy in the coming years

The need to improve EU funds absorption becomes more stringent in the context of fundamental changes in the fiscal policy approach. Due to the new European fiscal compact, in the following years the fiscal policy's room for maneuver will be reduced compared to the past, as the maximum permitted budget deficit will be lower. Moreover, a low efficiency of automatic stabilizers is an additional constraint for Romania and in these circumstances, EU funds absorption appears as a solution to stimulate the economy. In addition, budgetary constraints imposed by the fiscal compact require the need to improve the efficiency of budgetary expenditure, particularly those related to public investment and purchases of goods and services.

Romania's top priority should be an urgent and substantial increase of EU funds absorption. Unfortunately, so far, Romania's performance in this regard is very low, even if in 2012 we noticed an improvement in contracting structural and cohesion funds, the rate being 78% compared to 65% in 2011.

The efficiency of tax collection remains low

Romania has one of the lowest shares of overall government revenues to GDP in the EU (tax and non-tax revenue), of only 33.5% of GDP in 2012 which is 11.9 percentage points below the EU average. Also, in Romania, the ratio of fiscal revenue in GDP reached in 2012 a level of 28.1%, significantly lower than in countries like Hungary (38.1%), Slovenia (37.8%), Czech Republic (34.8%) and Poland (32.4%).

In 2012, the efficiency of tax collection for VAT and social contributions was among the lowest in the Eastern European countries, respectively 57% for VAT compared to 84% in Estonia, or 71% in Slovenia and Bulgaria and 65% for social contributions.

Under these circumstances, significant additional revenues can be collected by reducing the tax evasion.

The financial situation of the state pension system is very poor

The weight of the social assistance expenditure in Romania is consistent, and the issue of the structural deficit of the public pension system is not solved: budgetary expenditures on pensions are unsustainable in relation to the collected contributions, even if the new pension law contains some measures for improving the deficiencies over the medium and long term.

In the year 2012, Romania's position regarding the social assistance expenditure share in total revenues has improved from 2011, being in the second half of the EU countries ranking, but they remain at a significantly higher level than the received social contributions. Thus, there are still significant risks to the medium-term sustainability of the social security budget, and the opportunity of any increases of expenditures or reductions in contributions should be considered only in the context of identifying alternative solutions to reduce the deficit, particularly by broadening the base tax.

The lack of the investment priorities list at the national level

Despite the Fiscal Council's previous recommendations on the necessity of an investment priorities list at the national level, there are still lacking specific information on: the distribution of the investments by sectorial policies, the particularization of the prioritized investment projects and the multi-annual allocations of funds for them. In the opinion of the Fiscal Council, the transparent formulation of the investment budget based on an analysis of the portfolio of the existing projects and its rationalization by identifying the foreground projects, concomitantly with the multi-annual allocation of financing is essential for the efficient use of the available resources.

The accumulation of losses and arrears in the state companies constitute a risk to public financing sustainability on the medium term

A potential medium term risk for fiscal sustainability is represented by the losses and arrears for companies where the state is the major shareholder. At the end of 2012, 996 such companies reported financial statements to the Ministry of Finance, most of which were organized as commercial units and autonomous administrations, amounting to an aggregate turnover of 49 bn. lei. In spite of their contribution of 4.6% to the total turnover in 2012, these companies accumulated overdue payments amounting 21.7% of the arrears recorded for the whole economy. The issue of arrears for the state-owned companies is much more severe in comparison with the private companies as their dimension related to the volume of activity (total turnover or total assets) is much higher.

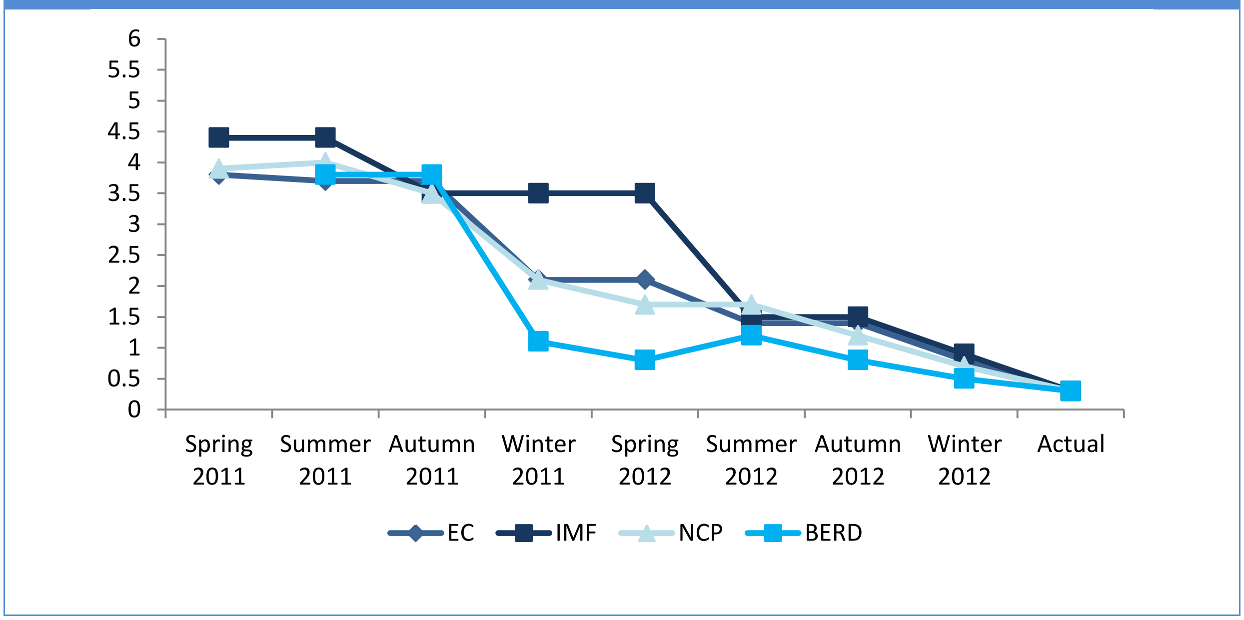
Tax evasion is very high in Romania and deprives the budget of consistent amounts

According to the calculations of the Fiscal Council, based on NIS data, the tax evasion has a very high dimension in Romania, representing 13.8% of GDP in 2012. If Romania collected the taxes at its maximum, it would have budgetary revenue as a percentage of GDP higher than the European average. Approximately 60% of the tax evasion is generated by VAT, while the social contributions contribute with about 24% to the total tax evasion, mainly through the phenomenon of "unrecorded work" (employees in the informal economy). An in-depth reform of the administration of taxes in Romania targeted towards increasing tax collection is absolutely necessary.

II. Macroeconomic framework in 2012

In 2012, Romania recorded the second consecutive year of economic growth as the GDP advanced by 0.7% in real terms, a significantly lower dynamic compared to 2.2% reached in 2011, while the negative gap compared to the peak reached in 2008 is still around 5%. Taking into account the initial forecasts considered in preparing the draft budget for 2012, but also the autumn forecasts of the European Commission and the National Commission of Prognosis, the economic growth was lower by about one percentage point, mainly due to an unfavorable supply shock in agriculture, reflected in the use of GDP at the level of private consumption and change in inventories. The adverse weather conditions have negatively affected growth in the first quarter of 2012, while the next three months were characterized by an acceleration of economic activity supported by public and private consumption. However, in the third quarter, the growth became negative again as a result of the severe drought, the deteriorating consumer confidence and the difficulties in the absorption of EU funds, the effects being felt in the last quarter of 2012, which marked a quasi-stagnation from the previous one.

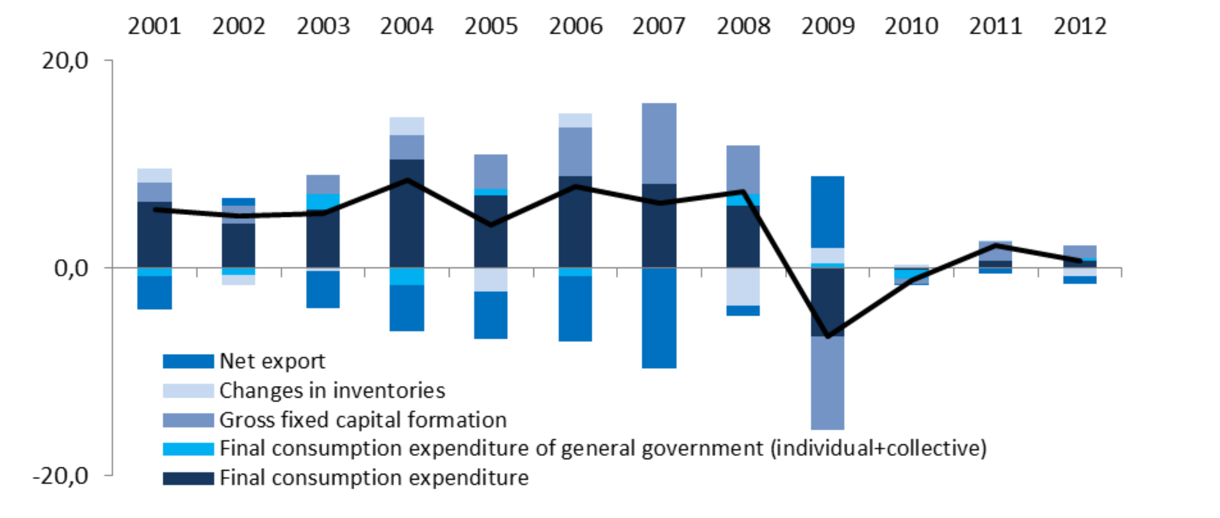
Figure 1: The evolution of economic growth forecasts for 2012



Source: EC, IMF, NCP, BERD

The main contributions to economic growth derived from gross fixed capital formation (+1.3 percentage points (pp.), corresponding to an annual increase of 4.9% in real terms), while the increase in expenditure related to households final consumption and non-profit institutions serving households (NPISH) have generated a positive contribution of 0.7 pp. (1% real annual growth). Also, the general government consumption had a positive contribution (+0.25 pp., corresponding to an advance of 2.4% in real terms). Changes in inventories (-0.7 pp.) and net exports (-0.8 pp.) had a negative contribution on the growth, especially because of a more pronounced reduction in real terms of exports (-3%) than imports (-0.9%). On the supply side, the largest increases were recorded in information and communication (+29.1%), professional, scientific and technical activities (+9.9%), shows, culture and recreation activities; repair of household goods and other services (+3.1%), and public administration and defense, education, health and social assistance (+2.2%), while negative developments occurred in agriculture, forestry and fishing (-21.6%), industry (-1%) and financial intermediation and insurance (-0.2%).

Figure 2: Contributions to economic growth

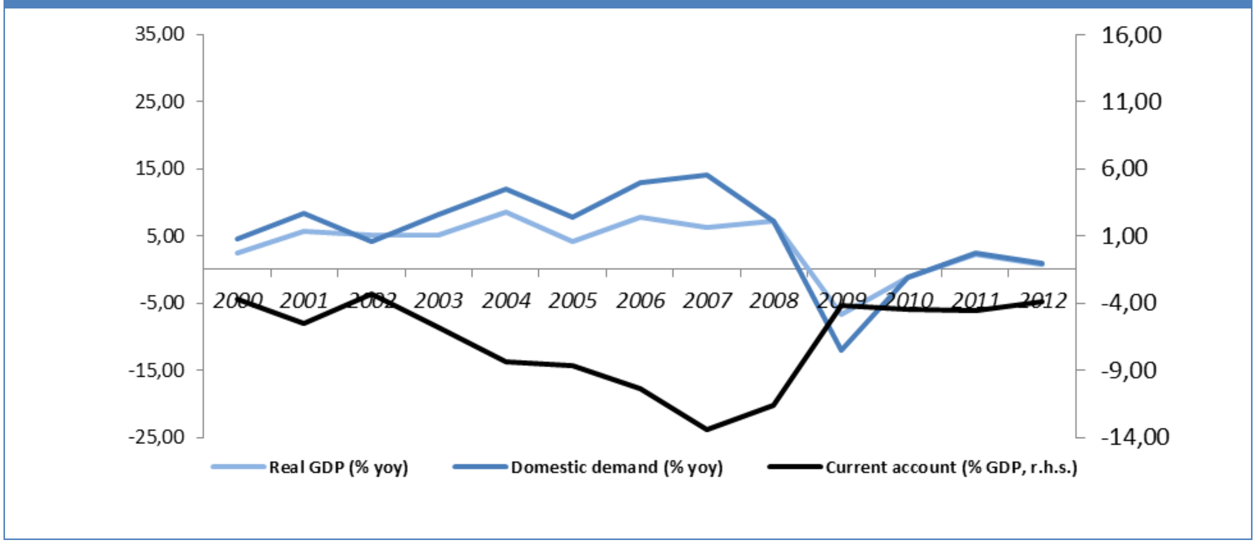


Source: Eurostat, Fiscal Council's calculations

Although the average inflation rate has remained in line with the forecasts considered in the Fiscal Strategy for 2012-2014 (annual average of 3.3%, compared to a projection of 3.5%), the general price increase in December 2012 over December 2011 recorded a level of 4.95%, significantly higher than the 3% forecast from the Fiscal Strategy. This evolution can be explained by the low inflation recorded in the first part of 2012, boosted by the great agricultural production from 2011, while the second half of 2012 was characterized by rising inflation due to the severe drought that significantly affected the food prices, the higher-than-expected increase in administered prices and as a result of the depreciation of the nominal exchange rate. In these conditions the central bank lowered the policy interest rate from 6% to 5.25% during the first 3 months of 2012, subsequently maintaining this level, in the context of rising inflationary pressures, especially in the second half of the period.

Romania's external position continued to improve gradually. The current account deficit declined from 4.52% of GDP in 2011 to 3.9% in 2012, in the context of a 13.3% nominal reduction and a constant level of GDP, taking into account values expressed in euros. The decrease of the nominal current account deficit from 5,937 million euro to 5,151 million euro was determined by a reduction in the income balance's deficit of 538 million euro, an increase in the services balance surplus of 200 million euro and also by the marginal improvement of the trade balance and of the current transfers balance. The exports and imports, considering euro values, fell slightly (-0.5%), while the prices of exported goods denominated in euro advanced faster (+3.2%) than the prices of imported goods (+0.75%). Thus, the trade deficit stood at a lower level in 2012 than in 2011, although in real terms exports decreased more than imports due to worsening economic situation of the main trading partners while the domestic demand was relatively stable.

Figure 3: The evolution of the real GDP, domestic demand and current account, 2000-2012



Source: National Bank of Romania, Eurostat, Fiscal Council's calculations

The foreign debt of Romania increased by 1.5% last year to a level of 99.2 billion euro. The medium and long-term external debt amounted 79.4% of total external debt at the end of the year, respectively 78.74 billion euro, increasing by 3.7% compared to December 31th 2011. The short-term external debt recorded a reduction of 10.21% to a level of 20.46 billion euro (20.1% of total external debt). The debt to IMF diminished at the end of 2012 over the same period of the previous year with 1.742 billion euro, respectively at a level of 10.8 billion euro from 12.54 billion euro.

In 2012, non-government loans granted by credit institutions decreased slightly in real terms, respectively by 3.48% in December 2012 compared to the same period of 2011. The decline was more pronounced in the case of foreign currency denominated-loans, respectively by 2.6% in euro equivalent, while the dynamic of domestic currency denominated-loans registered a decrease of only 1.1% in real terms. Also, a negative impact on lending was determined both by a reduced credit demand and increased capital requirements for financial institutions in the EU, which involved an accelerated reduction of debt (deleveraging) in banks and their branches in Central and Eastern Europe (CEE).

Regarding the developments in the labor market, 2012 marked the first notable improvement from the beginning of the crisis, the average number of employees (4,430 thousand persons) advancing by 1.9% compared to 2011, in the context of an increasing number of jobs created by the private sector, while the public sector recorded a further personnel reduction, but at a much slower pace than in the previous years. Also, at the end of 2012, the unemployment rate computed according to the criteria of the International Labor Office (ILO) fell by 0.7 percentage points, respectively from 7.4% to 6.7%, in the same direction with the evolution of the number of employees. In contrast, the total number of unemployed registered at the National Agency for Employment (NAE) has grown from 461,000 persons to 493,000 persons, the unemployment rate increasing from 5.12% to 5.59%, this evolution being in contradiction with both the dynamic of ILO unemployment rate and the change in the number of employees in the economy.

In 2012, the average gross wage per total economy was 2,133 lei, up 5% from 2011, while the net average wage was 1,547 lei, increasing by 4.9%. Considering an average inflation of 3.3%, the real wage increased by approximately 1.5%. The positive trend of the average wage growth was mainly driven by the public sector wages (+6.82%), while the full effect of wage recoveries will be observed in 2013. In the same period, the average wage in the private sector[1] rose by 4.5%, this dynamics being driven by the constraints on the labor market and the productivity gains.

The evolution of main macroeconomic indicators in 2012 compared with forecasts considered in the Fiscal Strategy for 2012-2014 are summarized in *Table 1*:

Table 1: Macroeconomic indicators (differences from prognosis)

	2012-2014 Fiscal Strategy	Effective 2012
	- % yoy -	
GDP		
GDP (million lei)	588,940.0	587,499.4
Real GDP	3.5-4.0	0.7
GDP deflator	4.3-4.8	4.8
GDP components		
Final consumption	3.2-3.6	1.1
Households final consumption	3.4-4.0	1.0
Individual final consumption expenditure of general government	1.4	1.6

[1] The private sector is approximated by eliminating public administration and defense, education, health and social assistance sectors.

Collective final consumption expenditure of general government	1.5	2.4
Gross fixed capital formation	5.3-5.8	4.9
Exports (volume)	9.7	-3.0
Imports (volume)	8.3	-0.9
Inflation rate		
End of period	3.0	4.95
Annual average	3.5	3.33
Labor market		
Unemployment rate at the end of period	4.5	5.59
Average number of employees	1.0	1.9
Gross average wage	4.9	5.0

Source: National Institute of Statistics, National Commission of Prognosis

III. Fiscal policy in 2012

III.1. The assessment of objectives, targets and budgetary indicators

Under article 48, paragraph (2) of the Fiscal Responsibility Law no. 69/2010, the Fiscal Council's annual report must contain "a discussion and analysis of the implementation of the fiscal policy in the previous year compared to the framework set forth in the Fiscal Strategy and Annual Budget" and will include:

a) *The assessment of macroeconomic and fiscal trends and projections contained in the Fiscal Strategy and Annual Budget to which the annual report corresponds;*

b) *A section containing an assessment of progress against the fiscal policy objectives, targets and indicators set out in the Fiscal Strategy and Annual Budget to which the annual report corresponds;*

c) *A section containing an assessment of the Government's compliance with the principles and rules of this law during the preceding budget year;*

d) *A section containing recommendations and opinions of the Fiscal Council in improving the conduct of fiscal policy consistent with principles and rules of this law in the current budget year.*

The general government balance for the year 2012 was elaborated considering a budget deficit target of 1.9% of GDP (in cash terms), significantly more ambitious that the level of 3% assumed in the Fiscal Strategy approved by the Government in August 2011, despite the significant downward revision of the macroeconomic framework. The Fiscal Council noted in its opinion on the draft budget the lack of a firm commitment to this new target, given that it was explicitly provided the possibility to increase it during the year in order to accommodate the rise in personnel expenditures due to recovery of the public sector wages cuts. Moreover, this intention has materialized during the year, and the new deficit target decided at the first budget revision in August 2012 was set at 2.25% of GDP. The budget deficit target according to ESA95 remained unchanged, respectively a level below 3% of GDP in order to ensure the exit from the excessive deficit procedure. The final budget execution recorded the achievement of the ESA95 deficit target, creating the premises for Romania's exit from the excessive deficit procedure initiated in 2009. In the case of the budget execution in cash terms, the budget deficit stood at a level of 2.5% of GDP, exceeding the initial target mainly due to the underperformance of revenues from EU funds, given the continuing funding of the projects started from budgetary sources, but also as a result of expenditures on goods and services significantly higher than the initial projection.

In the context of the fiscal policy rules, the nominal ceilings for the general government balance in 2012, for total expenses (excluding post-accession funds, pre-accession funds and financial assistance from other donors) and for personnel expenditure were established by Law no. 291/2011 (see *Table 2* below). The budget execution is in compliance with the ceilings for all the indicators mentioned above.

Table 2: Nominal ceilings for GCB balance, total expenditure and personnel expenditure

	Law no. 291/2011			2012		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
million lei	-17,675.2	203,084.2	42,500	-14,774.1	199,500.5	40,798.8
% of GDP	*-3%*	*34.48%*	7.20%	*-2.51%*	33.96%	6.94%

* Excluding financial assistance from EU and other donors

The first budget revision approved in August 2012 maintained relatively constant the projection for the total budget revenues (-80.1 million lei, excluding the impact of swap schemes for clearing outstanding obligations to the budget), but it envisaged significant changes in the structure of the revenues. Thus, the forecasted increases in personal income tax receipts (+1,957.8 million lei), VAT (+1,668 million lei), other general taxes on goods and services (+907.3 million lei) was completely offset by the diminishing projections for European funds revenues (-1,859 million lei), non-tax revenues (-1,386.4 million lei), excises (-797.5 million lei) and capital revenues (-578.5 million lei). Total expenditure increased by 2,369 million lei compared to the initial program, alongside with the budget deficit adjustment from 1.9% to

2.25% of GDP, the highest increases being localized to the following categories: “personnel expenditures” (+1,155.6 million lei in order to enable a new recovery in the public sector wage cuts introduced in 2010), “goods and services” (+1,037.4 million lei supplied on the revenue side mainly by the clawback tax, the advance being primarily motivated by the payment of arrears in the health sector), “interest expenditure” (+1 billion lei due to the rise of borrowing costs, the decision to increase the Treasury’s reserves and as a result of the domestic currency depreciation). Expenditures decreases were recorded in the case of some expenditures categories as “projects funded by external post-accession grants” (-772.2 million lei), “expenditure funded from reimbursable funds” (-416.2 million lei), “capital expenditure” (-196 million lei).

Compared with the parameters approved in the context of the first budget revision, the second revision provides an increase in general government revenue and expenditure by 1.95 billion lei, maintaining unchanged the deficit target at 13.6 billion lei, respectively 2.25% of GDP. Out of these differences, 450 million lei were explained by the influence of a new scheme for clearing outstanding payments to the budget (with identical impact on both total revenue and expenditure).

Beyond the impact of the compensation scheme mentioned above, the upward revision of the revenues totaled 1.5 billion lei and was due to the first tranche (0.91 billion lei) of the license fees for renting the frequencies bands to mobile operators, to which it has been added a net positive impact of 0.59 billion lei at the level of other categories of revenues. This latter amount reflects additional revenue having as sources non-tax revenues (+0.9 billion lei mainly from the upward revision by 0.69 billion lei of the estimate on payments from NBR's profit), clawback tax (+0.36 billion lei) and excises (+0.21 billion lei), which compensate the reductions in estimates of VAT receipts (-0.69 billion lei), personal income tax (-0.36 billion lei) and capital revenues (-0.1 billion lei).

Adjusted for the impact of the above mentioned swap scheme for clearing outstanding obligations to the budget (+0.45 billion lei, of which 0.25 billion lei on goods and services and 0.2 billion on capital expenditure), total expenditure increased compared to the first budget revision by 1.5 billion lei. The advance was primarily due to the significant upward revision of expenditure on projects funded through external post-accession grants (+2.27 billion lei), to which there have been added supplementary allocations to the category “goods and services” (+0.4 billion lei), justified by the use of the additional receipts from the clawback tax in the public health system; these cost increases are partially offset by the reduction of capital expenditure of 0.83 billion lei and of “other transfers” of 0.25 billion lei.

The Fiscal Council’s opinion on the first budget revision recorded the violation of the rules on budget revisions as stated by article 9, paragraph (2) and article 16 of the Fiscal Responsibility

Law (FRL) no. 69/2010; however, it should be noted that the FRL provides in article 23 letter c) as escape clause for the revision of the budgetary framework the change of the government. Also, on the occasion of the second budget revision from October 2012, it has been operated a further increase (by 1.95 billion lei) of total expenditures of the general government compared to the first revision, excluding the financial assistance from European Union and other donors, which involves a new derogation from the provisions of the article 16 of FRL. The Fiscal Council is concerned about the persistent appeal to derogation to circumvent the rules stated by FRL, adversely affecting their credibility.

The evolution of the main budgetary aggregates during 2012 is presented in *Table 3*.

Table 3: The evolution of the main budgetary aggregates during 2012 (billion lei)

	2012-2014 Fiscal Strategy	Initial budget	First amendment	Second amendment	Budget execution 2012
Total revenues	**199.7**	**193.8**	**193.7**	**195.2**	**190.9**
Tax revenue	112.6	108.8	112.3	112.8	111.9
Social contributions	51.3	50.9	51.1	51.0	51.3
EU funds	14.3	13.5	11.8	12.0	8.4
Total expenditure	**217.4**	**205.0**	**207.4**	**208.9**	**205.7**
Current expenditure	193.2	185.4	188.3	190.9	189.3
Capital expenditure	24.3	21.0	20.8	20.0	18.7
Budget deficit	**-17.7**	**-11.2**	**-13.7**	**-13.7**	**-14.8**

Source: Ministry of Public Finance

Note: Amounts without the impact of the compensation schemes

The results of the budget execution in the fiscal year 2012 partially disproved the forecasts of the second revision, both revenues and expenditures recording adverse developments. On the revenue side, the gap from the expected level of revenues was about 4.3 billion lei, mainly due to the very poor performance of the EU funds absorption (-3.6 billion lei) and lower than projected tax revenue as a result of an economic advance below expectations (-0.9 billion lei). Regarding expenditures, they fell only by 3.1 billion lei, the main categories that recorded reductions being capital expenditures (-1.3 billion lei), social assistance (-0.75 billion lei), interests (-0.5 billion lei), expenditure funded from reimbursable funds (-0.3 billion lei). In these conditions, the deficit target in cash terms was missed by 1.1 billion lei, the main cause being represented by national funding of the projects mainly supported by European funds, under the suspension of payments for several operational programs by the European Commission. Expenditure on goods and services were once again above the budgeted level (+860 million lei compared to the first revision and +2,293 million lei compared to the initial budget), highlighting major weaknesses in budgetary programming, inability to solve the structural causes that lead to the appearance of arrears and possibly a trend of outsourcing some services in the central and local authorities affected by staff downsizing.

Regarding the budget execution according to ESA95, the year 2012 marked a budget deficit decrease of 2.7 percentage points of GDP, respectively from 5.6% to 2.9% of GDP. The budget in 2011 included an one-off component on the expenditure side of 1.2% of GDP for the state salary obligations to certain categories of employees in the public sector as a result of enforceable final court ruling, while in 2012 this component represented approximately 0.2% of GDP, and the effective size of adjustment was about 1.7% of GDP, which reflects anyway a fast pace of the fiscal consolidation. However, after analyzing how the deficit reduction was completed, the good performance of the fiscal policy is less obvious. Thus, according to ESA95, the budget deficit decrease occurred mainly due to the reduction of the gross fixed capital formation (investment) by 0.8% of GDP compared to 2011, and the reduction of social assistance expenditure as a share of GDP by 0.8% while the revenues decreased as a share of GDP by 0.3 percentage points.

The fiscal consolidation started in 2010 in order to correct the existing major imbalances in the public finance position, was characterized by an alert pace, Romania succeeding in a relatively short period of time a reduction of the budget deficit, in accordance with ESA95, from 9% of GDP in 2009 to 2.9% of GDP in 2012. Thus, the premises for Romania's exit from the excessive deficit procedure were created, also considering that the medium-term projections confirmed the perspective of keeping the general government deficit below 3% of GDP. The fiscal adjustment in the period 2009-2012 considering ESA95 standards was performed by cutting spending by 4.7% of GDP (reversing partially the increase of 7.5% of GDP in the period 2005-2009) and increasing revenues by 1.4% of GDP. The adjustments in budget expenditure were made primarily in the compensation of employees (-3.1% of GDP), gross fixed capital formation (-1.3% of GDP) and social assistance (-1.1% of GDP). On the revenue side of the budget, their growth by 1.4% of GDP in 2009-2012 was mainly due to increased legal rate of VAT from 19% to 24% in 2010, VAT revenues advancing during 2009 – 2012 by 1.9% of GDP (2009 marked a decline in VAT revenues by 1.3% of GDP compared to 2008), thus offsetting the decrease in revenue from SSC, income and profit taxes.

Table 4: Development of budgetary expenditure and revenue according to ESA95										
	2005	2006	2007	2008	2009	2010	2011	2012	% change 2009 compared to 2005	% change 2012 compared to 2009
Total expenditure (% of GDP)	**33.6**	**35.5**	**38.2**	**39.3**	**41.1**	**40.1**	**39.4**	**36.4**	**7.5**	**-4.7**
Intermediate consumption	6.3	5.9	6.6	6.6	6.5	5.8	6.1	5.9	0.1	-0.6
Compensation of employees	8.7	9.3	9.7	10.5	10.9	9.7	7.9	7.8	2.2	-3.1
Interest payments	1.2	0.9	0.7	0.7	1.5	1.5	1.6	1.8	0.3	0.2
Social assistance	10.3	10.1	10.4	11.6	13.8	14.1	13.4	12.7	3.5	-1.1
Subsidies	1.5	1.8	1.3	0.8	0.7	0.6	0.4	0.4	-0.7	-0.4
Other current expenditure	0.7	0.9	1.8	1.4	1.4	1.9	2	2.3	0.7	0.9
Gross fixed capital formation	3.9	5.1	6.2	6.6	5.9	5.7	5.4	4.6	2.1	-1.3
% of din total expenditure *										
General public services	9.7	9.2	11.3	11.9	10.2	11.1	12.1	:	0.5	1.9
Out of which, interest	3.7	2.5	1.9	1.8	3.7	3.8	4.1	:	0	0.4
Defense	8.9	6.5	4.7	3.8	3.6	3.7	2.2	:	-5.2	-1.5
Public order and safety	6.3	6.7	6.4	5.7	5.3	6	5.6	:	-1	0.3
Economic affaires	15.7	19.5	21.8	19.9	18.7	17	16.9	:	3	-1.8
Environmental protection	0.9	1	1.1	1.2	1.4	1.8	2.4	:	0.4	1
Housing and territorial planning	4.8	4.1	4.1	3.3	3.4	3.3	3.1	:	-1.4	-0.2
Health	8	7.6	8.1	8.2	9.3	9	8.6	:	1.3	-0.7
Recreation, culture and religion	2	2.8	2.8	2.9	2.6	2.6	2.7	:	0.6	0.1
Education	10.7	11.6	10.3	11.4	9.9	8.3	10.5	:	-0.8	0.6
Social protection	33	30.9	29.4	31.6	35.5	37.2	35.9	:	2.6	0.4
Total revenue (% of GDP)	**32.4**	**33.3**	**35.3**	**33.6**	**32.1**	**33.3**	**33.8**	**33.5**	**-0.3**	**1.4**
Fiscal revenue	18.2	18.8	19	18.4	17.3	18	19.2	19.3	-0.9	2
Indirect taxes, out of which:	12.9	12.8	12.3	11.7	10.7	11.9	13.1	13.2	-2.2	2.4
VAT	8.1	7.9	8.2	7.9	6.6	7.7	8.7	8.5	-1.4	1.9
Excises*	3.1	2.9	3	2.7	3.1	3	3.1	0	0	0
Direct taxes, out of which:	5.3	6	6.7	6.7	6.5	6.1	6.2	6.1	1.2	-0.4
PIT	2.4	3	3.6	3.6	3.7	3.4	3.5	3.6	1.3	-0.1
CIT	2.7	2.8	2.6	2.4	2.4	1.8	1.9	1.7	-0.2	-0.7
SSC	10.3	10.3	10.5	10.1	10.2	9.5	9.1	8.8	0	-1.4
Other current revenue	1.9	2.1	1.8	1.5	1.7	2.7	2.2	2.5	-0.2	0.9
Budget deficit (% of GDP)	**-1.2**	**-2.2**	**-2.9**	**-5.7**	**-9**	**-6.8**	**-5.6**	**-2.9**	**-7.8**	**6.1**

Source: Eurostat

*Note: *for 2012 data are not available yet, the difference 2009-2012 refers to 2009-2011.*

Regarding the budget execution according to cash standards, in 2012 we noticed a budget deficit reduction of 1.8 percentage points of GDP, respectively from 4.3% to 2.5% of GDP. The adjustment was made by cutting expenditure with 1.6% of GDP (mainly through the reduction by 1.1% of GDP in investment expenditure and cutting with 0.8% of GDP social security spending) and a revenue increase of 0.2% of GDP (in particular based on the exceptional income from the leasing of frequencies to mobile operators).

Table 5: Development of budgetary expenditure and revenue according to cash methodology										
	2005	2006	2007	2008	2009	2010	2011	2012	% change 2009 compared to 2005	% change 2012 compared to 2009
Total revenue (% of GDP)	**31.4**	**32.3**	**32.3**	**32.2**	**31.4**	**32.2**	**32.7**	**32.9**	**0.0**	**1.5**
Fiscal revenue	17.8	18.6	18.4	18.4	17.6	17.8	18.8	19.4	-0.2	1.8
PIT	2.3	2.8	3.5	3.6	3.7	3.4	3.4	3.6	1.4	-0.1
CIT	2.3	2.3	2.5	2.5	2.4	1.9	1.9	1.8	0.1	-0.5
Property tax	0.7	0.7	0.7	0.6	0.7	0.7	0.7	0.7	0.0	0.0
VAT	7.8	8.1	7.5	7.9	6.8	7.5	8.6	8.6	-1.0	1.7
Excises	3.1	3.1	3.0	2.7	3.1	3.3	3.4	3.4	0.0	0.3
SSC	9.5	9.6	9.5	9.5	9.6	8.7	9.1	8.8	0.0	-0.8
Non fiscal revenue	3.2	3.3	3.4	3.1	3.1	3.8	3.3	3.1	-0.1	0.1
Donations	0.6	0.5	0.8	0.6	0.7	0.8	0.1	0.1	0.1	-0.6
Amounts received from EU for payments made	0.0	0.0	0.0	0.0	0.4	1.0	1.1	1.4	0.0	1.0
Total expenditure (% of GDP	**32**	**33.6**	**35.4**	**37**	**38.6**	**38.6**	**37**	**35.4**	**6.6**	**-3.3**
Personal expenditure	7.4	8.0	8.1	8.9	9.3	8.2	6.9	6.9	2.0	-2.4
Goods and services	6.3	6.2	6.1	6.4	5.7	5.6	5.7	5.9	-0.7	0.2
Interest payments	1.2	0.8	0.7	0.7	1.2	1.4	1.6	1.8	0.0	0.6
Subsidies	2.2	2.2	1.7	1.5	1.4	1.3	1.2	1.0	-0.7	-0.4
Projects financed from post –accession grants	0.0	0.0	0.0	0.0	0.5	1.4	1.9	2.2	0.0	1.7
Social protection	9.5	9.0	9.3	10.5	12.8	13.1	12.2	11.4	3.3	-1.3
Capital expenditure	3.0	4.3	4.7	5.0	4.4	3.7	4.1	3.3	1.4	-1.1
Total investment expenditure	0.0	0.0	0.0	0.0	7.1	6.5	7.0	5.9	0.0	-1.1
Budget deficit (% of GDP)	**-0.6**	**-1.3**	**-3.1**	**-4.8**	**-7.3**	**-6.4**	**-4.3**	**-2.5**	**-6.6**	**4.8**

Source: Ministry of Finance

III.2. Budgetary revenues

The revenues of the general consolidated budget, without the impact of compensation schemes, increased by 6.64% in 2012 compared to the previous year, to 190.94 billion lei (32.5% of GDP). The increase of revenues as a share in GDP from 32.16% in 2011 is explained mainly by the positive developments of revenues from other general taxes on goods and services (+0.3 percentage points of GDP due to income from clawback tax), the marginal improvement of European funds absorption compared with 2011 (+0.26 percentage points of GDP), and extraordinary receipts from the mobile operators for renting of frequency bands (+0.16 percentage points of GDP). Negative developments in terms of share in GDP were recorded at the level of social security contributions (-0.24 percentage points of GDP mainly due to the decision to return to pensioners the social security contributions illegally collected and also to the programmed increase of the amounts transferred to the second pension pillar[2]) and at the level of non-tax revenue (-0.16 percentage points of GDP).

Compared to the initial budget, total revenues were lower with 0.49 percentage points of GDP, mainly as a result of missing the target regarding the EU funds absorption, the difference between the execution and the initial budget being of -0.77 percentage points of GDP. Otherwise, the estimates regarding the tax revenue recorded a good degree of achievement, lower receipts from excises being offset by additional revenues from VAT, while the income from clawback tax and from renting the frequency bands to the mobile operators were not included in the initial budget, taking into account a conservative approach of revenue forecasting. Instead, at the level of the non-tax revenues and capital revenues, major differences were noted compared to the initial projections, the cumulative receipts being lower with 0.27 percentage points of GDP. In review, the extraordinary incomes from renting frequency bands by mobile operators and from clawback tax (+0.47 percentage points of GDP) have contributed significantly to the formation of the financial resources of the state in the context of the failure to attract EU funds. However, these revenues are only temporary and, in the following years, cannot substitute an underperformance of the budget revenue in general, or of the revenue from European funds in particular.

[2] These are recorded in the budget execution as negative revenues.

III.2.1. VAT and excises

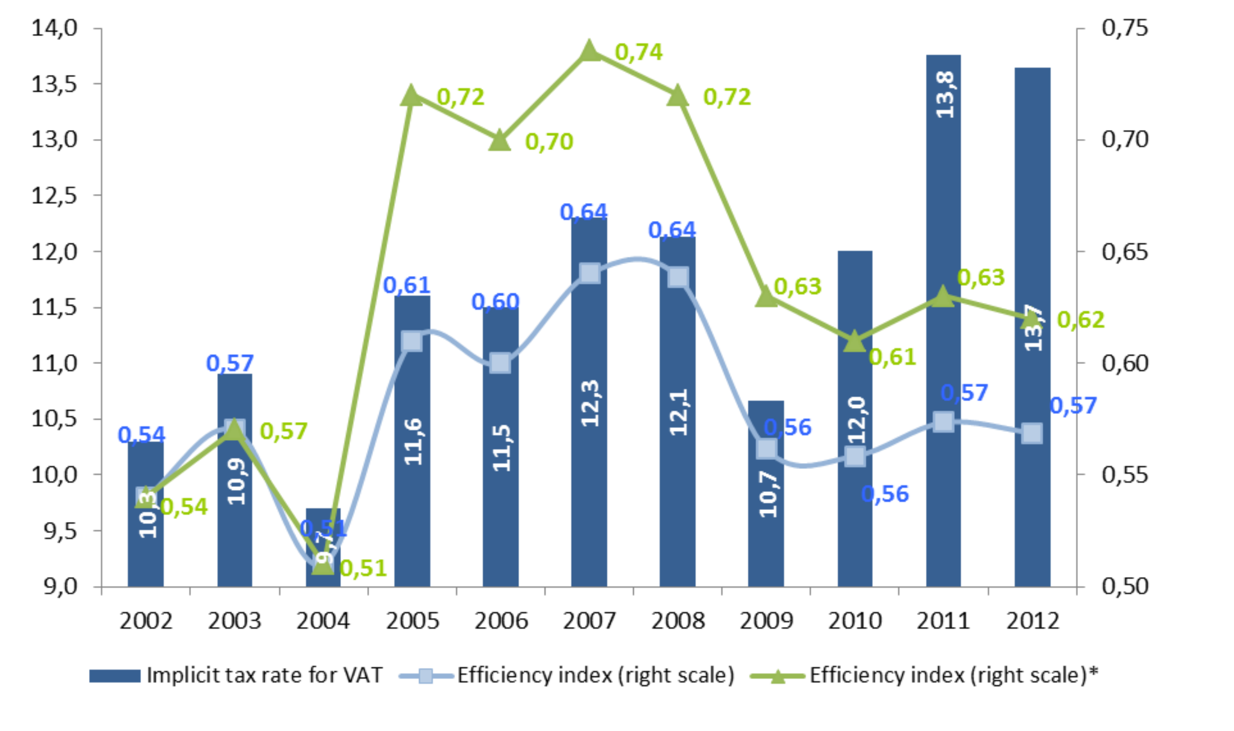
Estimated in the initial budget at 49.65 billion lei, VAT revenues reached a level of 50.51 billion lei at the end of 2012, the difference being fully explained by the additional revenues generated by the unexpected favorable evolution of private consumption while the increase of compensation schemes decided at the budget amendments from August and October 2012 (which envisaged an additional impact on VAT revenue of 1.2 billion lei) were not observable in the budget execution. Compared with 2011, VAT receipts (without swap schemes) increased by 2.76 billion lei (5.92%), in the context of the gradual revival of household consumption and rising prices.

Evaluating the efficiency of tax collection through the ratio between the implicit tax rate (defined as the ratio of actual revenues collected for a particular type of tax and the corresponding macroeconomic tax base) and the statutory rate of taxation, it can be concluded that the efficiency of taxation for VAT decreased in Romania compared to the pre-crisis period, but that is a common feature of EU new member states (NMS 10). It can be observed though a relative stability of the efficiency index in the period 2009-2012, the increase in the standard VAT rate from 2010 leading to higher nominal revenues while the collection's efficiency remained relatively constant.

The budget execution for 2012 suggests that the efficiency remained at the same level compared to the previous year (a degree of efficiency of 57%), the dynamics of VAT revenue being close to that of the corresponding macroeconomic tax base (household final consumption and NPISH[3]). A collection efficiency coefficient virtually unchanged suggests a lack of additional extraordinary revenues (revenue windfalls) – which could arise from reducing tax evasion, for example. Considering the relevant macroeconomic tax basis structure, the unfavorable supply shocks in agriculture adversely affected the "self-consumption" component which is not likely to generate tax revenue, while the taxable component of consumption recorded a higher positive dynamics. Thus, isolating the impact of the self-consumption component, the efficiency of collection worsened in 2012 compared to 2011.

[3] Non-profit institutions serving households

Figure 4 : Implicit tax rate and taxation efficiency index for VAT in Romania



*Source: Fiscal Council's calculation, * adjusted with self-consumption component and farmhouse market.*

The effectiveness of taxation for VAT of 57% in 2012 is significantly lower than in Estonia (84%), Slovenia (71%) and Bulgaria (71%). Romania collected in 2012 8.5% of GDP in VAT revenue (ESA95 execution), compared to 8.32% of GDP in Slovenia, 8.73% in Estonia and 9.15% in Bulgaria, while the standard rate of VAT in these countries was 20% (compared with 24% in Romania). In 2012, a lower efficiency of taxation as defined above was observed only in Latvia, Lithuania, Slovakia and Poland while the Romania's position within the group of analyzed countries improved due to efficiency losses in other countries. Although, it must be noted that differences in the efficiency index of taxation reflect also structural differences between economies, since the higher percentage of rural population in Romania is revealed in a higher share of the self-consumption component (non-taxable) and farmhouse market. Moreover, Aizenmann J. and Y. Jinjarak (2005)[4], examining a panel of 44 countries in the period 1970-1999, concludes that the VAT collection efficiency is negatively related to the share of agriculture in GDP, and directly proportional to the degree of urbanization and the openness of the economy – the corresponding indicators for the three variables in Romania being unfavorable.

[4] Aizenmann J., Jinjarak Y, "The Collection Efficiency of the Value Added Tax: Theory and International Evidence", National Bureau of Economic Research Working Paper no. 11539, August 2005

In addition, it should be noted that the method of calculating the VAT efficiency indicator does not take into account the impact of reduced VAT rates and other components of GDP that are subject to VAT (part of intermediate consumption and gross fixed capital formation - see chapter related to tax evasion).

Table 6: Taxation efficiency - VAT

Country	Standard VAT*			Implicit tax rate**			Taxation efficiency index***			Rank		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
BG	20.0	20.0	20.0	14.4	13.8	14.2	0.72	0.69	0.71	3	3	3
CZ	20.0	20.0	20.0	13.5	13.7	14.2	0.68	0.69	0.71	4	4	4
EE	20.0	20.0	20.0	16.5	16.4	16.9	0.83	0.82	0.84	1	1	1
LV	21.0	22.0	21.5	10.3	10.8	11.3	0.49	0.49	0.53	10	10	8
LT	21.0	21.0	21.0	12.2	12.3	11.8	0.58	0.59	0.56	6	7	7
HU	25.0	25.0	27.0	16.3	15.9	17.0	0.65	0.64	0.63	5	5	5
PL	22.0	23.0	23.0	12.4	12.9	11.7	0.57	0.56	0.51	8	9	10
RO	21.5	24.0	24.0	12.0	13.8	13.7	0.56	0.57	0.57	9	8	6
SI	20.0	20.0	20.0	14.7	14.3	14.3	0.73	0.72	0.71	2	2	2
SK	19.0	20.0	20.0	10.7	11.7	10.4	0.57	0.59	0.52	7	6	9

Source: European Commission, Eurostat, Ministry of Public Finance, Fiscal Council's calculations

* If standard rates have been modified during the year, a weighted average of standard rates has been reported.

** Calculated as a ratio between "VAT revenues" (ESA code D211R) and "Households and NPISH Final Consumption Expenditure" (ESA code P31_S14_S15 ESA). In Romania, the revenues for 2011 and 2012 include additional receipts due to implementation of compensation scheme for clearing arrears (+1709 mil. lei in 2011, and +1571 mil. lei in 2012).

*** Computed as a ratio between the implicit and legal tax rate.

The revenues from excises collected by cash standards in 2012 amounted to 20.26 billion lei (3.45% of GDP), out of which 3.3 million represent the impact of compensation schemes. Excluding their influence, the extra income compared to the previous year amounts to 1.22 billion lei (equivalent to a nominal growth rate of 6.43%), reflecting increases in the excise duty on certain products (diesel, beer and cigarettes) but also the favorable impact of the leu depreciation against the euro with 0.8%, considering the reference rate used in calculating excises.

The revenues from excises were inferior by 0.92 billion lei compared to the level programmed in the initial budget, and by 0.33 billion lei compared to the estimates from the second budget amendment, the efforts to reduce tax evasion during 2012 having a lower impact than the one estimated.

Moreover, the Fiscal Council drew attention both in the opinion on the draft budget and on the budget revisions that the excise revenues are overestimated, the dynamics of this category of revenue being projected to increase steadily at a higher rate than the relevant macroeconomic base. This evolution could be explained only by an increase in the efficiency of collection which did not materialize at the expected levels in 2012. The Fiscal Council recommends caution in estimating this category of revenue given that the impact of efforts to reduce tax evasion should be incorporated ex-post, after their impact is fully observable.

Figure 5: VAT revenues, 2012 (billion lei)

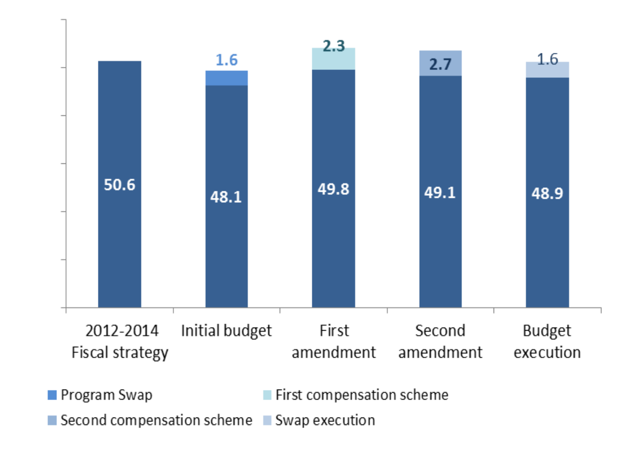
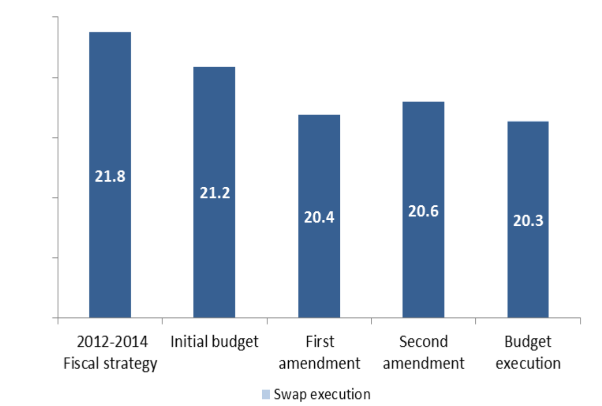


Figure 6: Excises, 2012 (billion lei)

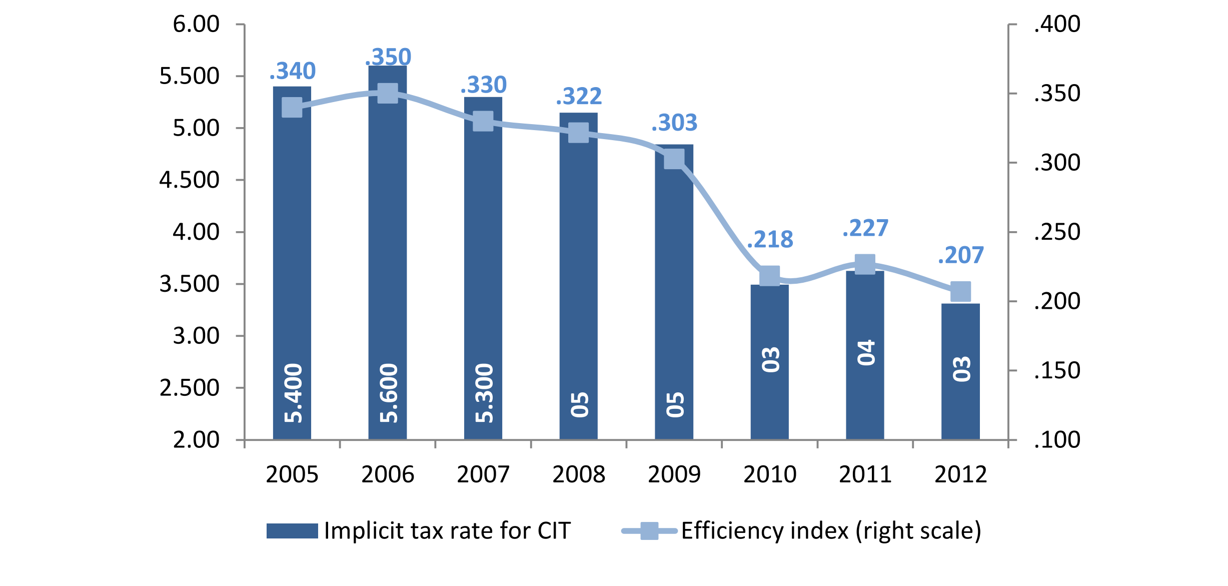


Source: Ministry of Public Finance

III.2.2. Direct taxes

Revenues from corporate income tax, without compensation schemes (+95 million lei), advanced by 4.45% compared to the previous year (+4.46 billion lei), being under the original budget estimates, by about 0.31 billion lei. Nominal revenues from corporate income tax remained significantly below pre-crisis levels. This trend can be observed also by considering the efficiency index, which showed a significant reduction in the period 2008-2012 (in line with developments in NMS 10); *Figure 7* suggests a direct link between the effectiveness of collection and the cyclical position of economy. After the recommencement of economic growth in 2011, the efficiency index seems to have stabilized – but a slight deterioration in 2012 can be observed, as the receipts from corporate income tax (excluding the impact of compensation schemes) advanced at a rate below that of the relevant macroeconomic base (gross operating surplus).

Figure 7: Implicit tax rate and taxation efficiency index for corporate income tax in Romania



Source: Fiscal Council's calculations

Compared with other countries from Central and Eastern Europe[5] in 2012, Romania is ranked on the fifth position (as in 2011), with an efficiency index of 21% and an implicit tax rate of 3.3% (calculated as the ratio of direct taxes paid by enterprises and gross operating surplus from national accounts, as an approximation of the actual tax base). It is worrying that among the analyzed countries, Romania and Slovenia were the only ones that registered a decrease in the efficiency of collection compared to the previous year. The improvement of this indicator is likely to depend on the position of the economy in the business cycle, but also on the measures taken by the Ministry of Public Finance to combat tax evasion or eliminate the loopholes in the tax legislation.

[5] Poland is not included in the rankings for the year 2012 due to unavailability of data on the gross operating surplus in national accounts.

Table 7: Taxation efficiency – Corporate income tax												
Country	**Legal corporate income tax**			**Implicit tax rate***			**Taxation efficiency index****			**Rank**		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
BG	10.0	10.0	10.0	4.2	3.8	3.9	0.42	0.38	0.39	1	1	1
CZ	19.0	19.0	19.0	6.8	7.0	7.1	0.36	0.37	0.37	2	2	2
EE	21.0	21.0	21.0	3.4	3.0	3.7	0.16	0.14	0.17	7	8	7
LV	15.0	15.0	15.0	2.0	2.8	3.2	0.13	0.19	0.21	10	7	4
LT	15.0	15.0	15.0	2.1	1.6	2.6	0.14	0.11	0.17	9	10	8
HU	20.6	20.6	20.6	2.9	2.8	3.3	0.14	0.14	0.16	8	9	9
PL	19.0	19.0	19.0	4.0	4.1	NA	0.21	0.22	NA	6	6	NA
RO	16.0	16.0	16.0	3.5	3.6	3.3	0.22	0.23	0.21	5	5	5
SI	20.0	20.0	20.0	5.4	4.8	3.6	0.27	0.24	0.18	3	4	6
SK	19.0	19.0	19.0	5.0	4.8	4.7	0.26	0.25	0.25	4	3	3

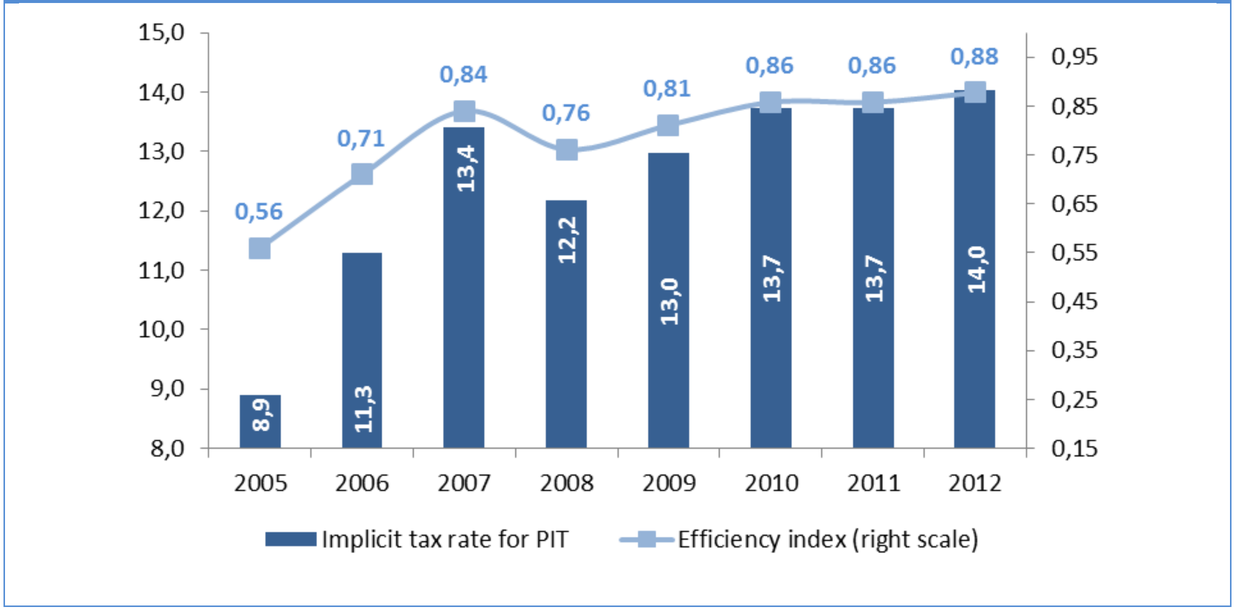
Source: European Commission, Eurostat, Ministry of Public Finance, Fiscal Council's calculations

* Calculated as the ratio between "direct taxes paid by enterprises" (ESA code D.5R (S11+S12)) and "gross operating surplus and gross mixed income" (ESA code B2G_B3G).
** Computed as a ratio between the implicit and legal tax rate.

Revenues from personal income tax according to cash standards have performed better than expected, exceeding the initial program by about 1.22 billion lei (+6.2%) and also being higher than 2011 earnings by 1.81 billion lei (+9.5%). This evolution reflects an average wage growth of 5% and improved conditions in the labor market (+3.12% in the number of employees in the economy[6]), while the slight increase in the implicit tax rate compared to the previous year is probably attributable to an increase in collection efficiency. Moreover, in recent years, the revenues from personal income tax have advanced steadily at a rate higher than the one registered by the corresponding macroeconomic tax base. The improvement in collection efficiency is evident, as demonstrated by the efficiency index, which is at the maximum of the last ten years. However, the figures should be interpreted with some caution, given that in the recent years, the successive increases of salaries in nominal terms were not accompanied by a revision of the income tranches on which tax deductions are granted. Thus, a given dynamics of the gross wages can generate higher revenues from personal income tax, without being necessarily based on an increase in the efficiency of collection.

[6] Dynamics calculated based on NIS data regarding employees from firms with more than 4 employees.

Figure 8: Implicit tax rate and taxation efficiency index for personal income tax in Romania



Source: Fiscal Council's calculations

Compared with other countries in the region, Romania kept its second position in the sample[7], with an efficiency of 88% and an implicit tax rate of 14% (calculated as the ratio of direct taxes paid by households[8] and gross wages from national accounts - including shadow economy, for which social security contributions paid by employees were deducted from salaries).

[7] Data regarding gross wages from the national accounts in 2012 are not yet available for Poland.

[8] Include also other forms of taxes paid by the population (e.g. tax on capital gains, interest income and pensions), not just wages. Unfortunately, no detailed data are available on types of taxes paid by the population in order to take into account only taxes on wages. This is the explanation for which the value of efficiency index may be higher than one (see for example Bulgaria in the period 2010-2012).

Table 8: Taxation efficiency – Personal income tax												
Country	**Legal personal income rate* (%)**			**Implicit tax rate****			**Taxation efficiency index *****			**Rank**		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
BG	10.0	10.0	10.0	10.3	10.3	10.7	1.03	1.03	1.07	1	1	1
CZ	15.0	15.0	15.0	8.3	8.8	8.7	0.55	0.59	0.58	10	10	9
EE	21.0	21.0	21.0	15.5	15.8	16.0	0.74	0.75	0.76	5	5	5
LV	26.0	25.0	25.0	19.6	19.6	18.7	0.75	0.78	0.75	4	4	6
LT	15.0	15.0	15.0	12.4	12.7	12.8	0.82	0.84	0.85	3	3	3
HU	24.5	16.0	16.0	15.2	11.8	12.3	0.62	0.74	0.77	7	6	4
PL	25.0	25.0	25.0	18.0	18.4	NA	0.72	0.74	NA	6	7	NA
RO	16.0	16.0	16.0	13.7	13.7	14.0	0.86	0.86	0.88	2	2	2
SI	27.0	27.0	27.0	15.9	16.2	16.6	0.59	0.60	0.62	8	9	8
SK	19.0	19.0	19.0	10.8	11.5	11.8	0.57	0.61	0.62	9	8	7

Source: European Commission, Eurostat, Ministry of Public Finance, Fiscal Council's calculations

* For countries with progressive taxation system (Hungary - until 2011, Poland, Slovenia), the figure reported is the average tax rate (Hungary, Poland - with two tax rates) or central rate (in Slovenia- three tax rates).

** Computed as the ratio between "revenues from direct tax paid by the population" and personal income tax base defined as gross wages from the national accounts from which social insurance contributions paid by employees were deducted. For Czech Republic and Hungary, the personal income tax base is "compensation of employees", which includes social security contributions paid by employers, given the use of the "super grossing" in computing the personal income tax due.

*** Computed as a ratio between implicit tax rate and legal tax rate.

Figure 9: Corporate income tax, 2012 (billion lei)

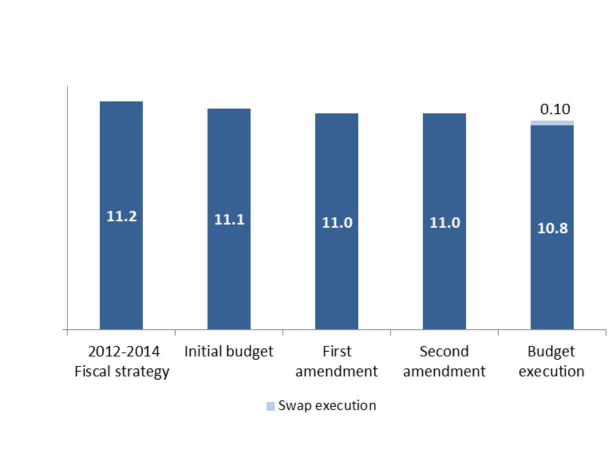
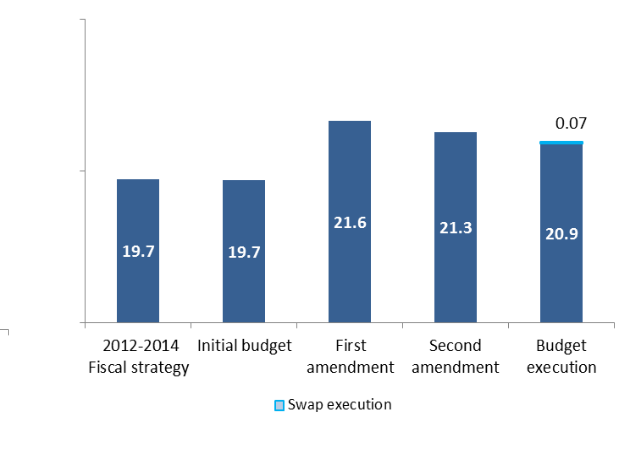


Figure 10: Personal income tax, 2012 (billion lei)

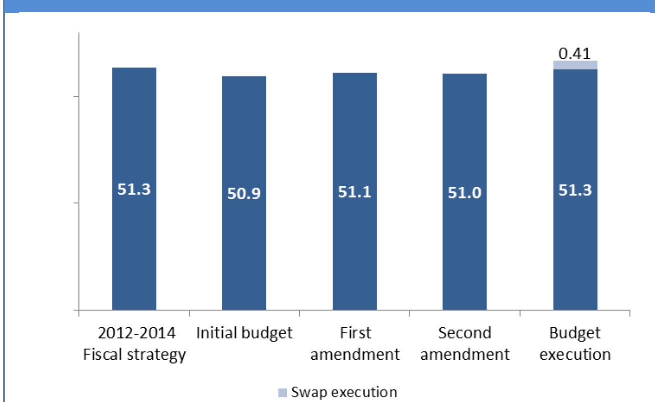


Source: Ministry of Public Finance

III.2.3. Social contributions

Revenues from social contributions, totaling 51.66 billion lei at the end of 2012 by cash standards, have exceeded initial estimates by 713 million lei given that the impact of implemented compensation schemes was +408 million lei, these not being included in the initial budget. This level stood above the one estimated at the second amendment by 202 million lei, registering an increase (net of the impact of compensation schemes) of 2.68% compared with the level of the previous year.

Figure 11: Social security contributions in 2012 (billion lei)

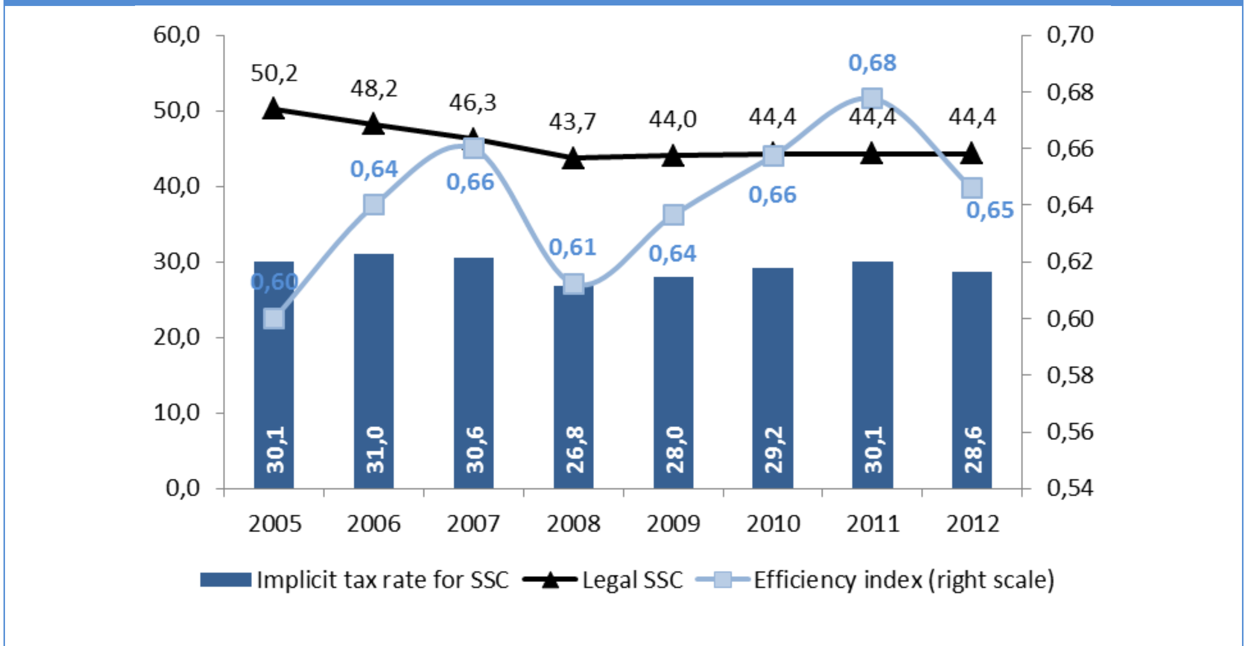


Source: Ministry of Public Finance

The revenue dynamic was lower than that of the relevant macroeconomic base (gross wages from the national accounts and the number of employees), which implies a decrease of the implicit tax rate and a deterioration of the taxation efficiency index (from 0.68 to 0.65). These evolutions are explained mainly by the impact of refunding the amounts from social security contributions illegally collected from pensioners (given that such amounts were collected during 2011, creating a base effect) and the increase in the amounts transferred to the second pillar which are recorded in the budget execution as revenues with a minus sign ("negative" revenues).

However, compared with the evolution of revenues from personal income tax (+9.5%) whose trajectory is affected by the same macroeconomic base, the dynamic of social contributions receipts is modest, suggesting a loss of collection efficiency. Moreover, the implicit tax rate related to social security contributions is lower than in 2010, before widening of the tax base (extended health insurance contributions for pensions over 740 lei monthly, redefining dependent activities and the introduction of social security contributions for military personnel).

Figure 12: Evolution of implicit tax rate and taxation efficiency index for SSC in Romania



Source: Fiscal Council's calculations

In comparison with other countries in the region[9], Romania continues to be ranked last in the matter of social contributions collection efficiency, the implicit tax rate being below the level from several countries that perceive a lower level of social security contributions. Thus, even if the aggregate statutory contribution rate ranks third in the region (after Slovakia and Czech Republic), Romania's implicit tax rate is close to the one of Latvia, which occupies the penultimate place in the region, considering the statutory rate of social security contributions. An improvement in the taxation efficiency index to a level equal to the one from Latvia (the country with the closest level of the taxation efficiency index) would have generated additional budget revenues of 4.4 billion lei (0.76% of GDP) in 2012.

[9] Data regarding gross wages from the national accounts in 2012 are not yet available for Poland.

Table 9: Taxation efficiency – Social security contributions												
Country	**Legal tax rate for SSC* (%)**			**Implicit tax rate****			**Taxation efficiency index*****			**Rank**		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
BG	28.9	31.0	31.0	21.3	22.6	22.8	0.74	0.73	0.74	7	7	6
CZ	45.3	45.3	45.3	47.7	47.8	47.8	1.05	1.06	1.05	1	1	1
EE	37.2	37.2	37.2	36.5	35.2	33.4	0.98	0.95	0.90	2	3	2
LV	33.1	35.1	35.1	23.4	25.0	24.7	0.71	0.71	0.70	9	9	8
LT	40.1	40.1	40.1	36.5	36.2	35.9	0.91	0.90	0.89	4	4	5
HU	44.0	44.5	47.0	33.1	36.6	35.7	0.75	0.82	0.76	8	8	7
PL	37.9	37.6	39.6	34.5	36.5	NA	0.91	0.97	NA	2	2	NA
RO	44.4	44.4	44.4	29.2	30.1	28.6	0.66	0.68	0.65	10	10	9
SI	38.2	38.2	38.2	33.1	33.4	33.8	0.87	0.87	0.88	5	6	4
SK	48.6	48.6	48.6	42.2	42.4	43.5	0.87	0.87	0.90	6	5	3

Source: European Commission, Eurostat, Ministry of Public Finance, Fiscal Council's calculations

* Aggregate data for employer and employee. Where rates were changed during the year, weighted average was used.

** Computed as the ratio between "actual social contributions" (cod ESA D.611) and "gross wages and salaries" (cod ESA D11). For Romania, 2011 and 2012 budget revenues include additional receipts due to implementation of compensation scheme for clearing arrears (+726 million lei in 2011 and +476 million lei in 2012).

*** Computed as the ratio between implicit and legal tax rate.

III.3. Budgetary expenditures

Budgetary expenditures, net of compensation schemes' impact, have grown slowly (+1.38% compared to the previous year) to 205.7 billion lei, mainly due to the declining of the expenditure funded from reimbursable funds by 23.4% compared to 2011 and reduced capital expenditure by 18%. Expenditure items that registered an increase compared to 2011 are interests (+20.6%), subsidies (+9.65%), goods and services related expenditure (+7.57%) and personnel expenditure (+5.98%).

Figure 13: Quarterly revenues of the general consolidated budget (million lei)

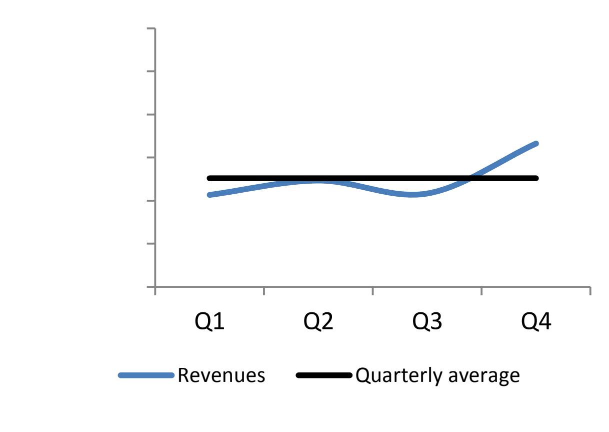
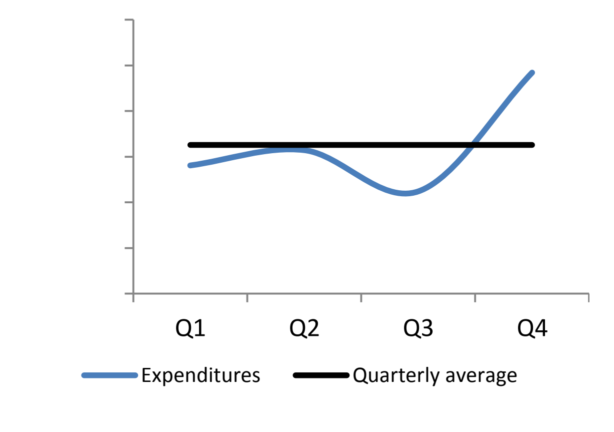


Figure 14: Quarterly expenditures of the general consolidated budget (million lei)

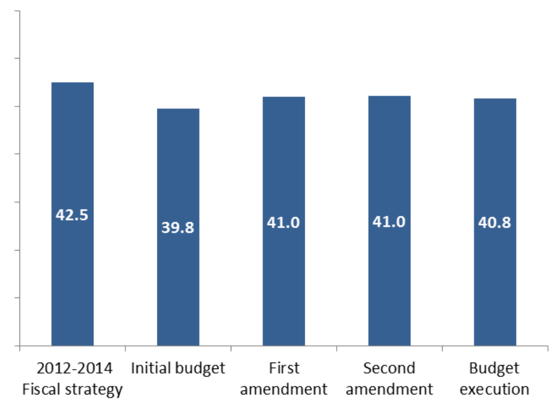


Source: Fiscal Council's calculations
Note: values excluding compensation schemes' impact

In 2012, the quarterly evolution of the general consolidated budget expenditures still indicates a spending acceleration in the last quarter of the year. Specifically, the total spending in Q4 2012 reached 59.2 billion lei, 28% higher than in the previous quarter, and approximately equal to Q4 2011. More than half of the spending hike in Q4 2012 was caused by capital spending (+ 83.8% compared to the previous quarter) and goods and services related expenditure which increased by 28% due to payment of arrears at the end of the year. The expenditure concentration in the last quarter highlights serious weaknesses in the budgetary programming process although the principle of prudence might partial justify the postponement of some expenditure until the projection regarding the budgetary incomes has a low degree of uncertainty.

III.3.1. Personnel and social assistance expenditure

Figure 15: Personnel expenditure in 2012 (billion lei)

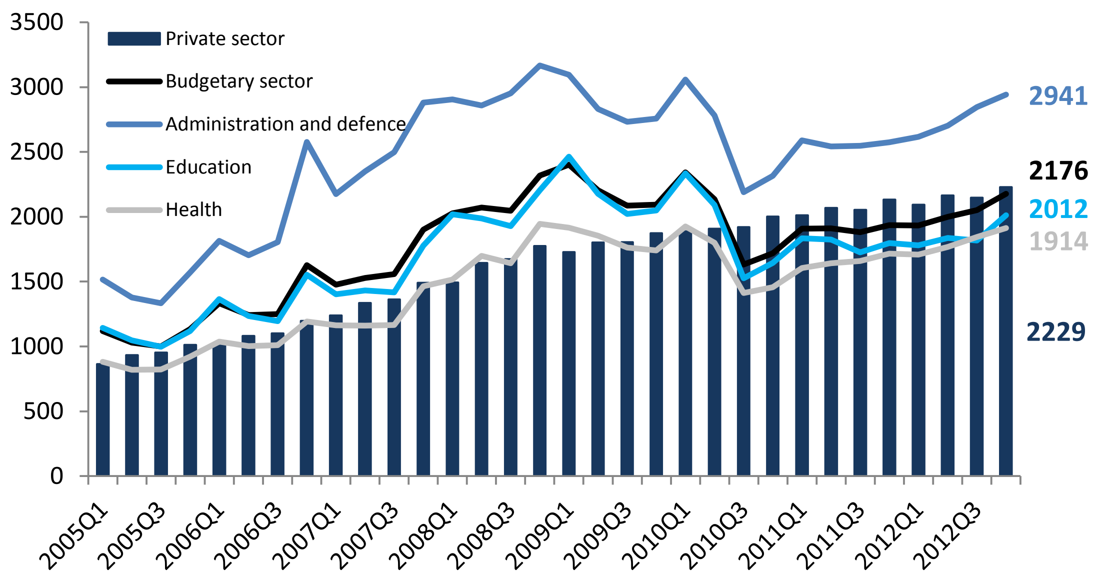


Source: Ministry of Public Finance

Personnel expenditures were revised upward during 2012, due to the decision of restoration of the salaries in the public sector (+8% in June 2012 and 7.5% in December 2012), despite the fact that the increase of expenditure after approval of the state budget is prohibited by the Fiscal Responsibility Law no. 69/2010. In order to promote a predictable fiscal framework based on clear rules and targets, the Fiscal Council recommends the inclusion in the draft budget of any changes regarding the wage policy.

Compared to 2011, personnel expenditures increased by 5.98%, 4 percentage points of this increase being explained by the restoration of the salaries in the public sector. The impact of this measure will be fully reflected in 2013 as the average salary in the public sector is projected to increase by 10.5% compared to 2012, the budgetary effort for 2013 amounting to 4.3 billion lei.

Figure 16: Average gross earnings in the private and public sector in the period 2005-2012 (lei/month)

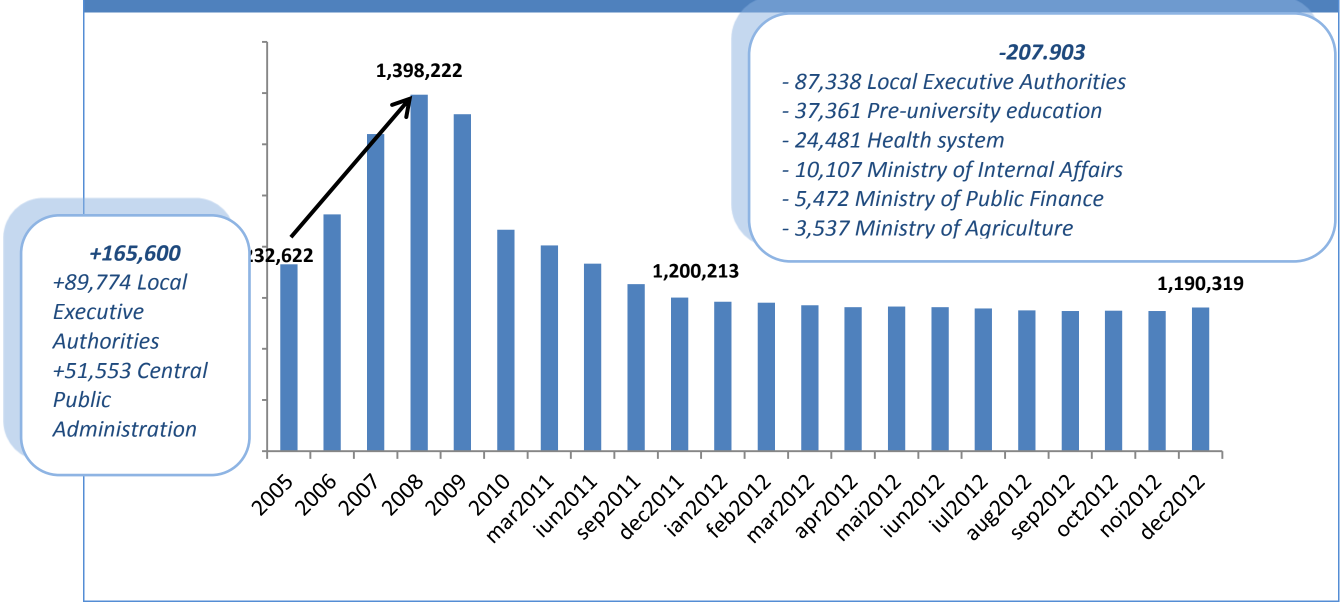


Source: National Institute of Statistics, Fiscal Council's calculations

Public employment decreased by 207,903 persons (to 1.19 million employees) between end-2008 and December 2012 (*Figure 17*), after an increase of 165,600 persons recorded in the period 2005 - 2008. The adjustment recorded in the period 2008 – 2012 was mainly at the level of local executive authorities[10], pre-university education, health system, Ministry of Internal Affairs, Ministry of Public Finance and Ministry of Agriculture. During the same period, increases were recorded in the General Secretariat of the Government (+3,899), Ministry of Labor (+1,820), Ministry of Justice (+1,789) and Ministry of Economy (+1,475).

Compared to the previous year, the total number of employees declined by 9,894 in 2012, mainly due to departures in local executive authorities (-9,653 employees). If in previous years, the reduction rate of public employment was sustained, the year 2012 being characterized by a sharp slowdown despite maintaining of the "1 to 7" staff replacement rule in the public sector.

Figure 17: Evolution of public sector employment

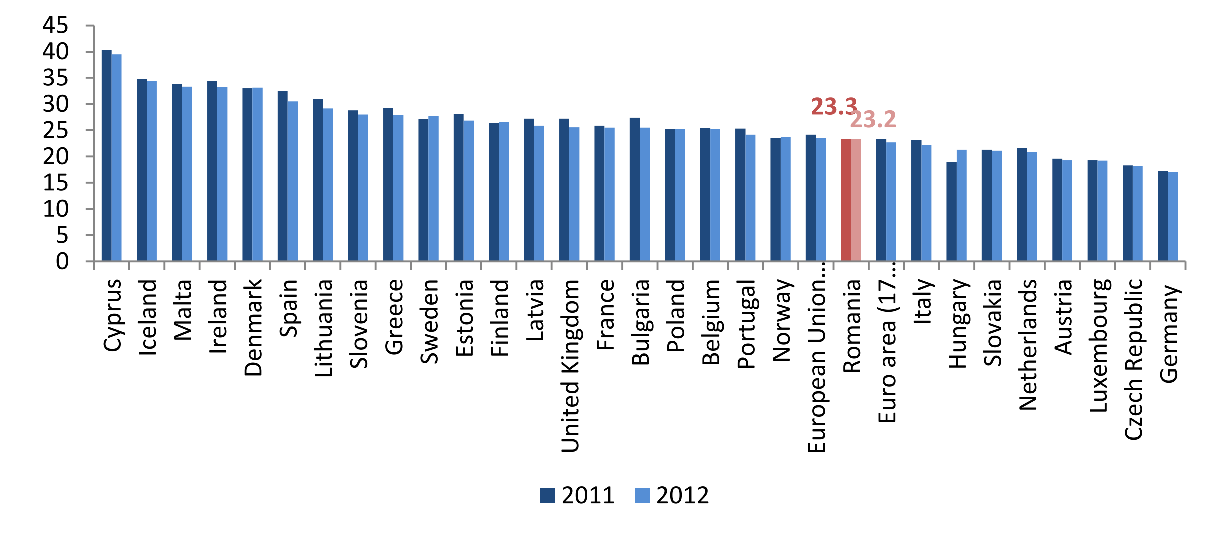


Source: Ministry of Public Finance

Compared to other European countries, Romania's position, in terms of the wage bill in the public sector as a percentage of the total revenues collected, has improved due to the fiscal consolidation measures undertaken since mid-2010. In 2010, the wage bill as a share of total budgetary revenues placed Romania in the first half of the ranking, while 2012 ESA95 data revealed a much better ranking for the country, although registering a higher expenditure than other comparable economies like Hungary, Czech Republic or Slovakia.

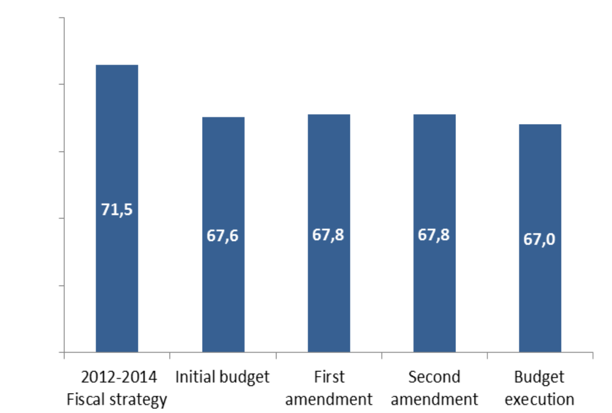
[10] It is possible for some of these reductions to be reflected in service outsourcing, explained by a significant increase in spending on goods and services.

Figure 18: Wage bill as a share of total budget revenues in EU27 countries



Source: EUROSTAT, 2012 data

Figure 19: Social assistance expenditure, 2012 (billion lei)



Source: Ministry of Public Finance

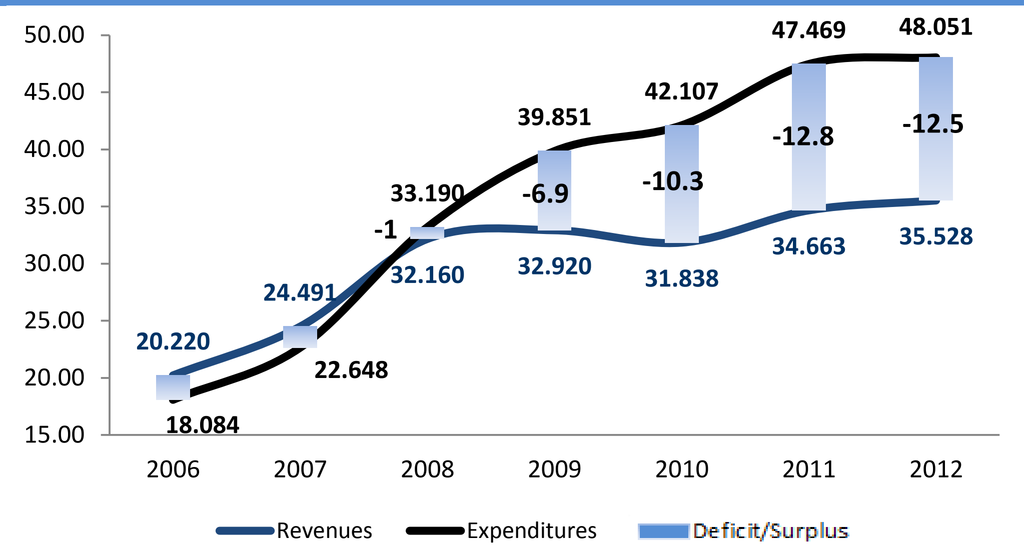
The budgetary execution shows that social assistance expenditures were in line with the forecasts. In the initial budget, the level of social assistance expenditure, net of the compensation schemes' impact, was set at 67.6 billion lei, but it only reached a level of 67 billion lei, 0.9% less than in the baseline scenario and 1% lower compared to the value registered in 2011. This reduction can be explained by the fact that the increase in pension expenditure (entirely due to the entry into the system of retirees with pensions higher than the average while maintaining constant the pension point in 2012) was exceeded by other social assistance items' decreases.

Social assistance expenditure have a significant share in the total budget expenditure and the structural problem of the public pension system deficit is not yet solved. Thus, pension expenditure is unsustainable in relation to the contributions collected, even if some measures were undertaken in order to improve this shortcoming in the medium and long run[11]. In recent years, social security budget deficit widened, reaching 12.5 billion lei in 2012 (2.2% of GDP), a

[11] Law 263/2010 regarding the unitary system of pubic pensions modifies the indexation system, increases standard retirement age and introduces more stringent criteria for early retirement.

slight improvement compared to the negative balance of 12.8 billion recorded in 2011. Pension expenditure advanced by 0.6 billion lei in 2012, mainly due to the entry of new participants in the pension system with higher-than-average pensions, while the revenues increased by only 0.8 billion lei, being partially affected by refunding the health contributions illegally collected from pensioners which are recorded in the budget execution as "negative" revenues. Given these changes, there are important risks regarding the medium term sustainability of the social security budget and the appropriateness of any potential pension increases or contributions reductions should be considered only in the context of identifying alternative solutions to reduce the system's deficit, especially by broadening the tax base. The new pension law should support on the medium and long term the improvement of the financial situation of the social security budget, under a strict application of its provisions.

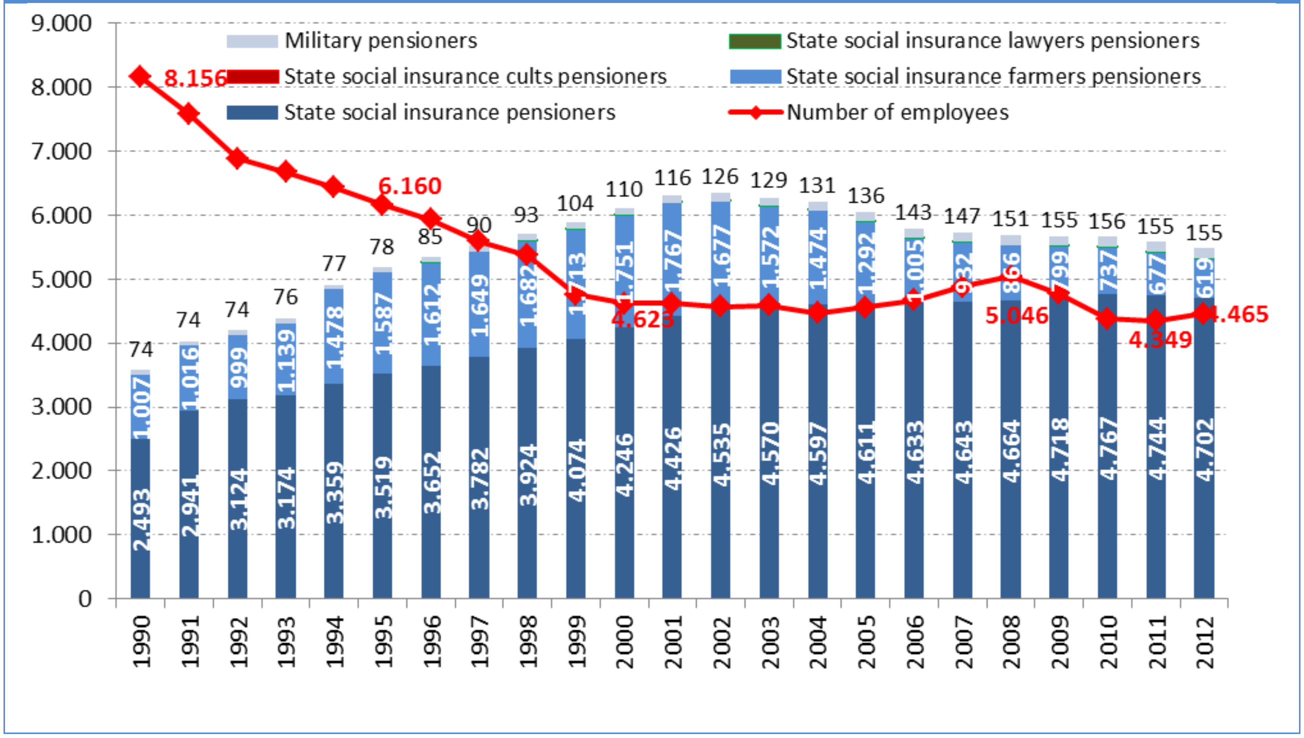
Figure 20: Revenue and expenditure of social security budget (billion lei)



Source: Ministry of Public Finance, cash-standard data

The financial situation of the pension system has deteriorated since 1990, the ratio of the number of contributors and the number of pensioners falling substantially, from 2.3 employees to a pensioner in 1990 to only 0.8 employees to a pensioner in 2012, the number of pensioners registering an increasing trend, while the number of employees had a decreasing trend, especially during 1999-2000.

Figure 21: The evolution of the number of pensioners versus the number of employees



Source: NIS

Through the new pension law (Law no. 263/2010 on the unified public pension system), a number of objectives aiming at improving the financial condition of the public pension system on the medium and long term were envisaged:

- separating the evolution of the pension point from the evolution of the nominal[12] wage, by indexing the pension point with 100% of the inflation rate, plus 50% (this percentage drops to 45% starting in 2021 and subsequently decreases by 5 percentage points per year until 2030, when it reaches 0%) of the real increase in gross average wages, realized during the previous year;
- integration in the unified public pension system of the persons belonging to special systems (military pensions) as well as of the persons who obtain income from liberal professions;
- introduction of more stringent requirements regarding the access to early pension and to disability pension;

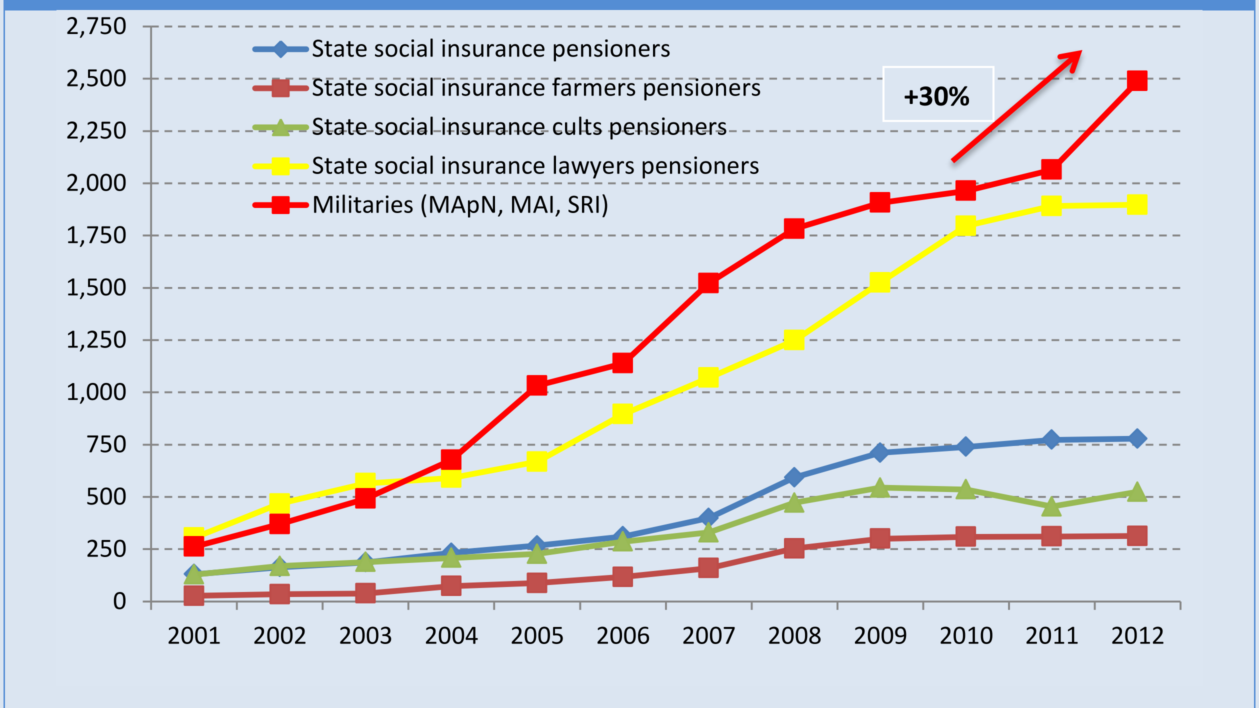
[12] The value of a pension point was previously established by law 19/2000 by updating it with at least the inflation rate, but the pension point value could not be less than 37.5% of the gross average wage used to the elaboration of the social security budget, starting the first of January 2008, respectively than 45% of the gross average wage used to the elaboration of the social security budget, starting with the first of January 2009.

- calculating all pensions based on the contribution principle, respectively in a direct correlation with the level of the income for which social security contributions were paid;
- increasing the retirement age due to increased life expectancy of the population and the gradual equalization – until 2030 – of the complete contribution period for women and men.

Box 1: The budgetary impact of recalculating military pensions

Military pensions recalculated or revised, according to Law no. 119/2010 regarding some measures on pensions and to Government Emergency Ordinance no. 1/2011 regarding some measures on pensions to beneficiaries from the system of defense, public order and national security, approved by Law no. 165/2011, amended and supplemented, increased by 30% (the average pension), after the recalculation, in the period 2010 – 2012, while that the initial forecasts indicated a decrease of these pensions after applying the contributiveness principle.

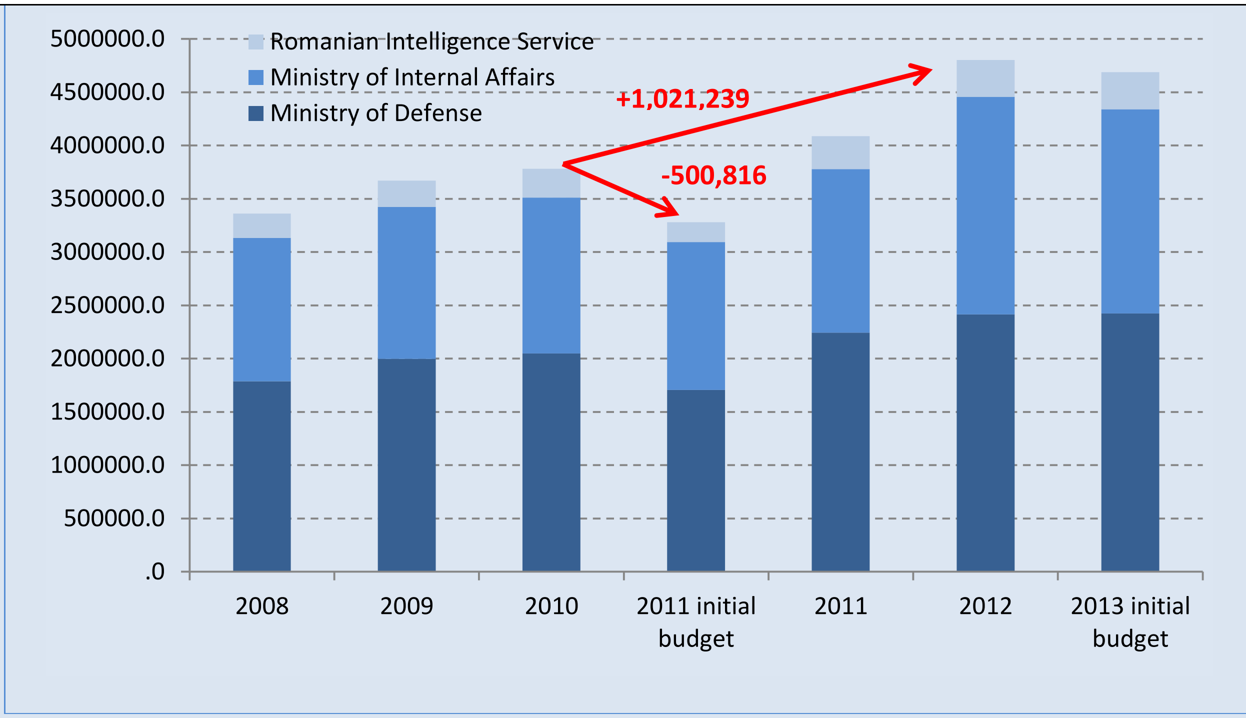
Figure 22: The evolution of the average pension (lei)



Source: NIS

The savings projected by the Government from the special pensions recalculation, amounted to 86.8 million lei in 2010, 260.6 million lei in 2011, 267.9 million lei in 2012, 274.6 million lei in 2013 and 281 million lei in 2014. However, the recalculation resulted in an increase of the fiscal effort of more than 1 billion lei.

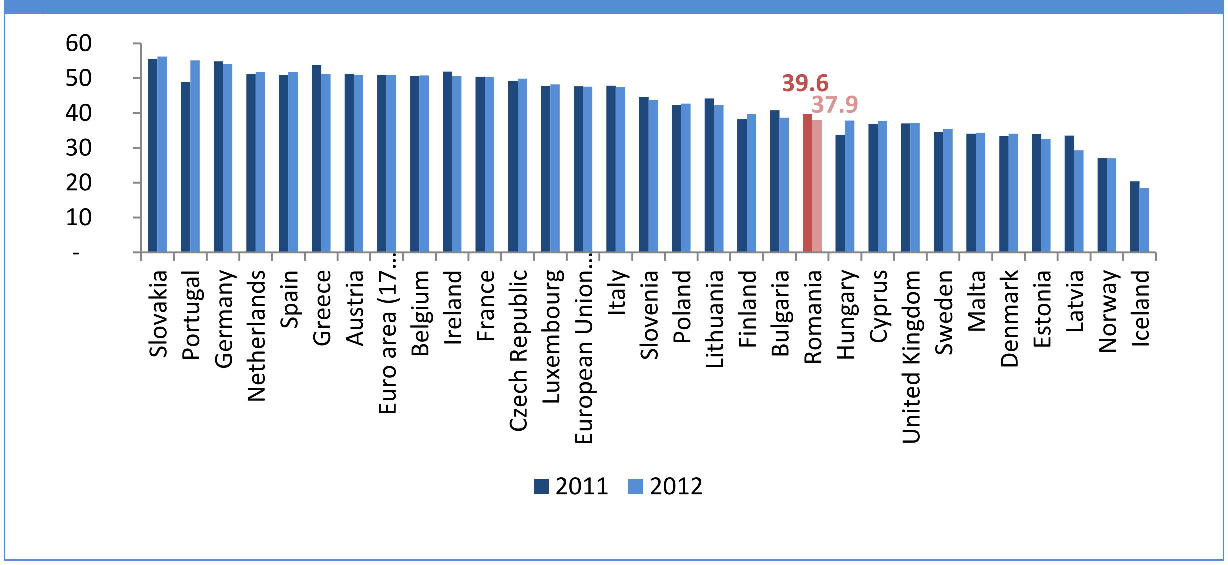
Figure 23: Evolution of budgetary expenses for military pensions (lei)



Source: NIS

In 2012, Romania's position regarding the social assistance expenditure share of total income has improved compared to 2011, being in the second half of the EU's ranking. However, they remain at a significantly higher level than the social contributions collected.

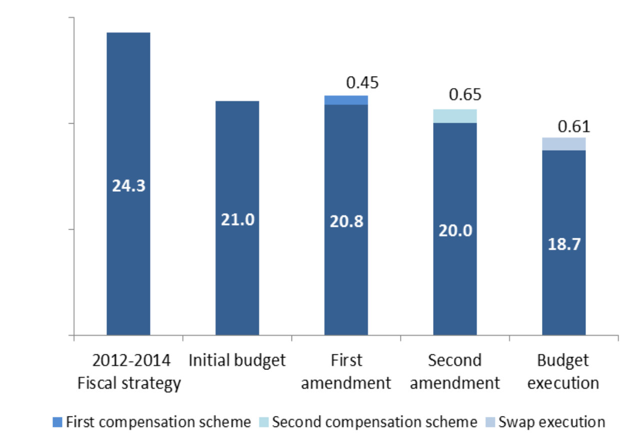
Figure 24: Social expenditure as a share of total budget revenues in EU27



Source: EUROSTAT

III.3.2. Public investment expenditure

Figure 25: Capital expenditure in 2012 (billion lei)



Source: Ministry of Public Finance

Among the items of public investment expenditure, which include capital expenditure, projects funded by external post-accession grants, expenditure for reimbursable programs and other transfers related to investments, capital expenditure registered a steep decrease in 2012, being below the level programmed in the second amendment (from October 2012) by 1.3 billion lei and by 2.3 billion lei lower than the initial budget.

Moreover, adjusting the capital expenditure was a way for the Government to achieve fiscal targets.

Figure 26: Projects funded by external post-accession grants, 2012 (billion lei)

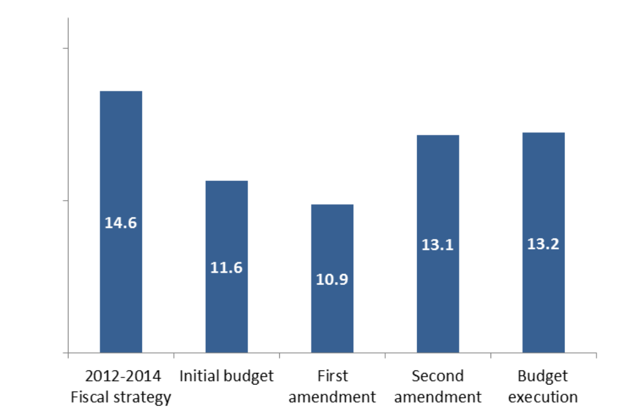
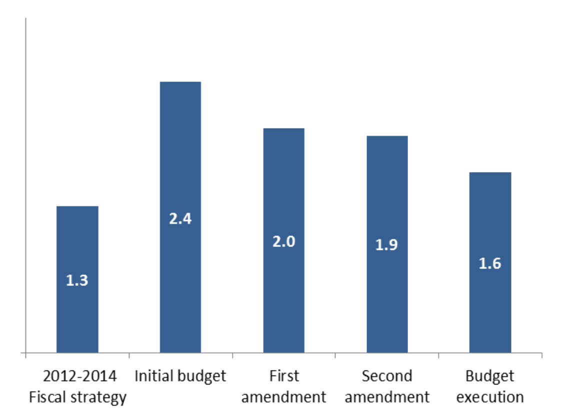


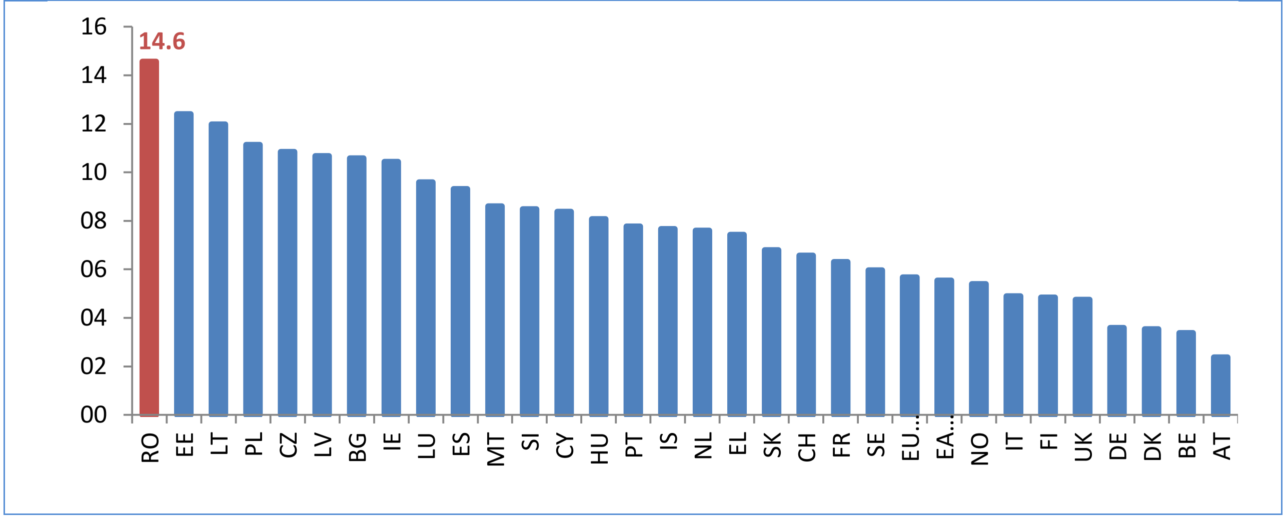
Figure 27: Expenditure funded from reimbursable funds, 2012 (billion lei)



Source: Ministry of Public Finance

During the period 2001-2012, Romania had one of the highest allocations for public investment expenditure as a share of total budgetary revenues (ESA95 standards), compared to EU27 countries. However, the results in terms of improving infrastructure quality were poor.

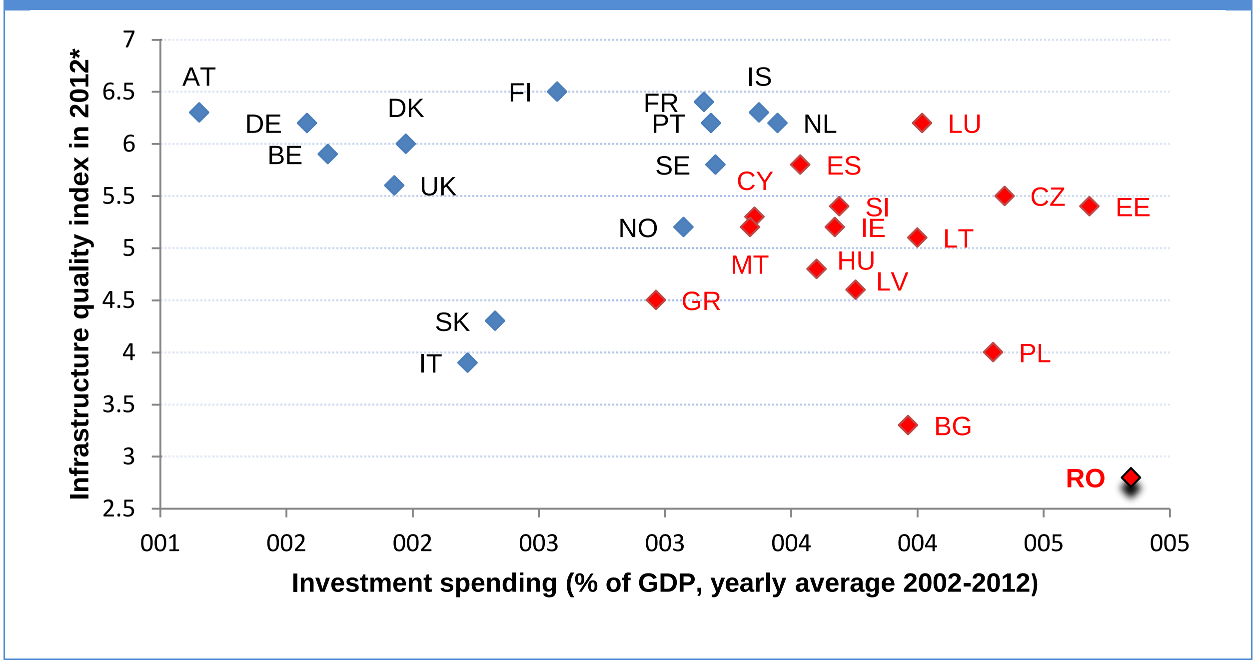
Figure 28: Public investment expenditure share in total budgetary revenues in EU27 (2001-2012 average)



Source: EUROSTAT

Although between 2001 and 2012 Romania had the largest public investment expenditure as a share of GDP among European countries, states like Poland, Hungary, Bulgaria, Slovakia and Slovenia, with lower investment expenditure, have a better infrastructure quality, which shows the low efficiency of this expenditure item in Romania *(Figure 29).*

Figure 29: Public investment expenditure and infrastructure quality



Source: EUROSTAT, World Competitiveness Report 2012-2013

Despite the previous recommendations of the Fiscal Council regarding the necessity of elaborating a list of priorities for all national investments, there are still lacking specific information on: investment distribution on sectorial policies, details on investment projects considered as being a priority and multi-annual fund allocations for these projects. In the Fiscal Council's opinion, more transparency in elaborating the investments budget based on a proper analysis of the existing projects portfolio and rationalizing it by prioritizing the projects, altogether with multi-annual allocation of funds is vital for an efficient use of available resources. In addition, such an approach would be consistent with the efficiency principle defined by the Fiscal Responsibility Law, according to which "the Government's fiscal and budgetary policies will be based on achieving an efficient use of scarce public resources requiring economic efficiency to be considered in defining fiscal policies and public investment decisions, including those related to EU funded initiatives or other donors, to be based inter alia on an economic appraisal as well as an assessment of the capacity to absorb increased funding levels".

In addition, the new budgetary constraints imposed by the fiscal pact oblige also to a more efficient spending of the public funds. Considering the same budgetary resources, an additional limitation of the budget deficit target imposes new solutions in order to obtain higher effects in the economy through the same level of public spending.

III.3.3. The contingency reserve fund

According to the Public Finance Law no. 500/2002, the contingency reserve fund at Government's disposal is allocated to line credit officers from state government and local governments, based on Government's decision to finance urgent or unforeseen expenditures incurred during the year. However, the law does not specify explicitly the categories of expenses that can be undertaken from the contingency reverse fund and it does not mention any limitations on the amount of allocations, thus providing space for discretionary and non-transparent allocations.

According to Government Emergency Ordinance no. 8/2012 for establishment of some financial measures, it is stated that by derogation from the provisions of article 30 paragraph (2) of the Public Finance Law no. 500/2002, from the contingency reserve fund at Government's disposal amounts can be allocated by Government decisions to pay arrears, but only until the end of 2012. It should be noted that in 2011, the Government used a similar derogation from the Public Finance Law, initiating an ordinance that provides the possibility for money allocation from the contingency reserve fund to settle the arrears. Although clearing the state outstanding payments towards the economic agents is an important element for improving their liquidity position and for promoting economic growth, the allocation of funds from the contingency reserve fund for this purpose can be justified only on the short term. In the medium term, the solution is to improve the budget programming process and to find viable solutions for eliminating the structural causes that led to the accumulation of arrears.

The opportunity of including a contingency reserve fund into the general budget is confirmed by the literature on budget programming, which also highlights the necessity of finding a balance regarding the dimension of such a fund. Thus, a too low level of the contingency reserve fund might be insufficient to cover unforeseen expenditures, while an oversized fund might grant too much power for the authorities to make excessive outlays, without the Parliament's approval.

In the international practice[13], national budgets include a contingency reserve fund usually between 1 and 3% of the total budgetary expenditure, the ceiling being established by the national Parliaments, which are regularly informed by the Governments on the amount and destination of the spending funded from this source. According to an IMF study[14], the best practices in budget programming provide strong requirements regarding the access to the reserve fund, the type of expenditure that can be approved and the frequency of reporting to the legislative on the reserve fund utilization level.

This report studies the use of the contingency reserve fund at Government's disposal during 2012, by identifying the Government's decisions published in Romania's Official Journal which allocates money from the budget reserve fund to line credit officers and to specific destinations.

[13] Potter şi Diamond (1999), „Guidelines for Public Expenditure Management", International Monetary Fund
[14] Ian Lienert (2010), „Role of the Legislature in Budget Processes", Fiscal Affairs Department, International Monetary Fund

Figure 30: Total contingency reserve fund allocations (billion lei)

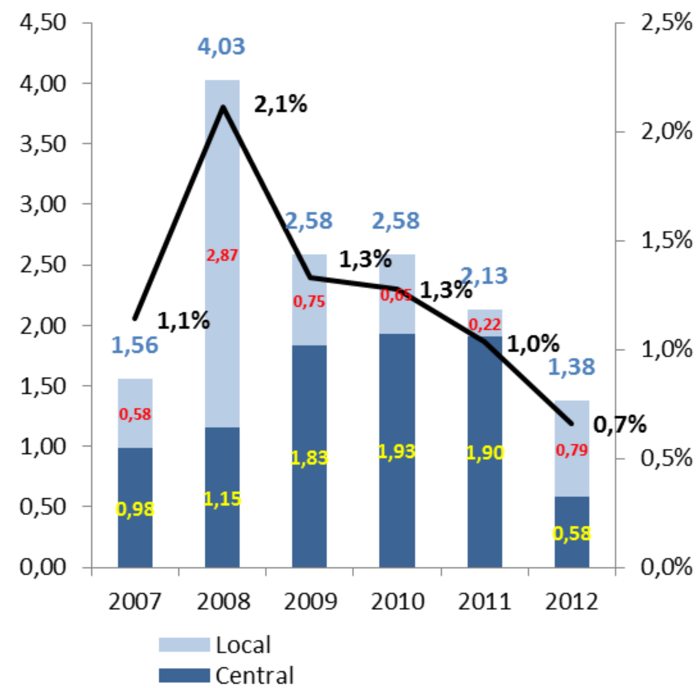
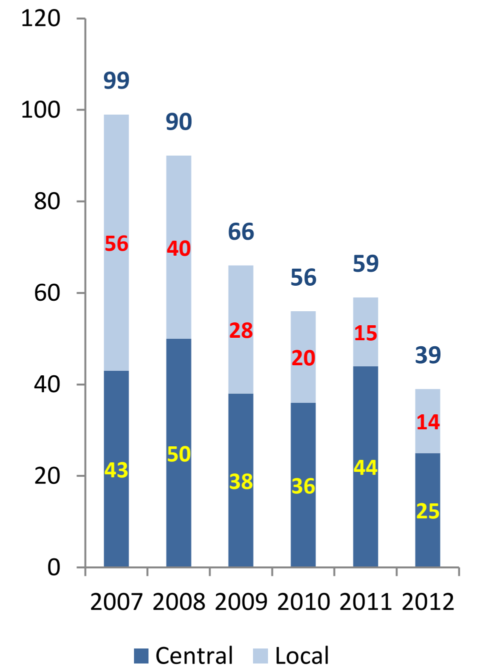


Figure 31: Number of Government decisions regarding contingency reserve fund allocations



Source: Fiscal Council's calculations

Thus, during 2012, 1.38 billion lei (0.7% of total expenditure) have been allocated from the contingency reserve fund, of which 0.58 billion were allocated for the central administration and about 0.79 billion for local authorities. Among allocations, the largest share was distributed for arrears payment and to ensure the co-financing for projects funded by external post accession grants, these amounting 884 million lei (64.23% of total allocations). Compared to the previous year, the contingency reserve fund allocations were lower by 750 million lei (35.27%), in the context of reduced amounts transferred to central administrations by 1.32 billion lei and increased transfers to local authorities by 0.52 billion lei. Recent years' evolution shows an improvement in the budget programming process regarding the contingency reserve fund, as the amounts allocated, as well as the number of Government decisions promoted to use the resources from this fund for unforeseen expenses decreased.

The amounts initially considered for the contingency reserve fund totaled approximately 227 million lei, representing about 1/6 of the total amount spent in 2012 by allocations from this fund. This situation was possible as a result of the expansion of the reserve fund by canceling budgetary credits from some of the authorizing officers and allocating the money to this fund.

In its report for 2011, the Court of Accounts, identified some practices of oversizing the necessary budgetary credits for certain authorizing officers, the additional resources being directed to the reserve fund, only to be discretionary spent later. Moreover, the Court of Accounts also identified in the above mentioned report other problems regarding the use of the reserve fund: the lack of clear and formalized criteria for classifying the expenditures that can be financed from the contingency reserve fund in the category of urgent or unforeseen expenses; perpetuating the situation observed in the previous years of allocating money from the contingency reserve fund without any control on the final objective provided by the law under which they were assigned; the increase of several times compared with the initial allocation of the amounts that can be spent from the reserve fund. Thus, the Court of Accounts notes that "the contingency reserve fund at Government's disposal received allocations through non-transparent renunciations and was also used in a non-transparent manner, by Government decision without parliamentary control, operating almost like a parallel budget".

Considering the best practice in this area and the Court of Accounts conclusions, the Fiscal Council recommends explicit identification of expenditure that can be made from the contingency reserve fund and a higher transparency, through reporting on a regular basis to the Parliament about the use of this fund. Thus, detailed allocations from the contingency reserve fund, presenting the conditions and criteria of allocations, and a breakdown between line credit officers are required. The Fiscal Council also recommends to limit the amounts that can be distributed and used from the fund as share of total budgetary expenditure, a level of 1% being apparently adequate, given the previous developments.

According to article 30, paragraph (4) of the Public Finance Law no. 500/2002, the intervention reserve fund at Government's disposal is allocated, based on government decisions, to some authorizing officers of the state and local budgets, to finance urgent expenditures designed to eliminate the effects of natural disasters and to support the individuals affected. If the possible destinations of the allocations from the contingency reserve fund can be interpreted differently, in the case of the intervention fund, the allocations' destinations are clearly indicated in the law, the existence of such a fund being justified. In 2012, the amounts allocated from the intervention reserve fund at Government's disposal amounted to 63.45 million lei and their destinations are in accordance with the Public Finance Law.

III.4. The public debt

The interest expenditure increased by 1.8 billion lei (+20.6%) compared to 2011, due to the rising of the public debt stock. The final value of this expenditure was higher than the one originally projected, despite the decline in bond yields during the year. The favorable effect of the lower financing costs was canceled by the nominal depreciation of the domestic currency relative to the major currencies, given that more than half of the public debt is denominated in euro, and by the decision of the Ministry of Finance to increase the Treasury's liquidity reserves, in order to finance in advance the general government deficit and to create a safety buffer for adverse conditions in the financial markets.

The public debt continued to rise in 2012, its value as a share of GDP increasing according to ESA95 methodology to 37.8%[15] from 34.7% at the end of 2011, in the context of a 2.9% of GDP budget deficit. The growth rate of the public debt decreased, despite the below expectations economic advance, slowing to 3.1 percentage points of GDP compared to 4.2 percentage points in 2011 due to the significant reduction of the budget deficit, lower interest rates and a slightly higher-than-forecasted GDP deflator. According to national standards, public debt increased to 41% of GDP at the end of 2012, compared to 40.1% in 2011 and 37.9% in 2010.

Central Government public debt[16] represents 93.23% of the total debt, compared to 92.71% in 2011, while local public debt is 6.77%, down from the level of 7.29% registered in the previous year. State loans have the largest share in total public debt, totaling 34.5%, followed by bonds, which represent 32.1%, and euro-bonds with 14%, while Treasury bills provide 12% of total public debt.

Regarding the maturity structure of newly issued government securities, there are substantial changes compared to the previous year as the Ministry of Finance succeeded in a greater extent to attract resources on a longer term. Thus, Treasury bills with a maturity up to one year accounted in 2012 only for 47% of new loans, compared to 67% in 2011, while the share of longer term financing advanced significantly, totaling 53% of loans. The increasing share of longer terms securities was favored by both lower yields and an improved risk perception regarding Romania.

The debt structure by currencies reveals a slight decreasing share of the debt denominated in national currency to 41.2% in 2012 from 42.3% in 2011, while funding in euro maintained its relative importance approximate to 47.5% of total public debt. State loans from the U.S. market led to an increasing share of the financing in dollars from 2.9% in 2011 to 5.5% in 2012.

The cost of attracting new resources in domestic currency registered a positive development as the government bond yields declined to about 6% at the end of 2012, compared to a level of 7% at the end of the previous year, as a result of reaching fiscal targets, reduced risk premium and a liquidity surplus in the financial markets.

[15] According to Public Debt Report for December 31, 2012, published by the Ministry of Finance. The Gross domestic product for 2012: 587,499 billion lei.

[16] According to ESA95 standards

In order to forecast the future evolution of the public debt in the coming years, its dynamic as a share of GDP can be expressed by the following formula, derived from the budget identity.

$$\frac{\boldsymbol{d_t}}{\boldsymbol{y_t}} = (\mathbf{1} + \boldsymbol{\lambda_t}) \times \frac{\boldsymbol{d_{t-1}}}{\boldsymbol{y_{t-1}}} + \frac{\boldsymbol{pb_t}}{\boldsymbol{y_t}} + \boldsymbol{sfa_t}$$

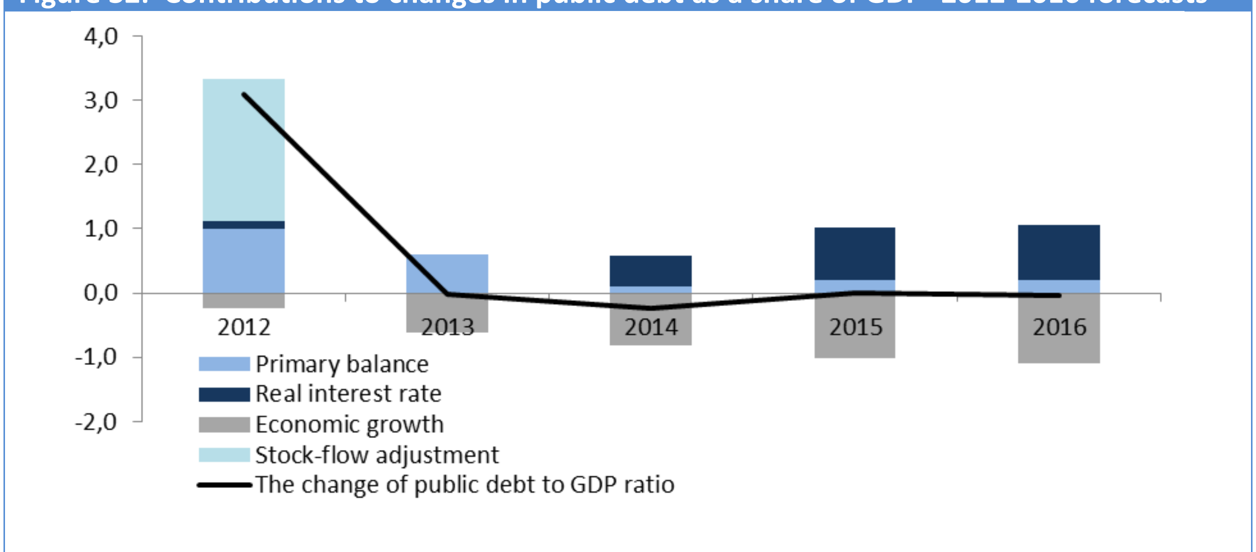
Where d_t is public debt stock at time t, y_t represents nominal GDP at time t, pb_t – is primary deficit at time t, sfa_t - stock-flow adjustments at time t, and

$$1 + \lambda_t = \frac{1 + i_t}{(1 + \pi_t) * (1 + \gamma_t)}$$

Where γ_t - real GDP growth rate during time t, i_t – interest rate at time t and π_t - inflation rate at time t.

The above relationship shows that public debt as share of GDP at time t depends on its weight in the previous period adjusted by the difference between the real interest rate and the economic growth rate, plus the consolidated general budget primary deficit expressed as percentage of GDP. In case of a real economic growth rate higher than the real interest rate for the public debt, the latter, expressed as a percentage of GDP, will have a downward trend even when the primary deficit equals to 0. It is therefore possible to reduce public debt as a percentage of GDP even when the primary balance registers a primary surplus lower than the interest expenditure provided that the real economic growth is higher than the real interest rate of public debt. The coefficient λ_t can be seen as a real interest rate adjusted by the economic growth.

Figure 32: Contributions to changes in public debt as a share of GDP- 2012-2016 forecasts

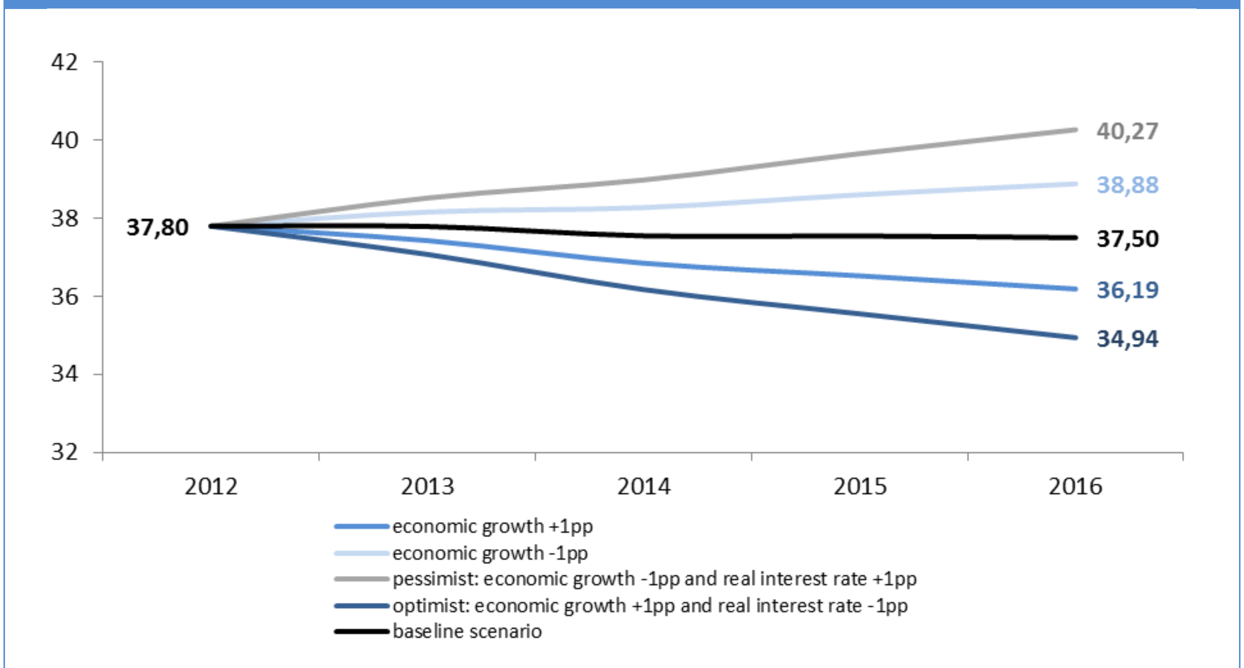


Source: NCP, Ministry of Public Finance, Fiscal Council's calculations

Using Government's official forecasts for the determinants of the trajectory of public debt, we computed their contributions to public debt variation as a share of GDP between 2012 and 2016. In 2012, the largest contribution to the increase in the stock of debt was generated by the stock-flow adjustment, mainly due to the decision of the Ministry of Finance to borrow in advance some of the amounts needed to finance the budget deficit, thereby increasing the Treasury reserves and as a result of the domestic currency depreciation relative to the major currencies which determined the increase of the total debt stock denominated in lei. In the period 2013-2016, according to the baseline scenario, the public debt is projected to be at a similar level to that of the end of 2012, the negative contribution of the real interest rate being offset by the acceleration of economic growth. The fiscal consolidation undertaken in the period 2010-2013 materialized in a significant reduction of the primary deficit, its contribution to the increase in the debt stock during 2013-2016 being very close to zero under the assumption of achieving budgetary targets.

The results obtained depend to a great extent on the forecasts used for the real interest rate and the growth rate of GDP. A higher-than-expected real interest rate involves additional costs for financing public debt and may lead to increased public debt as a share of GDP. Furthermore, a lower economic growth rate may cause an increase in the public debt's share to GDP compared to the initial forecasts. Considering the uncertainty associated to the forecasts, a sensitivity analysis is appropriate in order to assess the impact of changes in the variables used for evaluating the evolution of the public debt.

Figure 33: Scenarios for the evolution of public debt (% of GDP)



Source: NCP, Ministry of Public Finance, Fiscal Council's calculations

Under the baseline scenario, the public debt will be relatively stable during 2013-2016 and is projected to reach a level of 37.5% of GDP at the end of the period. In an optimistic scenario, characterized by a higher than expected economic growth by 1 percentage point and a lower real interest rate by the same percentage, a reduction in public debt to 34.94% of GDP will be observed. By contrast, considering a pessimistic scenario, where the growth rate of the real GDP decreased by 1 pp., in conjunction with a higher real interest rate by 1 pp., the public debt as a share of GDP will increase to 40.27%. The steep reduction in interests paid by the state to attract new loans which occurred in the first four months of 2013, will have a positive effect on the dynamics of public debt in the context of maintaining this trend in the medium term. Thus, a 1 pp. reduction in the interest rate will reduce public debt stock by 1.3 pp. of GDP in addition to the baseline scenario, and this evolution seems plausible in the context of the decrease of 1.5 pp. of the interest rate paid by state to attract new loans registered in the first four months of 2013.

III.5. The absorption of EU funds

In the period 2007-2013, Romania will be granted 19.2 billion euro of EU structural and cohesion funds. Coordinated by the EU cohesion policy, these funds are designed to support the convergence of member countries, increasing competitiveness and employment.

Table 10: Structural funds absorption by operational programs (billion euro)

	Total allocations 2007-2013	Payments December 2012			Absorption rate	Absorption excl. pre-financing
		Total, o/w:	**Pre-financing**	**EU Refunds**		
Regional Development	3.726	1,286.4	523.7	762.7	34.53%	20.47%
Environment	4.512	791.8	388.3	403.5	17.55%	8.94%
Transport	4.565	417.9	-	417.9	9.15%	9.15%
Competitiveness	2.554	509.4	153.7	355.7	19.95%	13.93%
Human Resources	3.476	1,112.6	545.4	567.2	32.01%	16.32%
Administrative Capacity Development	208	49.0	5.4	43.6	23.56%	20.97%
Technical Assistance	170	31.8	1.2	30.6	18.69%	18.00%
Total	**19.213**	**4,198.9**	**1,617.7**	**2,581.3**	**21.85%**	**13.43%**

Source: ACIS, Fiscal Council's calculations

With an absorption rate of only 21.85% of the total allocation for December 2012 (the highest rate of 34.53% for Regional Development Operational Program (OP) and the lowest of 9.15% for the Transport OP), Romania is facing serious challenges and risks to lose these opportunities, given the fact that normally, these allocations can be contracted maximum one year after the closure of the financial framework 2007-2013. However, Romania and Slovakia benefit for an additional year to draw EU funds, respectively until 2015, thus decreasing the risk of losing money due to automatic decommitment.

The Transport OP is the least efficient operational program, with only 417.9 million euro paid until the end of 2012 (about 9% of the total allocations for 2007-2013).

The Regional OP and the Human Resources OP are still the best performing programs in terms of absorption of structural funds. These programs had an absorption rate of 34.53% and 32.01%, with paid grants of 1,286.4 million euro and 1,112.6 million euro respectively.

It is true that in many new Member States, EU funds' absorption after accession was quite slow, so in this respect, Romania is not atypical. Nevertheless, Romania is now in its seventh year as an EU member state, and available funds have a time limit.

Table 11: Absorption of structural funds-comparison with other EU Member States

	Total allocations 2007-2013 billion euro	Payments June 2012 billion euro	Absorption Rate	Total allocations per capita euro	Total payments per capita euro
Estonia	3.4	2.41	70.95%	2538	1801
Latvia	4.5	2.64	58.65%	2204	1293
Poland	67.2	39.74	59.14%	1744	1031
Czech Republic	26.5	11.12	41.95%	2523	1058
Bulgaria	6.7	2.68	40.00%	914	366
Romania	19.2	5.03	26.20%	899	236
Hungary	24.9	11.88	47.71%	2501	1193
Lithuania	6.8	4.82	70.83%	2261	1601
Slovenia	4.1	2.15	52.41%	1995	1045
Slovakia	11.5	5.23	45.51%	2128	968

Source: European Commission

Compared to many new member states, Romania's performance in terms of EU-funds absorption is very poor, only 26.2% after six and a half years, well below Bulgaria which registered an absorption rate of 40%. The low absorption rate may be explained by the blockages in attracting EU funds registered in the period 2011-2013 after identifying serious problems at the level of the management authorities regarding the public procurement system.

A particular situation was recorded on the Regional OP, the 6th axis where frauds and irregularities were discovered, which led to a long-lasting blockage that persists in the present.

In order to unblock European funds, a series of measures were agreed, such as the revision of the assessment and selection methodologies, reviewing the procedures for examining the requests for reimbursement, site visits, revising the legal and procedural frameworks. The European Commission had a positive overall assessment on the actions taken by the Romanian authorities and decided to resume reimbursements for several operational programs, while for others a final decision has not been yet taken.

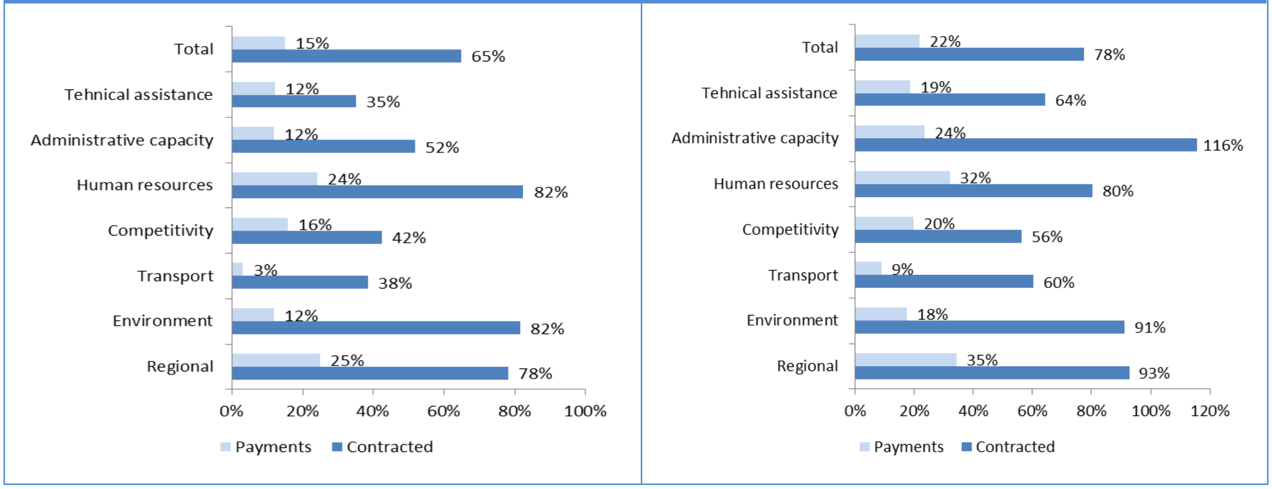
In the EU regulation no. 1311/2011 is provided that Member States experiencing or threatened by serious difficulties regarding their financial stability, may request for the increase of interim and final payments from the Structural and Cohesion Funds with an amount equivalent to ten percentage points above the applicable co-financing rate for each priority axis. For Romania, the access to this facility is equivalent to a reduction in the required national counterpart by ten percentage points (broadly, from 15% to 5%) for the disbursement requests submitted to the Commission in the period 1 January 2010 - March 2013 (or until the assistance program between Romania and the IMF, the European Commission and the World Bank is concluded), thereby supporting the increase of EU funds absorption.

In terms of EU funds absorption, Estonia ranks first among the analyzed countries, with a rate of 70.95%, which means that it used 2.41 billion euro from 3.40 billion euro allocated for the period 2007-2013. Similar situations are recorded in Lithuania, Poland, Latvia and Slovenia that managed so far to spend 70.83% (about 4.82 billion), 59.14% (about 39.74 billion), 58.65% (about 2.64 billion) and 52.41% (about 2.15 billion) from the amounts allocated.

Considering the EU funds allocated divided by the number of inhabitants, Romania is also ranked on the lowest position in the EU, with 236 euro/capita compared to 1801 euro/capita in Estonia or 366 euro/capita in Bulgaria.

Figure 34: Absorption of funds: payments and contracting

2011 **2012**



Source: Fiscal Council's calculations

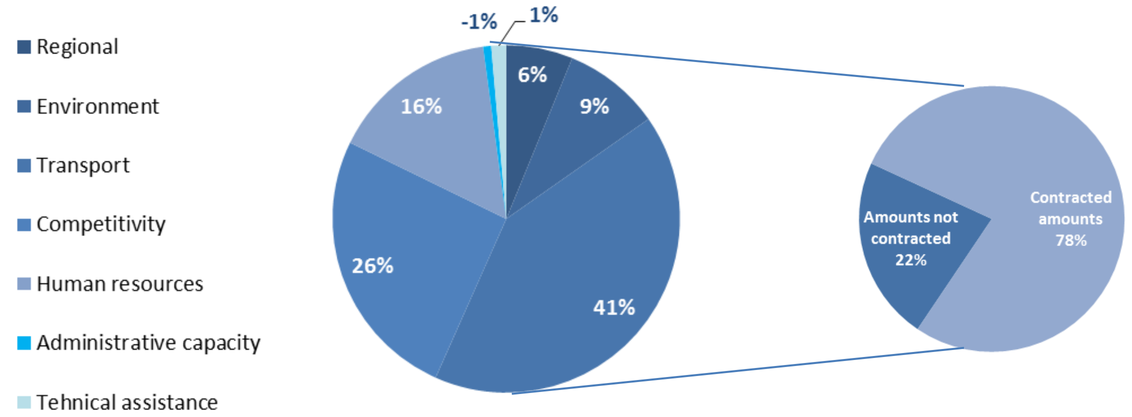
Instead, in 2012, an improvement in the process of contracting structural and cohesion funds can be observed, with a contracting rate of 78%, up from 65% in 2011.

Nevertheless, there are significant differences between the seven operational programs. The Administrative Capacity Development OP, the Regional Development OP and the Environment OP are the top performers, with contracting ratios of 116%, 93% and 91%. The contracting rate for a specific operational program may exceed 100% given the fact that management authorities are authorized to accept additional contracts due to the achievement of some savings, or as a result of the decision to stop or to reduce the ammounts for other contracts.

Instead, the worst performing programs are the Economic Competitiveness Sectoral OP with a contracting rate of only 56% and the Transport Sectoral OP with a rate of 60%, which are also recording very low actual payments (20% and 9%). However, in the case of the Transport Sectoral OP an improvement can be observed as the contracting rate increased to 60% in 2012, compared with only 38% during the previous year.

Regarding the breakdown by operational programs of EU funds to be contracted (*Figure 35*), the Transport Sectoral Operational Program has the largest amount of approximately 1.8 billion euro (41%), followed by the Competitiveness Sectoral Operational Program (1.11 billion euro, or 26% of total).

Figure 35 : Amounts not contracted by Operational Programs



Source: ACIS, Fiscal Council's calculations

The need to improve EU funds absorption becomes more stringent in the context of fundamental changes in the fiscal policy approach. Due to the new fiscal compact, in the following years the fiscal policy's room for maneuver will be reduced compared to the past, as the maximum budget deficit permitted will be much lower. Moreover, a low efficiency of the automatic stabilizers is an additional constraint for Romania, and in these circumstances, EU funds absorption appears as a solution to stimulate the economy.

The potential multiplier effect of EU funds related budgetary expenditure is much higher than for the projects funded entirely by domestic financial resources. Considering the 15% co-financing ratio for projects funded from EU funds, with 1 leu from own resources – budgetary deficit – bugdetary expenditure of 6.67 lei can be allocated (EU fund absorption's impact on the budget deficit is represented only by the co-financing amount, as the sums received from EU are registered both on the revenue and the expenditure side of the budget), compared to a 1:1 equivalence ratio for projects financed entirely from own resources.

Unfortunately, so far, Romania's performance in terms of EU funds absorption is very low. Moreover, the deficit target according to the cash methodology was missed, mainly as a result of the failure to attract EU funds given that the expenditure financed by external funds have not been adjusted to the same extent. The Fiscal Council recognizes the need to ensure financing for ongoing projects, but believes that actual expenditure related to these projects should depend to a greater extent to the amounts actually reimbursed by the European Commission.

Romania must have as a top priority the urgent and substantial increase of the EU funds absorption rate, as it is threatened with the loss of significant amounts given the automatic decommitment procedure, even considering the one year extension of the deadline for contracting and spending funds.

IV. The structural fiscal position

The stability of the public finances plays a special role in ensuring the smooth functioning of the Economic and Monetary Union (EMU). The Stability and Growth Pact (SGP) sets the regulatory framework for the coordination of national fiscal policies within the EMU. Thus, ensuring the financial discipline is a prerequisite for achieving a stable price level over the medium term and a sustainable economic growth. In the context of giving up the exchange rate as a monetary policy tool, the fiscal policy, through the automatic stabilizers and discretionary measures, plays a fundamental role in alleviating economic fluctuations caused by asymmetric shocks that may affect the EMU countries.

The Stability and Growth Pact sets the medium-term objective for the budgetary positions of the Euro area's Member States to be *close to balance or in surplus*, a situation which should enable them to deal with normal cyclical fluctuations without exceeding the 3% of GDP reference level for the effective budget deficit. Also, reaching and maintaining the medium-term objective should ensure a rapid progress towards a sustainable situation, while generating sufficient fiscal space for discretionary fiscal policy measures, such as increased investments in the infrastructure.

Therefore, the maximum effective budget deficit of 3% stated in the Stability and Growth Pact is not a level that can be reached every year, but a ceiling that must not be exceeded even in adverse economic conditions. The actual budget balance is affected by cyclical fluctuations of the economy, as budgetary components are influenced by the position within the economic cycle. Thus, in periods of expansion, the revenues are higher, reducing the budget deficit, without this necessarily meaning a change in the conduct of fiscal policy or improved tax collection. In the context of the Stability and Growth Pact, the identification of a fundamental fiscal position, which is not dependent on the cyclical fluctuations of the economy and which will ensure compliance with the 3% of GDP ceiling for the budget deficit even in the event of a recession, is fundamental in order to respect the SGP provisions and to ensure a sustainable fiscal position over the medium and long term.

In 2011, the reinforced Stability and Growth Pact was signed. The document includes amendments regarding the medium-term objective (MTO) and the assessment of compliance to it. Thus, the MTO considers a structural deficit of maximum 1% of GDP for the euro area Member States and the observed deviation is considered important (for a member state which has not achieved its medium-term objective) when the structural deficit and the total expenditure criteria are simultaneously violated, the latter assessing the deviations of the position of public finances due to uncontrolled evolution of total expenditure.

The medium-term objective in terms of the structural deficit that Romania needs to align to as a result of its status as an EU member is determined starting from the deficit that stabilizes the share of GDP of the public debt stock plus an adjustment due to the incorporation of a portion of the long-term costs of ageing. In the case of Romania, the MTO was revised upwards by the European Commission at 1.25% of GDP (from 0.7% of GDP) as a result of the favorable impact of the structural reforms on pensions, assessed in the context of the Ageing Report 2012 developed by the European Commission. However, given that the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, ratified by Romania, sets a maximum limit of the structural deficit at 1% of GDP for countries with a low public debt (significantly below 60% of GDP), the operational medium-term objective for Romania is set at this latter level.

The long-term compliance of medium-term objective will impose strict controls on public finances in Romania, this constraint having clear advantages, but also disadvantages. An important advantage is represented by the impossibility of conducting pro-cyclical fiscal policies and by a pronounced fiscal discipline, given that Romania has a negative experience in this field. For Romania, the disadvantage of the new European fiscal rule is that the existing fiscal space to stimulate the economy during recessions will be very low. In Romania, the 1% of GDP ceiling for the structural budget deficit will likely be reached before the actual government deficit reaches 3% of GDP, making it significantly more stringent than the Maastricht criterion per se.

In order to strengthen the surveillance of the budgetary positions and the coordination of the economic policies, 25 EU countries signed in March 2012 The Treaty for Stability, Coordination and Governance in the EMU. The most important component, the Fiscal Compact, aims to strengthen fiscal discipline in the European Union by introducing automatic sanctions and a more stringent supervision of the Member States.

In essence, the new treaty includes the requirement that national budgets should be balanced or in surplus, a requirement that will be considered satisfied if the annual structural deficit will not exceed 0.5% of GDP. Member States will be obliged to introduce the "balanced budget rule" in their national legal systems, preferably at the constitutional level, while the period during which it is imperative to fulfill this obligation is one year after the entry into force of the Treaty. If a country has a debt level significantly below 60% of GDP and the risks to the long-term sustainability of public finances are low, it may have a structural deficit of more than 0.5% of GDP, but not exceeding 1% of GDP. Failure to meet the requirement regarding structural balance will automatically trigger a corrective mechanism, as established by each Member State on the base of principles proposed by the European Commission.

The authority responsible for the assessment of the balanced budget rule's domestic implementation is the European Court of Justice; its decisions are binding and may be followed by fines of up to 0.1% of GDP for the euro area countries, paid to the European Stability Mechanism.

The Fiscal Compact entered into force and become mandatory for the EMU countries after being ratified by at least 12 euro zone members. For other EU countries, the provisions of the Treaty will be binding when adopting the single currency or earlier, in case of a positive national decision regarding this matter.

The differences and similarities between the Reinforced Stability and Growth Pact and the Fiscal Compact are shown in the box below.

BOX 2: The reinforced Stability and Growth Pact vs. Fiscal Compact

	Reinforced Stability and Growth Pact Preventive Arm	*Fiscal Compact*
Legal basis	*Secondary EU law*	*Primary law (intergovernmental and national law)*
Budgetary objective	• *Close to balance or in surplus* • *Country – specific medium term objective (MTO): maximal structural deficit of 1% of GDP for euro area countries*	• *Balanced or in surplus* • *Country – specific MTO: maximal structural deficit of 0.5% of GDP (or at most 1% if debt-to-GDP ratio is below 60% and long-term risks to fiscal sustainability are low)*
Escape clauses	• *Severe economic downturn in euro area or EU as a whole* • *Unusual event outside the control of the government with major financial impact* • *Implementation of structural and/or pension reforms (under strict conditions)*	• *Replicates reinforced SGP (without explicit reference to structural and/or pension reforms)*
Convergence to budgetary objective	• *Assessed on the basis of the structural balance and expenditure rule*	• *Rapid convergence to MTO (details to be proposed by the Commission) taking sustainability risks into consideration*

	• *Benchmark: annual improvement of structural balance of 0.5% of GDP (higher in economic good times and/or if debt-to-GDP ratio exceeds 60% or if there are pronounced risks to the sustainability of overall debt; might be lower in bad economic times)*	• *Evaluation of progress as in the reinforced SGP*
Assessing compliance	• *Significant observed deviation (for a Member State that has not reached its MTO) in case of simultaneous breach of the following criteria (or breach of one limited compliance with the other):* • *Structural deficit criterion: exceeding adjustment path to MTO by at least 0.5% in one or 0.25% on average in two consecutive years* • *Expenditure criterion: negative impact of expenditure developments (net of discretionary revenue measures) on adjustment path of government balance of at least 0.5% of GDP in one or cumulatively in two consecutive years*	• *Assessment of "significant observed deviations from the MTO or the adjustment path towards it" follows the reinforced SGP* • *Common principles on the role and independence of national monitoring institutions to be proposed by the Commission*
Correction mechanism	• *In case of a significant observed deviation from the adjustment path towards the MTO: warning by European Commission* • *Council's recommendations for the necessary policy measures on the basis of a Commission recommendation (deadline of not more than 5 months (3 months in particularly serious cases) for addressing the deviation)*	• *To be triggered automatically in the event of significant observed deviations from the MTO or its adjustment path (including obligation to implement measures to correct the deviations over a defined period of time)* • *Implemented at the national level on the basis of common principles to be proposed by the Commission that concern, in particular, the nature, size and time frame of the corrective action to be undertaken also in the case of exceptional circumstances* • *Correction should include the cumulated impact of past deviations on government debt dynamics*

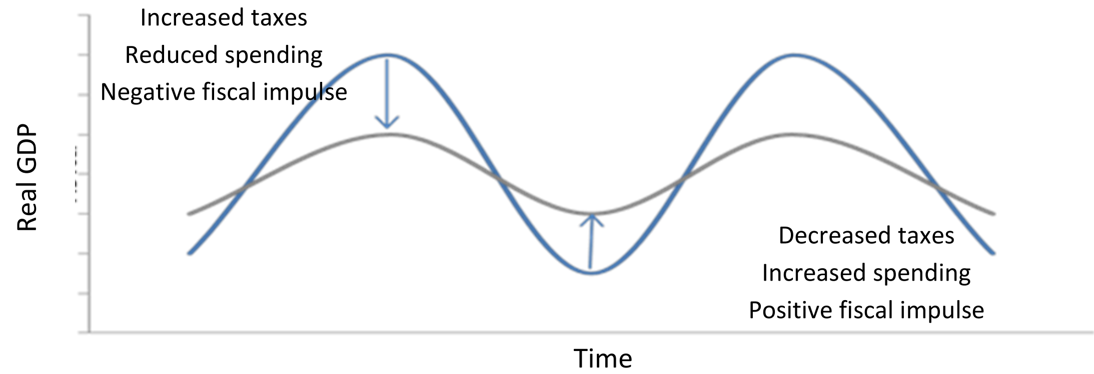
Enforcement	• *Commission cam propose financial sanction (interest-bearing deposit of 0.2% of GDP) if no effective action has been taken* • *Automatic approval (of the sanction) – unless the Council rejects the Commission recommendation by qualified majority of euro area Member States excluding the country concerned*	• *In addition to the reinforced SGP, financial sanctions can be imposed by the European Court of Justice if the balanced budget rule and the correction mechanism are not properly implemented in national law*

Source: ECB

In recent years, the role of the cyclically adjusted budget balance in the conduct of economic policies in the EU has significantly increased. Before reviewing the Stability and Growth Pact in 2005, the cyclically adjusted budget balance was used as a policy tool to better assess the fiscal position of the EMU Member States, while after the reform of the SGP, it has become the focus of the fiscal surveillance mechanism within the European Union. The key requirements regarding the fiscal policy in the euro area are expressed in terms of cyclically adjusted values, net of temporary or one-off measures.

The use of a cyclically adjusted budget balance is not only related to the sustainability of public finances: its annual variation (the fiscal impulse) is a commonly used measure in assessing the impact of the fiscal policy on the aggregate demand. Thus, a positive fiscal impulse, corresponding to an increase in the cyclically adjusted balance, reflects an expansionary fiscal policy, while a negative fiscal impulse, corresponding to a reduction in the cyclically adjusted balance, signals a restrictive fiscal policy. Analyzed together with the economy's cyclical position, the fiscal impulse enables us to assess the extent to which the fiscal policy is acting like a macroeconomic stabilizer - acting in the sense of decreasing aggregate demand pressures in times of economic boom or for the purpose of stimulating aggregate demand during recessions.

Figure 36: The stabilizing role of fiscal policy (Counter-cyclical fiscal policy)



The identification of the fundamental fiscal position is based on the definition and calculation of the cyclically adjusted or structural budget balance. The two indicators are similar, but the difference is the exclusion from the cyclically adjusted balance of the temporary and one-off measures. In essence, the cyclically adjusted balance represents that level of the budget balance observed when the economy is at its potential level. Thus, this indicator can be used to identify how changes in the fiscal position (taxes, transfers, expenses) are the result of the economic conditions or the consequence of discretionary measures regarding the fiscal policy. In practice, the effective budgetary position is decomposed into two factors - temporary and permanent. Schematically, the computation of the cyclically adjusted balance is based on the following identity:

Effective budget deficit = Cyclical deficit (automatic stabilizers) + Cyclically adjusted deficit (discretionary policies)

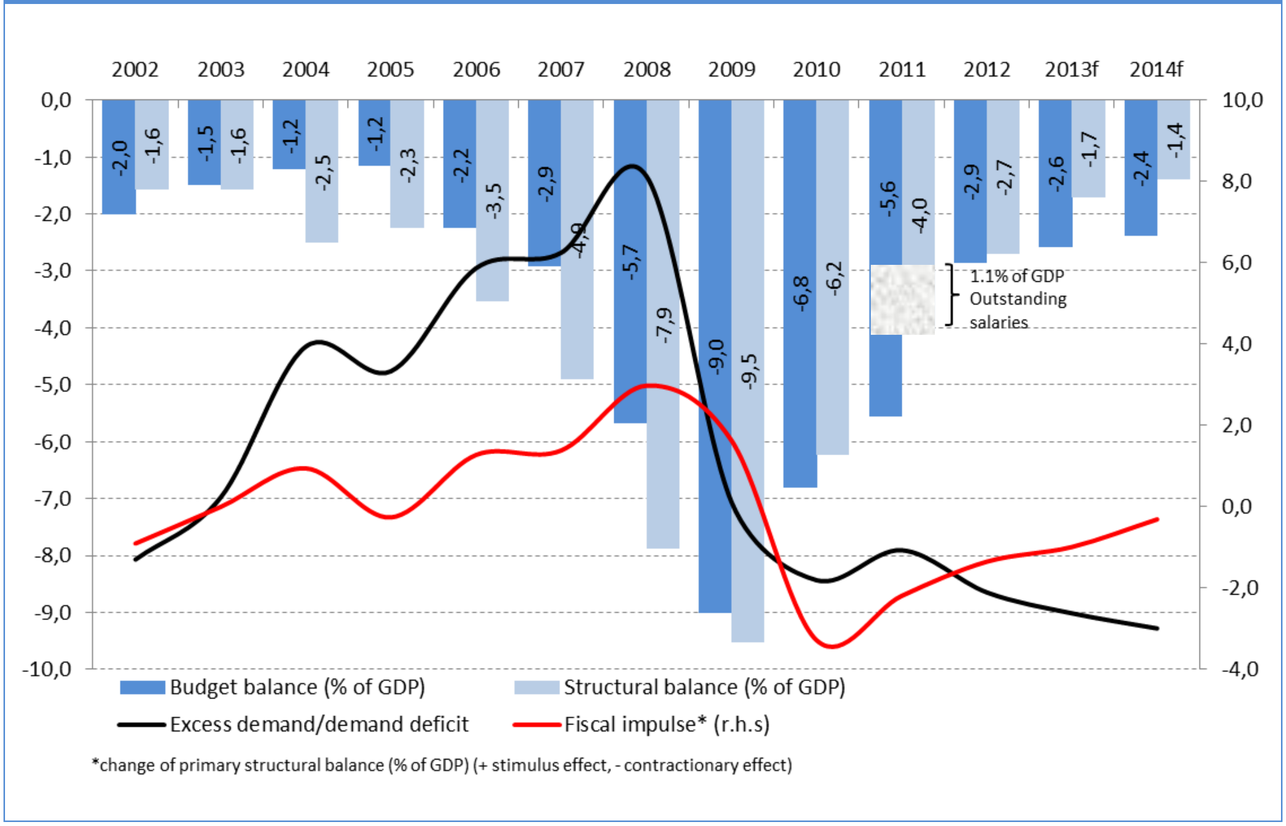
The fiscal policy objectives can be better expressed in terms of the cyclically adjusted budget balance, ensuring the long term sustainability of public finances and allowing automatic stabilizers to smoothen economic fluctuations. In essence, the automatic stabilizers reflect that revenues and, to a lesser extent, expenditures are affected by the position within the economic cycle and contribute to the smoothing of cyclical fluctuations. For example, in case of an economic expansion, the budgetary revenues from value added tax, excises, social security contributions, personal and corporate income tax increase, reducing disposable income of businesses and households, thereby slowing economic growth and determining the return of the GDP to the potential level. In a case of a recession, lower revenues are collected while expenses related to unemployment benefits increase, with a positive impact on firms and households revenues, thereby supporting the economic recovery and the return of the GDP to its potential level. The effectiveness of automatic stabilizers depends on the government sector's size but also on the elasticity of budgetary revenues and expenditures with respect to cyclical fluctuations of the economy. The larger the government sector's size and the higher the elasticity of revenue and expenditure with respect to cyclical fluctuations of the economy, the stronger the softening effect of automatic stabilizers on the economic fluctuations.

The global economic crisis revealed that, in terms of demand shocks, the monetary policy is unable to respond strongly enough if the transmission mechanism is blocked by adverse conditions in the financial markets. Expansionary discretionary fiscal policy can be used in this case, when an adequate fiscal space exists, but it has several disadvantages: it requires a relatively long period of implementation, it is subject to political influences and it is not automatically reversed when the position within the economic cycle changes. Automatic stabilizers do not have these disadvantages, but their efficiency is dependent upon the choices regarding institutional and fiscal policies. For example, the economic literature shows that the effectiveness of automatic stabilizers can be increased by expanding the share of government sector or by increasing tax progressivity[17].

In Romania, during the rapid economic growth prior to the financial crisis, the fiscal impulse was positive, contributing to the overheating of the economy and thereby deepening the accumulated imbalances in the economy (*see Figure 37*). In addition, fiscal policy pro-cyclicality during the pre-crisis period of economic boom exhausted the necessary fiscal space to stimulate the economy during the recession that followed; the need to reduce the budget deficit during the crisis (primarily due to financing constraints) lead inevitably to maintaining the pro-cyclicality of fiscal policy. Thus, the automatic, beneficial and stabilizing action of the cyclical deficit (automatic stabilizers) was canceled by discretionary policy.

[17] See for example: *Carlo Cottarelli and Annalisa Fedelino, "Automatic Stabilizers and the Size of Government: Correcting a Common Misunderstanding", IMF working paper, WP/10/155, 2010*, or *Thomas Baunsgaard and Steven A. Symansky, "Automatic Fiscal Stabilizers", IMF Staff position note SPN/09/23, September 28, 2009 Baunsgaard and Steven A. Symansky, „Automatic Fiscal Stabilizers", IMF Staff position note SPN/09/23, September 28, 2009.*

Figure 37: Structural deficit, fiscal impulse and excess demand



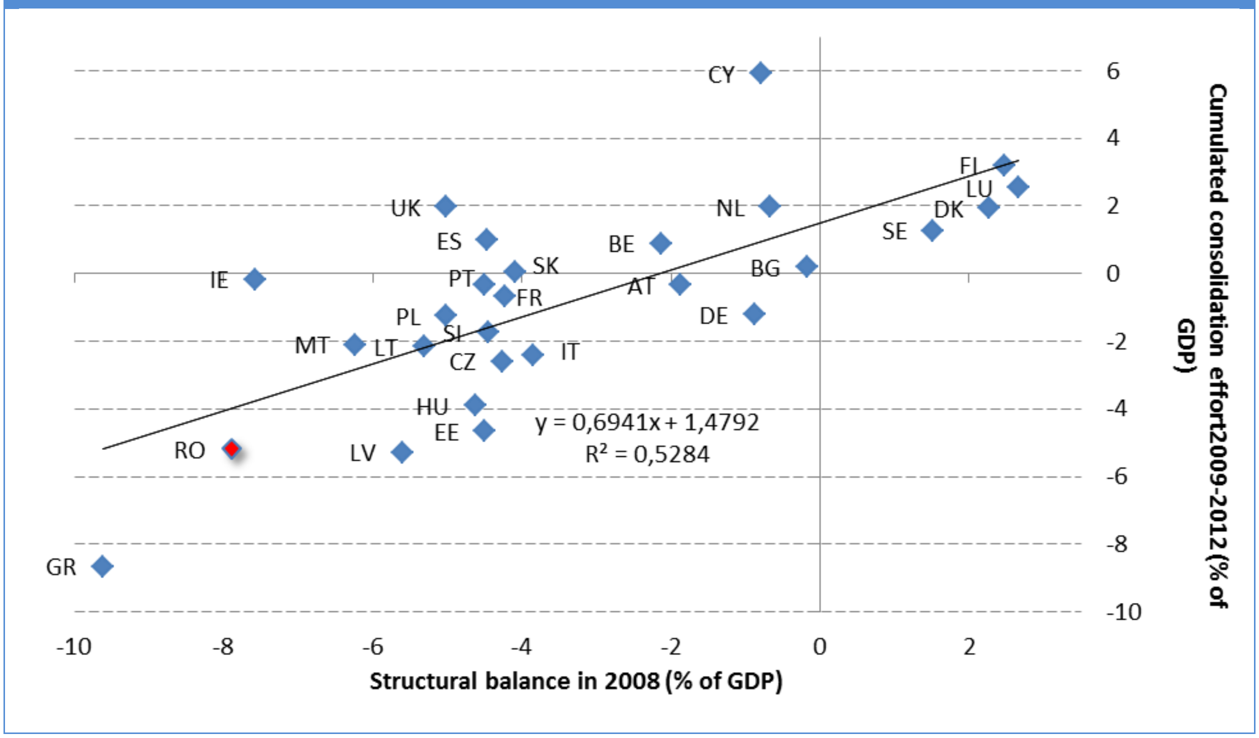
Source: AMECO, Fiscal Council's calculations

In 2009-2012, the structural budget deficit fell from 9.5% of GDP to 2.7%, the adjustment pace of about 1.7 percentage points per year being very rapid (*see Figure 37*); at the same time, the high starting level required rapid adoption of decisive measures in order to ensure fiscal policy sustainability. The adjustment was made mainly on the expenditure side, the implemented structural reforms regarding particularly the salaries of public employees, the public pension system and the budget programming. On the revenue side, the most important measure was represented by the increase in the VAT standard rate from 19% to 24% starting from July 2010. The proposed structural adjustment effort for the years 2013 and 2014 appears to be significantly lower than in the period 2010 – 2012, its cumulative level over two years (about 1.3 percentage points of GDP) being similar to that already undertaken during 2012.

Given the assumptions regarding the potential GDP included in the Convergence Program 2013-2016 - otherwise very close to those of the European Commission (a growth rate of 2.1 percent in 2013, followed by an acceleration to 2.6% in the next year), the projected trajectory for the real GDP growth actually implies a continuous widening of the output gap until 2015 (to a level of 3.1% of potential GDP), followed by a relative stabilization in 2016. Under these conditions, the size of negative cyclical component of the budget balance is expected to increase compared to the starting point, which implies that the adjustment of the structural deficit will be higher than the one of the actual budget deficit. The European Commission proposal for achieving the medium-term objective is less ambitious than that of the Romanian authorities which decided to achieve these targets in 2014. Thus, the EC considers as adequate a slightly reduced structural adjustment pace with the structural deficit level of 1% of GDP to be reached in 2015.

The estimated cumulative adjustment undertaken by Romania between 2009-2012 is the second most ambitious from the European Union - but the chart below reveals that its size is directly proportional to the size of the initial structural fiscal imbalance (of 2008).

Figure 38: The size of the consolidation effort, 2009-2012

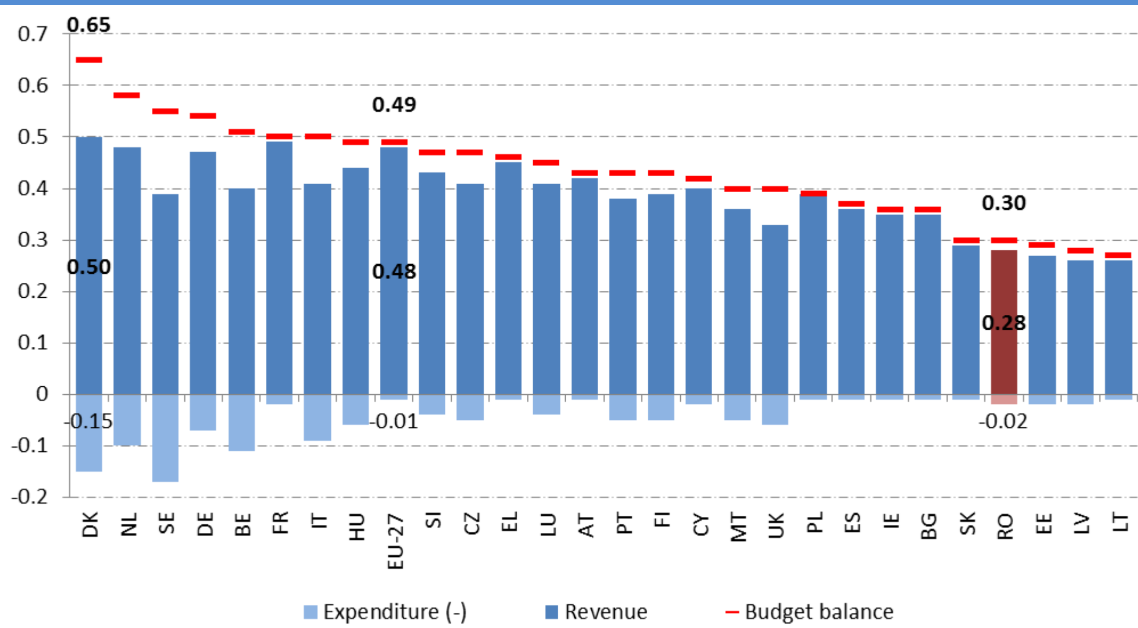


Source: AMECO, Fiscal Council's calculations

It can be shown both theoretically and empirically that in the medium and long term (over a full business cycle), the average actual deficit is equal to the average structural deficit, while the average cyclical deficit is 0. By targeting a maximum structural deficit of 1% of GDP, Romania is committed to reduce the actual budget deficit, as an average over a business cycle (and as a long-term average), to a maximum of 1% of GDP; in comparison with historical standards (4.2% of GDP average of structural deficit in the 2002-2012 period), this will mean a much lower budget deficit and a reduced room for "manoeuver". Due to the relatively weak automatic stabilizers (*see Figure 38*), Romania may need the possibility of implementing stronger discretionary fiscal stimulus (higher structural deficit) in times of recession, in order to help the economy to get out of recession faster and return to the potential growth. *Figure 39* suggests that the size of the automatic stabilizers is largely explained by a scale effect - the share of tax revenues (including social security contributions) in GDP. Other factors that may explain their size are the revenue structure by types of taxes (corporate income tax for instance has usually significantly higher sensitivity to the cyclical position of the economy), but also the progressivity of the personal income tax.

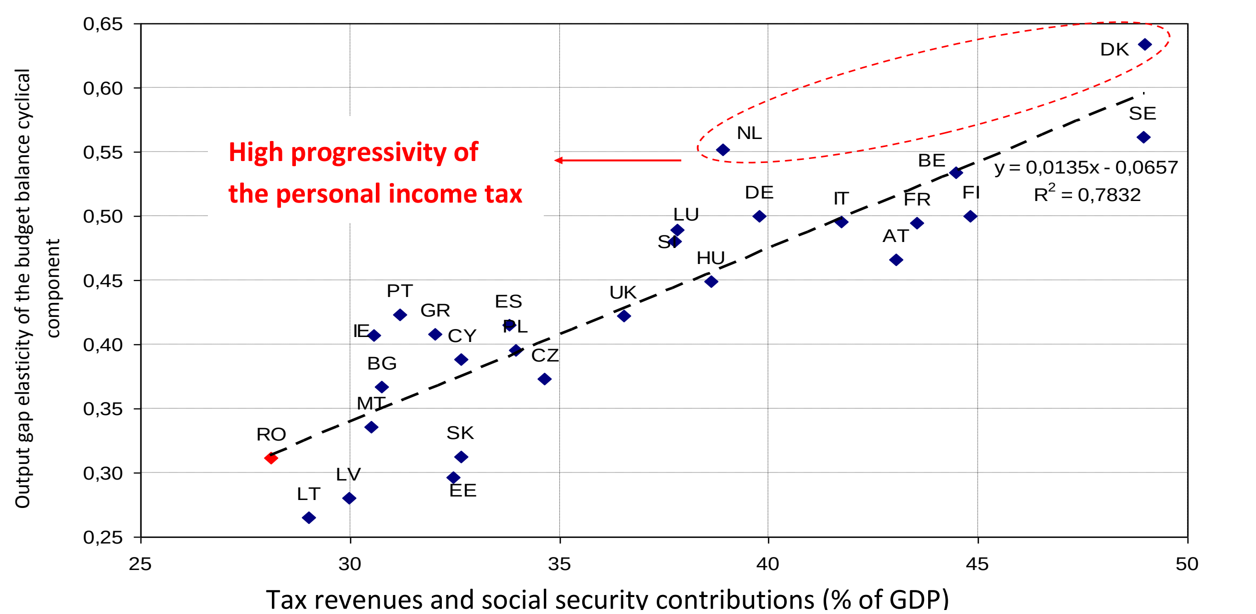
But it must be said that the Stability, Coordination and Governance treaty is flexible in this regard, given that it explicitly allows temporary deviation from the MTO when the economy faces a severe economic contraction.

Figure 39: Change of the actual budget balance due to a one percentage point increase in the output gap (in percentage points) *



Source: AMECO, own estimates.
*For the budget balance, the impact is in % of GDP.

Figure 40: The relationship between the size of automatic stabilizers and the fiscal burden



Source: AMECO, own estimates

V. The sustainability of public finances

V.1. State owned companies – arrears, efficiency and fiscal impact

A potential risk for the fiscal sustainability on the medium term is represented by the accumulation of losses and arrears in companies where the state is the major shareholder (SOEs). If these companies fail to streamline their activity, sooner or later the Government will be forced to intervene with public resources, which may deteriorate the fiscal balance.

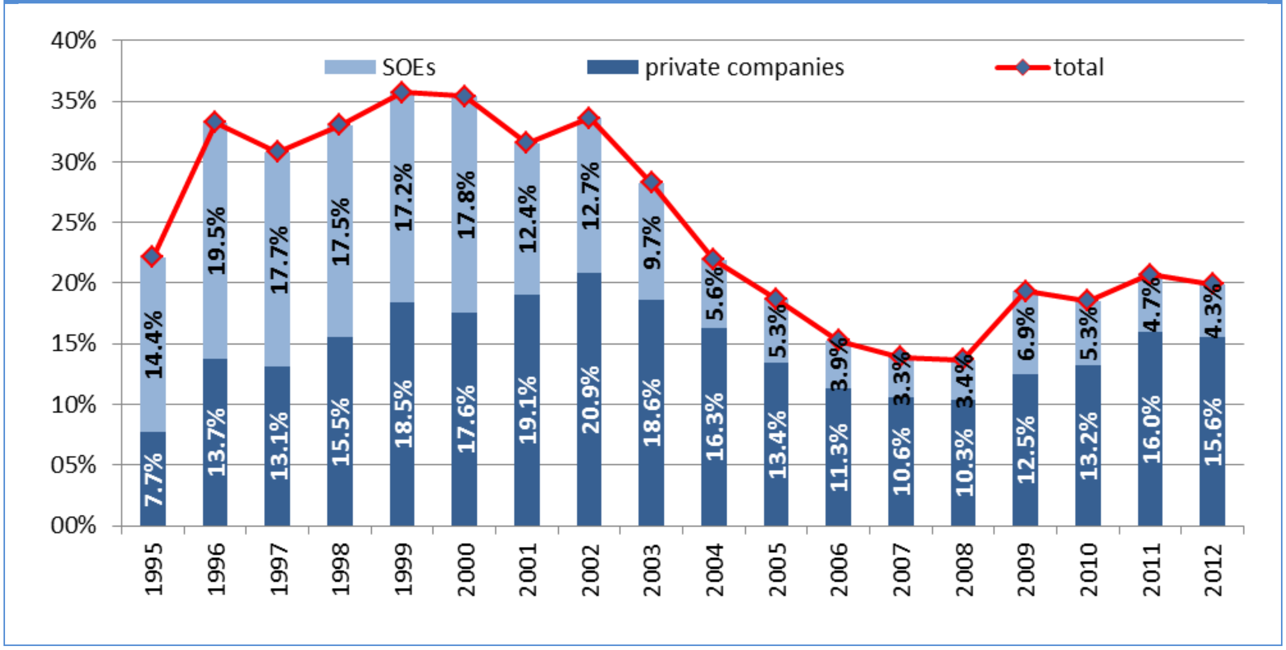
At the end of 2012, there were 996 SOEs that reported financial statements to the Ministry of Finance, the most of them being organized as companies and autonomous administrations, with an aggregate turnover of nearly 49 billion lei. It can be observed a decrease of SOE's contribution to the overall economy turnover during 2005 – 2012, to the added value, respectively the number of employees in the economy. Regarding the profitability of SOEs, it was negative in 4 of the 8 years analyzed. Moreover, there is a disproportion between SOE's contribution to the overall economy turnover or to the added value or the number of employees in the economy and the share of these companies in total outstanding payments at an aggregate level of the national economy. Thus, although the contribution of these companies to the overall economy turnover was 4.6% in 2012, the accumulated outstanding payments represented 21.7% of the arrears registered in the economy.

Table 12: The evolution of the number of SOEs by components								
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Autonomous administrations	128	129	128	117	150	152	173	180
Companies owned 100% by the state	467	411	385	358	333	389	437	431
National Research and Development Institutes	101	80	62	51	51	57	81	64
National companies and societies	46	40	50	41	45	50	61	48
Companies representing subsidiaries of companies owned by the state	0	0	0	0	0	0	43	44
Other state economic units untransformed in companies or autonomous administrations	0	0	0	0	0	0	0	14
State – owned companies, local and foreign state capital (state capital >= 50%)	10	7	13	5	25	9	44	40
State –owned companies, local and foreign private capital (state capital >=50%)	25	23	21	7	20	9	16	18
State –owned companies and with local private capital (state capital >=50%)	222	158	105	85	87	82	98	85
State –owned companies and with foreign private capital (state capital >=50%)	8	5	5	4	11	12	15	12
State –owned companies, privatized in the reporting year	57	58	50	50	52	31	74	60
Total number of SOEs	**1.064**	**911**	**819**	**718**	**774**	**791**	**1.042**	**996**

Table 13: The evolution of certain financial indicators of companies considering the form of ownership									
		2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Companies number	SOEs	1.064	911	819	718	774	791	1.042	996
	Total companies	531.269	564.408	617.272	663.860	602.190	613.080	644.379	630.066
	Share of SOEs in total companies	0,2%	0,2%	0,1%	0,1%	0,1%	0,1%	0,2%	0,2%
Total income, mn lei	SOEs	44.693	48.491	51.953	56.660	50.756	55.022	57.809	49.079
	Total companies	527.022	625.162	779.968	977.619	845.396	920.600	1.056.190	1.072.777
	Share of SOEs in total companies	8,5%	7,8%	6,7%	5,8%	6,0%	6,0%	5,5%	4,6%
Gross value added, mn lei	SOEs	27.333	32.205	37.689	42.318	40.417	44.786	45.593	41.449
	Total companies	255.233	304.270	368.356	458.536	450.979	466.397	487.327	513.803
	Share of SOEs in total companies	10,7%	10,6%	10,2%	9,2%	9,0%	9,6%	9,4%	8,1%
Employees number, thousands of persons	SOEs	418	396	406	390	364	414	340	324
	Total companies	4.537	4.594	4.721	4.806	4.595	4.238	4.162	4.292
	Share of SOEs in total companies	9,2%	8,6%	8,6%	8,1%	7,9%	9,8%	8,2%	7,6%
Gross profit, mn lei	SOEs	1.109	1.525	1.400	-1.026	-2.777	-2.101	1.326	-636
	Private companies	28.521	42.614	43.008	23.513	19.914	27.934	10.468	15.699
Arrears, mn lei	SOEs	15.200	13.557	13.690	17.294	34.405	28.012	26.247	25.355
	Private companies	38.818	39.101	44.050	53.127	62.406	69.193	88.886	91.543
	Total companies	54.018	52.658	57.740	70.422	96.811	97.205	115.133	116.899
	Share of SOEs in total companies	28,1%	25,7%	23,7%	24,6%	35,5%	28,8%	22,8%	21,7%
Arrears, % of GDP	SOEs	5,3%	3,9%	3,3%	3,4%	6,9%	5,3%	4,7%	4,3%
	Private companies	13,4%	11,3%	10,6%	10,3%	12,5%	13,2%	16,0%	15,6%
	Total companies	18,7%	15,3%	13,9%	13,7%	19,3%	18,6%	20,7%	19,9%

Source: Fiscal Council's calculations based on data from the National Trade Register Office and the Ministry of Finance

Figure 41: The evolution of SOE's and private companies' arrears (% of GDP)



Source: Fiscal Council's calculations based on data from the National Trade Register Office and the Ministry of Finance

The financial crisis, started in 2008, caused an increase of the companies' arrears both in the case of public and private companies. However, the problem of arrears in public enterprises is more serious than in the case of private companies as their size compared to the activity volume (turnover or total assets) is much higher.

Figure 42: Arrears (% of turnover)

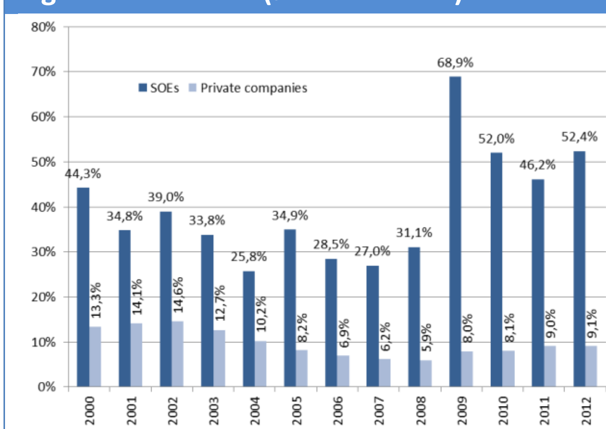
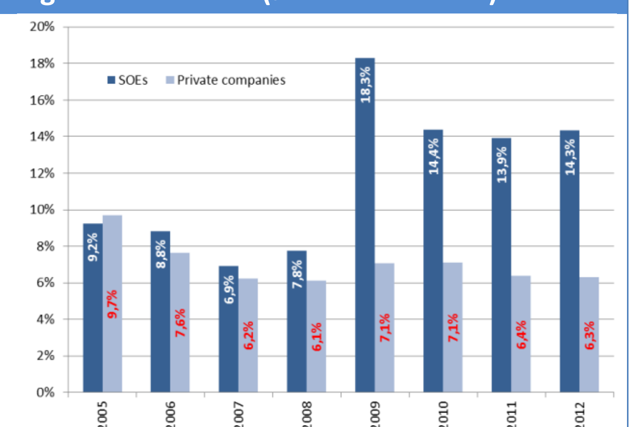


Figure 43: Arrears (% of total assets)



Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Moreover, arrears were, also, before the financial crisis a more serious problem in the case of state companies given their size compared to the volume of activity of these firms. The persistence of arrears in public companies indicates a culture of late or non-payment to the budget and private sector, thus undermining the efficient allocation of resources and creating an uneven playing field among enterprises. There are several explanatory factors for the growth of the SOE's arrears. First, the budgets of public enterprises are often approved without ensuring that the enterprises will be able to pay their budgetary obligations. Secondly, certain legal provisions favor the lack of financial discipline, particularly in relation with the utility suppliers. Thirdly, offsetting schemes and frequent debt cancelations create moral hazard and low incentives for state companies to pay their outstanding obligations. In the last 3 years, more swaps for arrears were implemented. According to these swaps, significant sums from the general state budget were transferred to local budgets and to some SOEs and Ministries, so that, in the end, these transfers would lead to clearing some outstanding obligations to the budget.

Furthermore, the majority of the SOE's arrears are directed towards the general consolidated budget, particularly to the social security budget. In contrast, most of the outstanding payments of the private companies are to the suppliers. SOEs are the largest debtor towards the social security budget; their total outstanding debt amounts over 1.9% of GDP (11.3 billion lei) in December 2012, of which 1.13% of GDP was towards the social security budgets (6.6 billion lei). In general, SOEs do not pay their debts on time to the general consolidated budget (especially to social security budgets) and to other public companies.

Figure 44: Structure of arrears - SOEs (million lei)

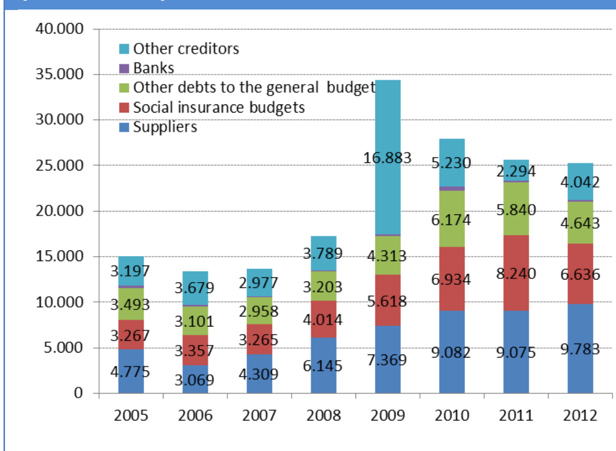
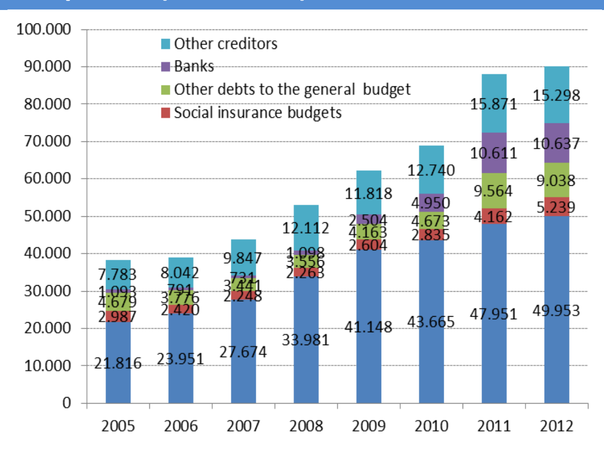
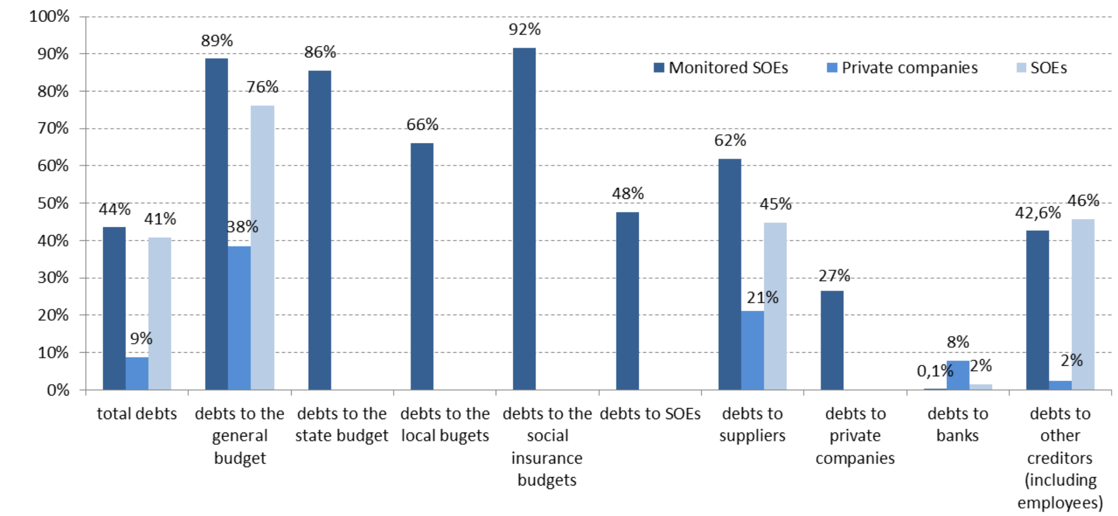


Figure 45: Structure of arrears – private companies (million lei)



Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Figure 46: Arrears as share of debts (2012)



Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Note: Monitored SOEs - 238 central SOEs supervised in the IMF/EC/WB agreement.

Besides direct fiscal consequences generated by SOE's arrears – revenue shortfalls to the general consolidated budget - the accumulation of outstanding payments towards the private sector is likely to create liquidity problems and to hamper the economic recovery.

The top 10 companies in terms of outstanding payments account for over 60% of the total arrears of SOEs, the arrears being particularly high in the railway, mining and energy sectors.

Table 14: Top 10 SOE's arrears

Top 10 arrears in Dec 2012

	Company name	Arrears (million lei)
1	COMPANIA NATIONALA A HUILEI SA	4,904.60
2	SC OLTCHIM SA	2,505.96
3	RADET BUCURESTI	2,412.76
4	SNTFM CFR MARFA SA	1,572.26
5	CNCF CFR SA	1,491.56
6	S.C. P.E.E.H. HIDROELECTRICA S.A.	1,058.58
7	S.N.T.F.C. CFR CALATORI S.A.	762.28
8	C.N.M.P.N REMIN S.A	576.51
9	SOCIETATEA NATIONALA A CARBUNELUI SA PLOIESTI	516.86
10	S.C.UZINA MECANICA CUGIR S.A.	457.00
	% din total	**64.1%**

Top 10 arrears in Dec 2011

	Company name	Arrears (million lei)
1	COMPANIA NATIONALA A HUILEI SA	5,228.03
2	CNCF CFR SA	4,454.50
3	RADET BUCURESTI	2,021.63
4	SC PENTRU INCHIDEREA-CONSERVAREA MINELOR SA	1,762.82
5	SNTFM CFR MARFA SA	1,209.12
6	SC ELECTROCENTRALE BUCURESTI SA	920.55
7	C.N.M.P.N REMIN S.A	576.20
8	S.C.UZINA MECANICA CUGIR S.A.	439.64
9	S.N.T.F.C. CFR CALATORI S.A.	419.11
10	SOCIETATEA NATIONALA A CARBUNELUI SA PLOIESTI	387.70
	% din total	**66.4%**

Top 10 arrears in Dec 2010

	Company name	Arrears (million lei)
1	CNCF CFR SA	6,598.66
2	COMPANIA NATIONALA A HUILEI SA	4,791.61
3	SC TERMOELECTRICA SA	3,020.51
4	RADET BUCURESTI	1,077.17
5	CNADNR SA	946.71
6	SNTFM CFR MARFA SA	867.98
7	SC ELECTROCENTRALE BUCURESTI SA	591.68
8	C.N.M.P.N REMIN S.A	572.08
9	S.N.T.F.C. CFR CALATORI S.A.	523.39
10	SC ELECTRIFICARE CFR SA	519.39
	% din total	**69.6%**

Top 10 arrears to consolidated general budget in Dec 2012

	Company name	Arrears (million lei)
1	COMPANIA NATIONALA A HUILEI SA	4,865.40
2	SNTFM CFR MARFA SA	876.92
3	SOCIETATEA NATIONALA A CARBUNELUI SA PLOIESTI	505.30
4	C.N.M.P.N REMIN S.A	501.09
5	S.C.UZINA MECANICA CUGIR S.A.	449.80
6	CNCF CFR SA	304.98
7	SOCIETATEA ROMANA DE TELEVIZIUNE	273.70
8	SNCFR RA	267.55
9	S.C.FORTUS S.A.IASI	252.38
10	SC ELECTROCENTRALE BUCURESTI SA	220.80
	% din total	**75.5%**

Top 10 arrears to consolidated general budget in Dec 2011

	Company name	Arrears (million lei)
1	COMPANIA NATIONALA A HUILEI SA	5,176.37
2	CNCF CFR SA	2,063.23
3	SC PENTRU INCHIDEREA-CONSERVAREA MINELOR SA	1,239.19
4	SNTFM CFR MARFA SA	673.88
5	C.N.M.P.N REMIN S.A	500.27
6	S.C.UZINA MECANICA CUGIR S.A.	431.11
7	SOCIETATEA NATIONALA A CARBUNELUI SA PLOIESTI	374.64
8	SNCFR RA	267.47
9	S.C.FORTUS S.A.IASI	240.61
10	S.C.MOLDOMIN SA	225.88
	% din total	**79.5%**

Top 10 arrears to consolidated general budget in Dec 2010

	Company name	Arrears (million lei)
1	COMPANIA NATIONALA A HUILEI SA	4,743.82
2	CNCF CFR SA	2,883.46
3	SC ELECTRIFICARE CFR SA	514.64
4	SOCIETATEA NATIONALA A CARBUNELUI SA PLOIESTI	503.06
5	C.N.M.P.N REMIN S.A	496.43
6	SNTFM CFR MARFA SA	433.14
7	SNCFR RA	267.45
8	SOCIETATEA NATIONALA A LIGNITULUI OLTENIA SA	249.94
9	S.C.FORTUS S.A.IASI	225.41
10	S.C.MOLDOMIN SA	222.06
	% din total	**80.4%**

Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Table 15: SOEs arrears evolution by type of company								
Total arrears (million lei)	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Autonomous administrations	1,450.98	1,120.11	960.09	1,130.70	1,411.14	2,019.32	3,153.75	3,662.52
Companies owned 100% by the state	9,031.55	8,272.53	5,876.08	6,802.97	8,102.41	9,648.19	7,670.87	5,605.94
National Research and Development Institute	93.25	71.38	74.93	77.60	184.32	298.81	320.34	79.31
National companies and societies	2,316.54	1,945.73	5,511.38	7,945.22	23,710.69	15,032.90	12,773.24	10,350.17
Companies representing subsidiaries of companies owned by the state	0.00	0.00	0.00	0.00	0.00	0.00	444.61	458.84
Other state economic units untransformed in companies or autonomous administrations	0.00	0.00	0.00	0.00	0.00	0.00	0.00	334.01
State – owned companies, local and foreign state capital (state capital >= 50%)	4.76	6.91	4.65	5.52	1.05	0.26	46.28	3.27
State –owned companies, local and foreign private capital (state capital >=50%)	34.20	32.39	529.42	717.28	35.38	78.59	330.44	2,551.90
State –owned companies and with local private capital (state capital >=50%)	2,165.38	2,098.41	552.79	609.37	957.00	932.08	1,504.96	2,308.42
State –owned companies and with foreign private capital (state capital >=50%)	2.05	0.00	2.11	0.86	1.66	0.37	0.47	0.43
State –owned companies, privatized in the reporting year	101.27	9.38	178.37	4.81	1.38	1.79	2.06	0.62
TOTAL arrears	**15,199.98**	**13,556.86**	**13,689.81**	**17,294.33**	**34,405.02**	**28,012.31**	**26,247.02**	**25,355.42**

Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Figure 47: Operating surplus (%)

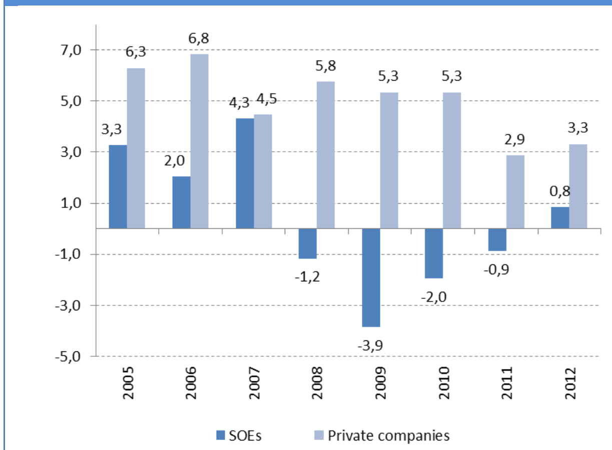
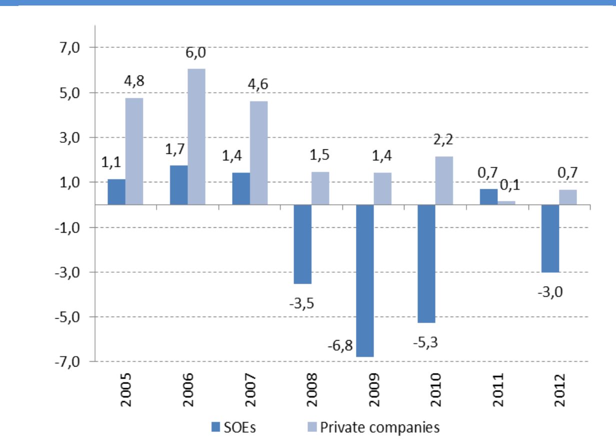


Figure 48: Profit margin (%)



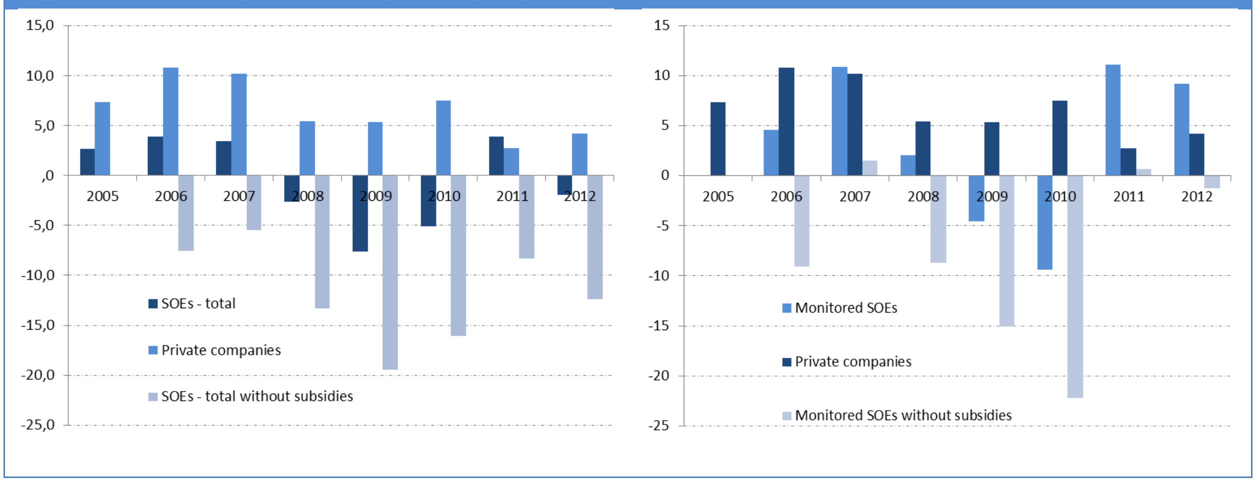
Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

*Note: Operating surplus (%)=Operating surplus /Total income*100*
*Profit margin (%)=Net result/Total income*100*

Regarding the financial performance of SOEs, they are less efficient and oriented towards performance compared to private companies. SOE's profitability is much weaker than the one of the private sector, as shown in the profit margin or in the operating surplus rate.

Moreover, if we exclude subsidies and transfers received from the general consolidated budget, state companies had a negative result for the entire period 2006 – 2012. It is to be mentioned that, in 2011 – 2012 a significant improvement in the gross profit rate per employee for the 238 central companies monitored in the agreements with IMF/EC/WB was recorded; even without subsidies and transfers from the general consolidated budget the losses were eliminated at the aggregate level. At the same time, local state companies continued to deteriorate their financial performance in 2011 – 2012 and the losses recorded being even higher.

Figure 49: Gross profit rate per employee



Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Note: Monitored SOEs - 238 central SOEs supervised in the IMF/EC/WB agreement.

The reduced capacity of the state companies to generate profit compared to the private ones is reflected in a lower ability to pay the debts. Moreover, the coverage rate of interest expenses in the case of state companies was very low (even negative in 2009, 2010, 2012), which means that their result before interest payment was negative, not allowing them even to pay their interest to the accumulated debt.

Figure 50: Interest coverage ratio

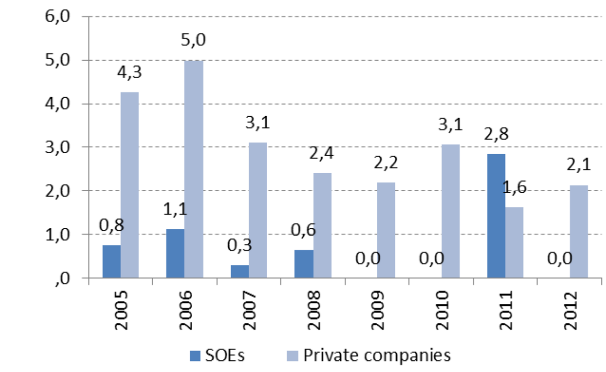
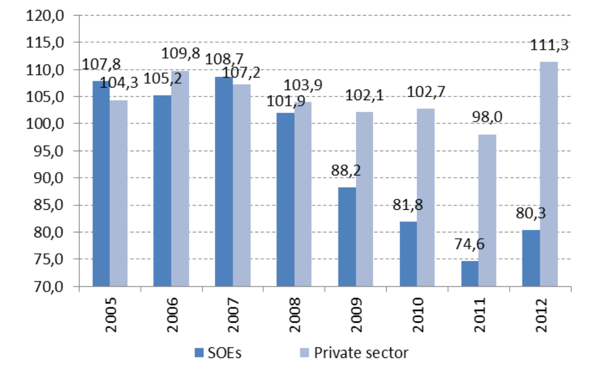


Figure 51: Liquidity ratio (%)



Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Note: Interest coverage ratio = (Profit or current loss + interest expenses – interest incomes)/interest expenses

*Liquidity ratio (%)= current assets / short term debts *100*

In terms of liquidity, the state companies were significantly affected by the financial crisis, their liquidity rate being far below that of the private sector. As a result of the poor financial performance, state companies are less able to make new investments compared to the private sector.

Figure 52: New investments (% of total assets)

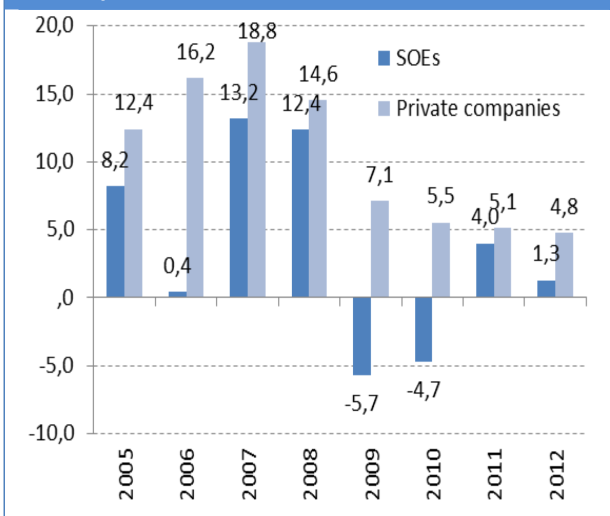
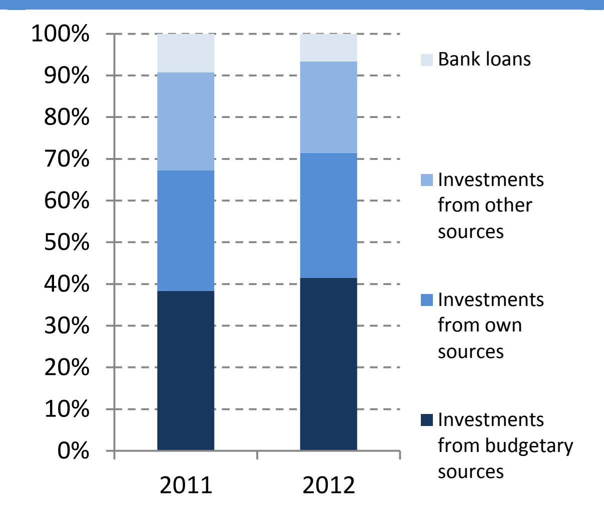


Figure 53: Structure of financing sources of SOEs investments



Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

Note: New investments are calculated as non-financial fixed assets + amortization and depreciation expenses

In addition, as a consequence of the poor financial performance, the main source of investment financing is represented by budgetary sources, the access to the bank financing being relatively low.

A potential risk to the sustainability of public finances in the medium term is related to the accumulation of losses and arrears in companies where the state is the majority shareholder. Their functioning in conditions of poor financial discipline harms the business environment, but also has an indirect impact on public finances If these companies fail to streamline their business, sooner or later, the government will be forced to interfere to save them, with negative implications on the budget deficit. The impact on budget deficit in cash terms might manifest through direct payments from the state budget to pay arrears (subject to European rules on state aid), by increasing capital or by lower budgetary revenues caused by the poor collection of corporate income tax, personal income tax or social contributions. Given the high level of arrears accumulated by SOEs, at the end of 2012 the unpaid debt to the general consolidated budget represented 1.9% of GDP.

The impact of state companies on the budget deficit in European standards based on commitments (ESA95) may be an additional pressure on the budget deficit targets undertaken by the government in accordance with the Maastricht criteria (below 3 percent of GDP in ESA95 terms) and the Fiscal Compact (structural deficit below 1% of GDP). The impact on the budget deficit in ESA95 standards manifests (i) by the issuance of state guarantees (also subject to EU rules on state aid) and especially (ii) by the reclassification of state enterprises within the public administration.

According to the Eurostat accrual methodology (ESA95), several state enterprises have been reclassified in the public sector. The 28 central state companies and the 68 local state companies had a negative influence on the general government deficit in ESA95 terms in 2006 – 2009, their contribution being slightly positive in 2010 – 2012.

Table 16: Contribution of state companies included in the public sector to the consolidated budget deficit (mn. lei)

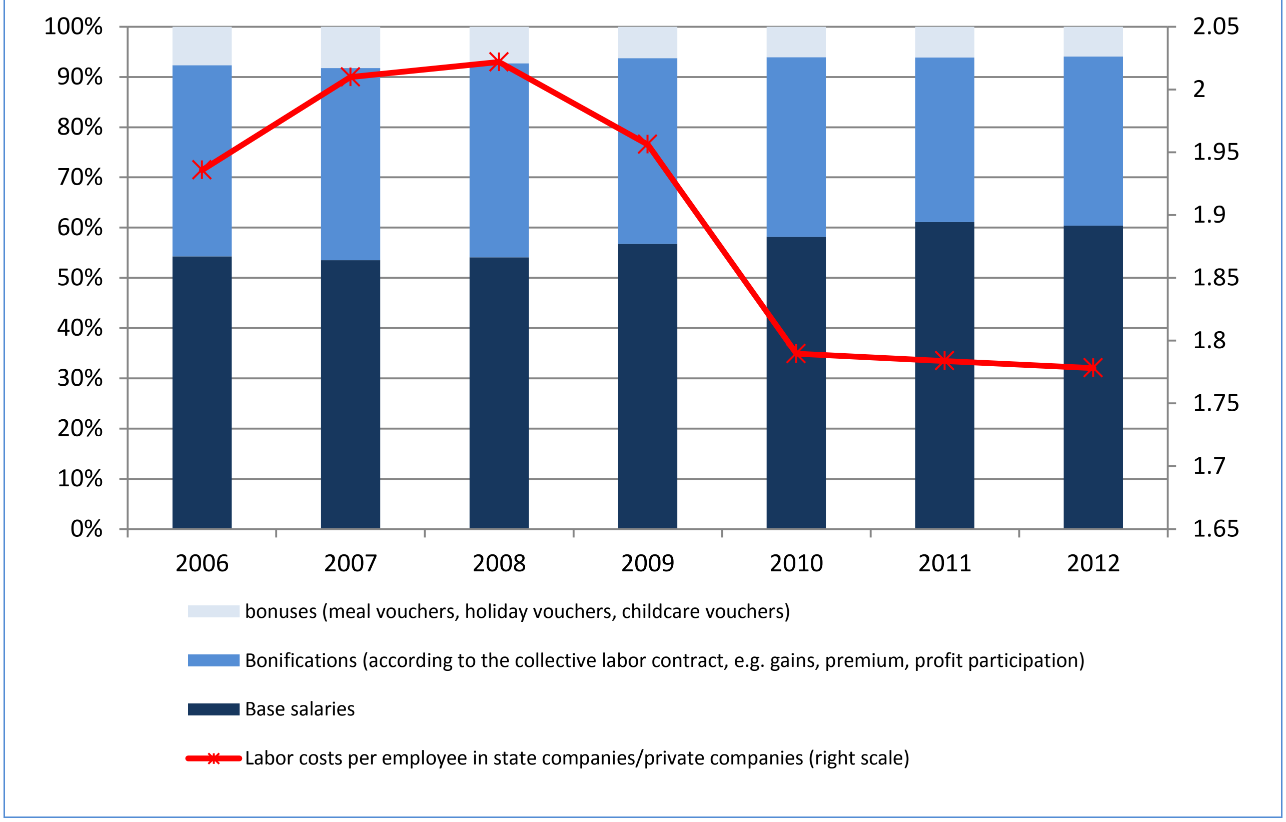
	2006	2007	2008	2009	2010	2011	2012
1. Total central companies	**-112,7**	**-621,5**	**-1612,4**	**-3056,1**	**648,8**	**1239**	**783,2**
Compania Naţională de Autostrăzi şi Drumuri Naţionale				-1590,9	863,5	1100,5	-1070,1
Metrorex				-333,5	-31,3	-18,1	-20,4
Administraţia fluvială Dunărea de Jos Galaţi				25,8	7,4	-0,6	-10,5
CFR Călători SA				139,9	158	62,6	-182,4
CN a Huilei Petroşani				-139,7	-81	-205,5	40,3
SN a Cărbunelui				-0,7	-6	-0,2	0

CN de Radiocomunicaţii Constanţa				0,5	2,5	0,2	-0,2
Administraţia Naţională a Îmbunătăţirilor Funciare				-34,3	-60,9	NA	NA
SC Intervenţii feroviare SA				-32,4	-38	-4,5	-8,2
Fondul Proprietatea				131,5	-12,8	192,3	-6,6
SC Electrificarea SA				-147,8	-43	-24,1	-9,3
SC TERMOELECTRICA SA				71	-94,9	-24,5	-127,5
CN de Căi Ferate CFR SA				-1089,2	77,4	181,5	2226
CN Administratia Canalelor Navigabile Constanţa SA				0,5	-2,3	-1,7	5,2
Societatea Nationala Aeroportul International Mihail Kogalniceanu				9,7	-49,4	-0,4	-0,1
SC CN Romarm SA Buc - Filiala SC Uzina Mecanica Cugir SA				-39,2	-44,5	4	-37,2
SC Santierul Naval Mangalia SA				-1,8	-2	1	0,8
Societatea Feroviara de Turism SFT CFR				-5,7	19,6	0,5	-1,4
SC Uzina Mecanica Orastie				-0,7	-0,4	-9,9	-9,4
Societatea de Transport Maritim si de Coasta CFR Ferryboat SA				-2,4	-2,4	-3,2	-0,1
SC Avioane Craiova SA				-4	-3,5	-5,9	-1,9
SC Petromin SA				-5,9	-1,4	0	0
SC Constructii Aeronautice SA				-4,1	-3	-0,8	-1
SC Sanevit 2003 SA				-1	-3,3	-0,8	-1,4
SC Uzina AutoMecanica SA Moreni				-7,9	-1,5	-4	-2
SC TEROM SA				0	0	0	0
SN Plafar SA				7,3	0	0,6	0,6
SC NICOLINA SA				-1,1	2	0	0
2. Total local companies	**-44**	**-116,3**	**-382,7**	**-145,1**	**-51,2**	**23,4**	**23,4**
Local airports				18,9	18,1	14,5	14,5
Central heatings of local subordination				-117,9	161,4	-18,7	-18,7
Other local units				-46,1	-230,7	27,6	27,6
3. Total SOEs	**-156,7**	**-737,8**	**-1995,1**	**-3201,2**	**597,6**	**1262,4**	**806,6**
% of GDP	**-0,05%**	**-0,18%**	**-0,39%**	**-0,64%**	**0,11%**	**0,23%**	**0,14%**

Source: NIS

Regarding wage policies within state companies, the available data suggest that they are completely disconnected from efficiency and productivity gains. In the period 2005 – 2008, the wage bill in the state enterprises sector increased by over 70% (from 8.7 billion lei in 2005 to 14.9 billion lei in 2008, falling to 13.8 billion lei in 2012), despite that their financial performance deteriorated, registering losses in the entire analyzed period, excluding subsidies and transfers from the general consolidated budget. In addition, the remuneration policies in state companies were completely nontransparent and included in the analyzed period a component of about 40% composed of bonuses and other incentives, much higher than the one suggested by the best practices in OECD countries. The base salaries in the case of state companies are equal to the total remuneration in the case of most OECD countries (e.g. Australia, Canada, Iceland, Ireland, Denmark, Portugal, Sweden, Switzerland, UK, USA) and represents between 70% and 95% in countries such as Austria, Finland, Germany, France and only 20% in Greece. In addition, labor costs per employee in the case of state enterprises were 2 times higher than in private companies in 2007 – 2008, being still by 75% higher in 2012.

Figure 54: The share of base salaries in total salaries in the public companies and the wages' ratio of SOEs and private companies



Source: Fiscal Council's calculations based on data from the National Trade Register Office and Ministry of Finance

V.2. Arrears of the general budget

If in 2011, compared with the previous year, the general consolidated budget arrears[18] to the private sector have improved significantly[19], in 2012 all quarterly targets assumed in the agreement with the IMF were exceeded. Thus, the gap to the target for the end of 2012 compared to December 31th 2011 was about 550 million lei (primarily located in the local budgets) also in the context of increasingly ambitious targets, Romania committing itself to the IMF to take decisive measures to eliminate this source of inefficiency in the economy.

Table 17: Quarterly evolution of general consolidated budget arrears in 2012 (million lei, without hospitals)

	2011 QIV	2012 QI	2012 QII	2012 QIII	2012 QIV	2013 QI
State budget	**284.2**	**668.1**	**695.4**	**430.6**	**331.4**	**293.8**
Under 90 days	198.3	510.9	548.4	247.3	303.7	223.7
Between 90 -120 days	19.2	64.6	32.8	73.6	12.3	30.9
Between 120-360 days	46.0	67.8	88.7	81.1	9.3	31.3
Over 360 days	20.7	24.8	25.5	28.5	6.1	8.0
Local authorities	**1379.5**	**1521.8**	**2130.8**	**2297.3**	**1922.2**	**1848.1**
Under 90 days	626.7	701.9	958.0	971.7	1082.0	914.8
Between 90 -120 days	172.6	223.1	240.3	408.0	210.7	309.2
Between 120-360 days	280.7	271.7	542.1	491.7	323.9	374.0
Over 360 days	299.6	325.1	390.5	426.0	305.6	250.1
Social security budget	**1102.5**	**1328.8**	**1418.8**	**1421.9**	**1415.7**	**1352.4**
Under 90 days	1102.5	1328.8	1418.8	1421.9	1415.7	1352.4
Over 90 days	0.0	0.0	0.0	0.0	0.0	0.0
Total	**2766.2**	**3518.7**	**4245.1**	**4149.8**	**3669.3**	**3494.2**
Under 90 days	1927.5	2541.7	2925.3	2640.8	2801.4	2490.9
Between 90 -120 days	191.8	287.6	273.1	481.7	223.0	340.0
Between 120-360 days	326.7	339.5	630.7	572.8	333.3	405.3
Over 360 days	320.2	349.9	415.9	454.5	311.6	258.0
Total arrears	**838,7**	**977,0**	**1319,8**	**1509,0**	**867,9**	**1003,3**
IMF target	**840**	**960**	**560**	**790**	**320**	**320** [20]
Overrun	**-1.3**	**17.0**	**759.8**	**719.0**	**547.9**	**683,3**

Source: Ministry of Public Finance

[18] Arrears are overdue payments older than 90 days, calculated from the due date.

[19] The compliance of quarterly targets agreed with the IMF and the reduction of 287.2 million lei at the end of 2011 compared to the end of 2010 were achieved.

[20] The previous target is maintained (Q4, 2012).

Analyzing the evolution of arrears during 2012, a strong increase in the first two quarters due to the electoral process can be observed, followed by a reduction in the last part of the year, but insufficient to achieve the targets. With a share of over 50% of the total outstanding payments (respectively 84-97% of the arrears), local governments are the main source of arrears, even if consistent legislative measures have been taken in order to reduce them and to prevent the accumulation of new arrears (see *Box 3*).

As a result of the implementation of these measures, the accelerated increase of arrears in the first half of the year was tempered in the last quarter, but exceeding the indicative target agreed with IMF was significant (548 million lei). The evolution of arrears in 2012 reveals a considerable advance in the April – September period (gaps from the targets of 760 million lei in the second quarter, respectively 719 million in the third quarter) followed by a relative recovery in the fourth quarter (when compared to the third quarter local budgets arrears are reduced by about 500 million lei).

BOX 3: Summary of the main measures taken to reduce budgetary arrears:

- 20% of the share from personal income tax that reverts to local authorities is distributed by County Council resolution (respectively 15% by General Council of Bucharest decision) for the payment of arrears arising from the nonpayment of operating and/or capital expenses, in chronological order of their seniority, to support the local development programs and infrastructure projects that require local financing;
- Authorizing officers of local budgets with arrears are required to reduce in each month the stock of arrears by 5% in the case of local authorities, respectively by 3% for self-financed local institutions compared to the previous month;
- Ceasing in case of non-compliance to the above mentioned rule of the transfer of revenues from the state budget that reverts to local authorities for line credit officers of local budgets
- Ceasing the payments of self-financed public institutions except for salaries, or arrears.
- 30% reduction of the entertainment expenses and expenses related to abroad travel made by public authorities and institutions, central or local;
- Approval of new expenditure commitments, within the approved budgetary provisions, only after clearing the outstanding payments (with the exception of new commitments for projects funded by external post-accession grants);

- Supplementing the budget of the Ministry of Transport and Infrastructure from the Contingency reserve fund at the government's disposal, stipulated in the state budget for 2012.
- Supplementing the share from VAT that reverts to local authorities to balance local budgets for 2012 regarding the payment of arrears corresponding to current and capital expenditure, and for co-financing the projects funded by external post-accession grants.

The efficiency of the measures taken in 2012 is questionable given the constant failure to meet the targets and the continuous accumulation of new arrears. It is worth noting that, in the first quarter of the current year the stock of arrears recorded again an increase (located at the level of the local budgets), the gap to the indicative target of Q4 2012 rising to 683 million lei, which proves the urgency of additional measures for increasing the fiscal discipline of local authorities.

In this respect, we could note that, although since January 2013 new measures were taken in order to reduce the arrears of the local budgets[21], the outstanding payments have increased compared to December 2012 (840 million lei), reaching at the end of February 2013 1200 million lei, respectively 933 million lei on March 31th.

By the recent approval of the Local Insolvency Law by the *Emergency Ordinance regarding the financial crisis and the insolvency of local authorities*, an obligation which was assumed by the Government in autumn 2012 in the letter of intent to the International Monetary Fund, the premises for restricting excessive expenditure of the local authorities and for a better correlation of these with the real possibilities of the public budget are created.

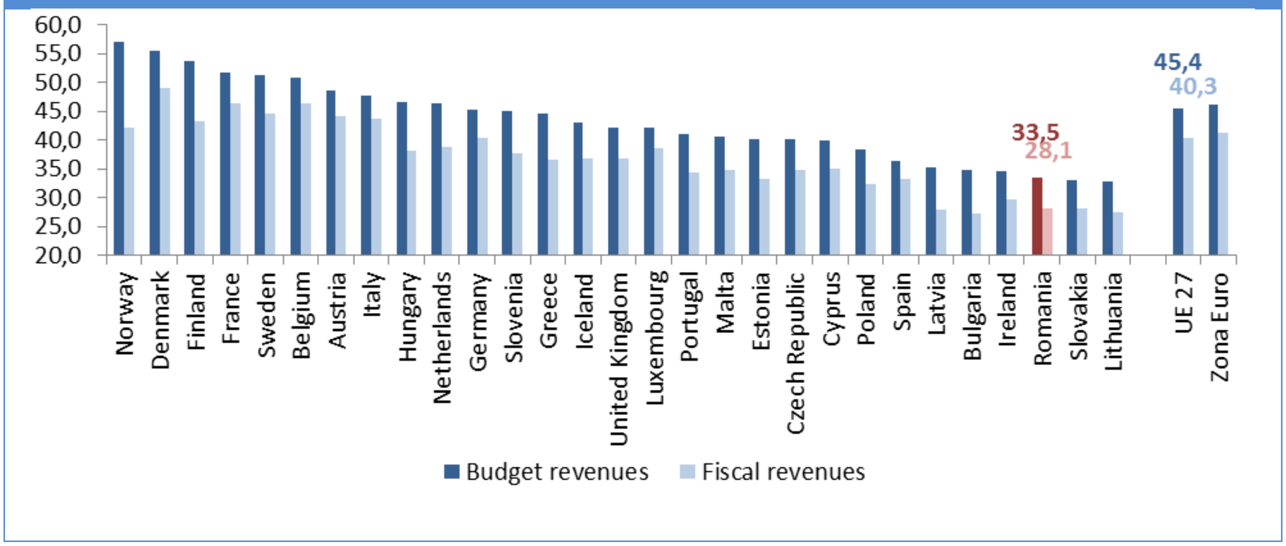
The Fiscal Council supports the measures taken and considers that positive effects could be generated in the longer run, but notes that at the present this recurring problem is not solved. Also, the Fiscal Council considers that decisive measures should be taken in order to eliminate the structural causes that lead to the accumulation of arrears, while these measures constitute only a short-term solution for this problem and are not sufficient.

[21] The local authorities that recorded arrears on January 31st 2013 were required to reduce the debt by at least 85% within two months, until March 31st , otherwise the Treasury will limit payments that can be made on their behalf. By exception from the Law on local public finances, local authorities are allowed to contract from the Ministry of Finance, until March 29th 2013, loans from privatization receipts recorded in the general account of the Treasury, with a maximum reimbursement term of five years and a maximum available ceiling of 800 million lei.

V.3. Tax collection in Romania – international comparisons

Romania has one of the lowest shares of overall government revenues to GDP in the EU (tax and non-tax revenue), of only 33.5% of GDP in 2012, 11.9 percentage points of GDP lower than the EU average. Tax revenue to GDP (taxes and social contributions) in Romania was equal to 28.1% in 2012, 12.2 percentage points lower than the EU 27 average (40.3%). However, it is to be mentioned that in 2012 the gap between Romania and the EU average decreased compared to previous year by 0.2 percentage points of GDP both in the case of the total and tax revenues. The share of tax revenue to GDP is significantly lower than in similar economies like Hungary (38.1%), Slovenia (37.8%), Czech Republic (34.8%) and Poland (32.4%).

Figure 55: Budgetary revenues and fiscal revenues (% of GDP, ESA95, 2012)



Source: EUROSTAT; tax revenues include social contributions

The structure of tax revenue in Romania reveals a high share of revenues from indirect taxes, respectively 46.81% of total tax revenue compared to the EU 27 average of 33%, while the share of revenue from social security contributions was 31.47% (EU 27 34.74%) and from direct taxes - only 21.72% (EU27 32.26%). Compared to 2011, the structure of tax revenue has remained approximately the same, given that there are no major changes in the tax system or collection efficiency. The indirect taxes are the main component of tax revenues, their weight being significantly above the EU average, given that the fiscal consolidation initiated in 2010 included on the revenue side of the budget an increase in indirect taxes that led to a widening gap between Romania and EU average in this respect.

The tax system in Romania is characterized by a weak tax collection, with inefficient administration and excessive bureaucracy (*Table 17*), a relatively small tax base, with many legal exemptions and deductions and increased tax evasion (*Chapter V.5 Tax evasion*).

However, in recent years several measures were initiated in order to improve this situation but their efficiency will be probably fully observable in the future.

According to an OECD report on tax administration[22], the efficiency of tax administration is very low in Romania, being second to last in the NMS group, although in recent years some progress can be observed. According to the "Paying taxes 2013" report published by the World Bank, Romania is placed on the 136th rank from 183 countries worldwide regarding the ease of paying taxes (a better position compared to the previous year when it was on the 154th place). Also, a company from Romania has to initiate 41 payments per year in order to pay taxes, significantly higher than in other surveyed countries, but this number is in a sharp decrease compared to the previous year when 113 payments to settle the tax obligations were required. In 2011, in Romania 263 financial administrations were functional, having after Poland the second most complex administrative system among the analyzed countries. Relative to the population, the situation is more favorable with the specification that in Romania also the number of taxpayers is lower. Compared to 2009, an improvement in the efficiency of the tax administration can be noticed, both in terms of number of financial administrations, number of employees in these administrations and in terms of the ease of paying taxes. The reform initiated in Romania in this area seems to lead to positive results, but these must be confirmed by the 2012 data as well as the ones from the coming years.

Table 18: Efficiency of tax administration

Country	Administrative offices				Number of administrative offices to 1 million people	Revenue (% of GDP)/ Administrative offices	Number of employees	Number of employees	Total tax revenue (% of GDP)	Tax revenue (% of GDP) to 1000 employees **	Total payments number***	Ease of paying taxes (rank)	Number of employees to 1 million people
	Total, o/w:	Central	Local	Differences compared with 2009 (total)				Differences compared with 2009					
	2011				2011		2011		2011		2012		
Bulgaria	29	6	23	0	3.9	0.9	7708	-268	27.3	3.54	15	91	1046
Czech Republic	207	8	199	0	19.7	0.2	14640	-893	34.8	2.38	8	120	1396
Estonia	4	4	0	0	3.0	8.3	783	-95	33.2	42.40	8	50	584
Latvia	34	0	34	-29	16.4	0.8	4300*	-	27.9	6.35*	7	52	2073
Lithuania	10	10	0	0	3.3	2.7	3516	-300	27.4	7.79	11	60	1152

22 „Tax Administration 2013: Comparative Information on OECD and other advanced and emerging economies", 2013.

Poland	432	32	400	15	11.2	0.1	49273	-11128	32.4	0.66	18	114	1279
Romania	263	42	221	-177	12.3	0.1	22985	-2402	28.1	1.22	41	136	1073.4
Slovakia	110	8	102	-1	20.4	0.3	5343	-343	28.2	5.28	20	100	991
Slovenia	76	16	60	0	37.1	0.5	2417	-53	37.8	15.64	11	163	1179
Hungary	77	25	52	69	7.7	0.5	23059	7877	38.1	1.65	12	118	2309

Source: OECD, Eurostat, World Bank

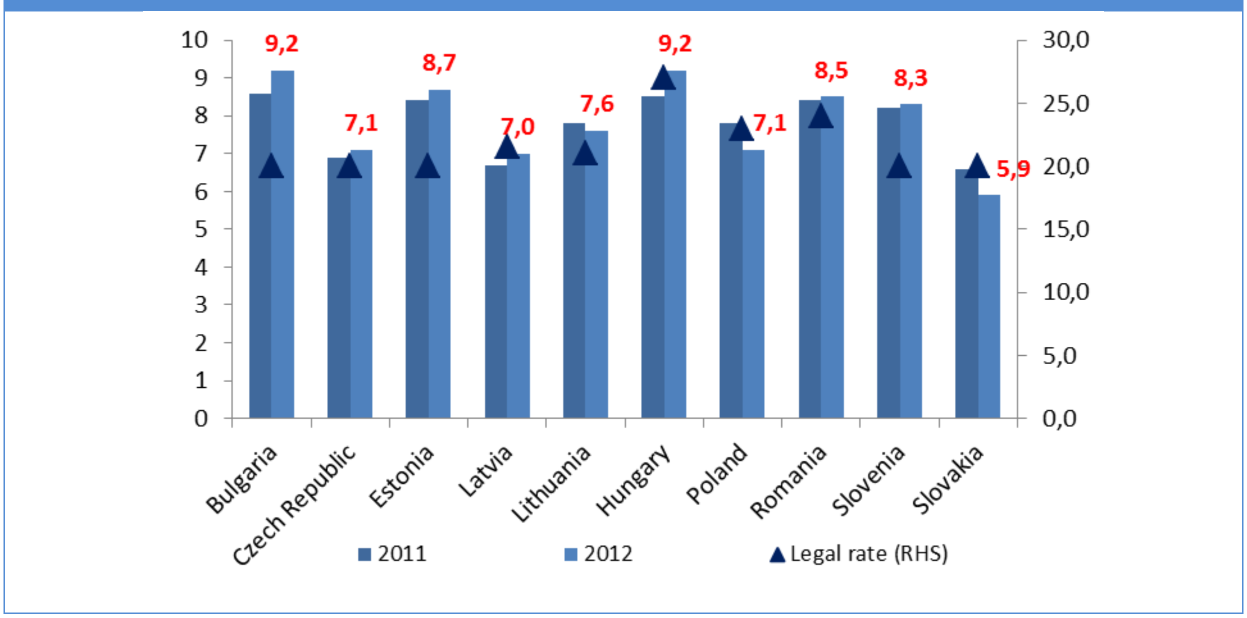
* 2009 data.

** The index is computed as ratio between tax revenues (% of GDP) and total employees in the tax collection system, reported by OECD in 2011, expressed as thousands of employees.

*** This index shows the total number of taxes and contributions paid, payment method, payment frequency, frequency of completing tax returns and the number of agencies involved in the tax collection process for companies in the second year of operation.

As an example of poor tax collection, Romania collected 8.5% of GDP from VAT revenues in 2012, slightly lower than in Estonia, while the legal VAT rate in Romania is much higher than that of Estonia (24% compared to 20%). Moreover, Bulgaria, having a structure of the economy similar to that of Romania and a lower legal VAT rate (of 20%), collected much more revenues from VAT in 2012, respectively 9.2% of GDP.

Figure 56: VAT revenues (% of GDP) – 2012

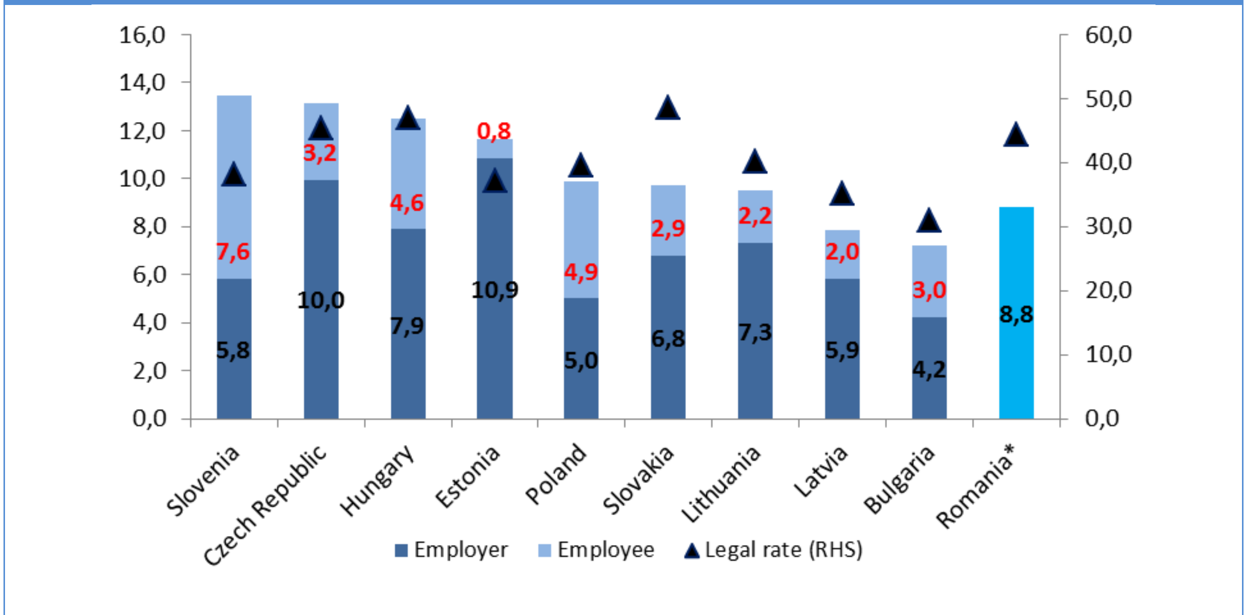


Source: European Commission, Eurostat

Regarding social contributions paid by both employees and employers, the revenues collected in 2012 amounted to 8.8% of GDP, a much lower figure than in the Czech Republic (13.1% of

GDP) and Hungary (12.5% of GDP), even if the three countries have relatively similar legal contribution rates. Romania's collection ratio is also much lower than the ones of Slovenia (13.4%), Estonia (11.7% of GDP), Lithuania (9.5%), and Poland (9.9%), where the statutory social contribution rates are significantly lower than in Romania.

Figure 57: Social contributions revenues (% of GDP) – 2012



Source: European Commission, Eurostat

** total social contributions revenues*

The Fiscal Council supports the start of the reform regarding the tax collection system, which should meet two key objectives: a significant increase in the collected revenues and lower administrative costs. In the Fiscal Council's opinion, this reform must focus primarily on the following components:

- an increase of the voluntary compliance of taxpayers, especially by simplifying the Tax Code and the Tax Procedure Code and also through a comprehensive program of total transparency regarding public expenditure;
- an increase in the efficiency and a reduction of collection costs, particularly by consolidating the number of tax administration offices, system computerization and aggressive promotion of electronic filling of tax returns and also electronic payments of taxes;
- the increase of professional quality of the personnel and the reduction of corruption, especially through appropriate training programs, introducing a code of ethics and a

clear system of measuring and rewarding performance, respectively punishing under-performance and corruption among employees;

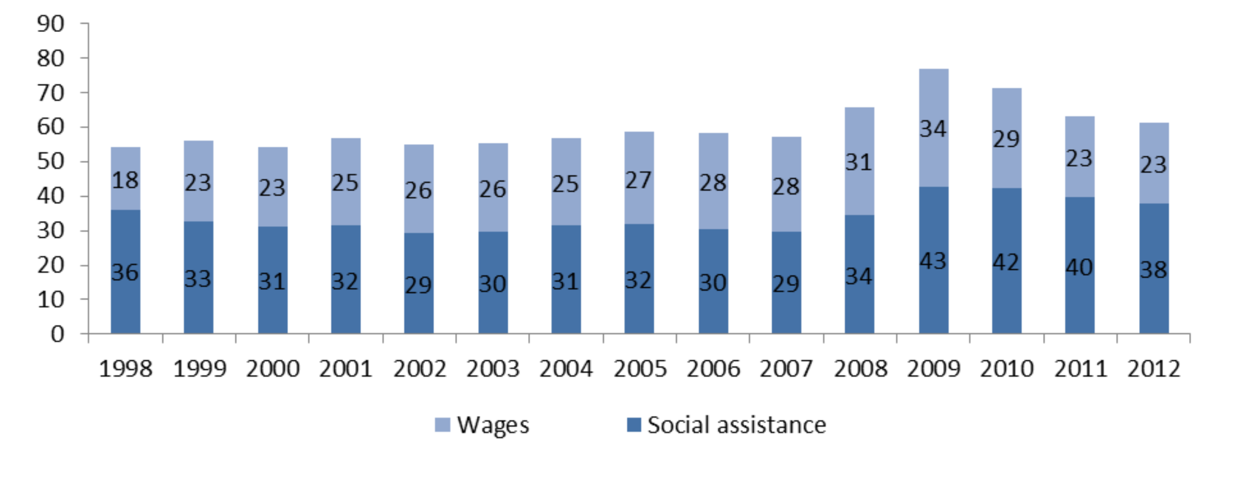
- the indirect stimulation of a more sustainable economic growth model through increased tax collection rates in order to allow accommodation of potential adjustments in the tax system aimed especially to stimulate employment (especially by reducing social security contribution statutory rates, which are high at the moment) and increase domestic savings in order to reduce reliance on foreign capital inflows to finance investments.

The Fiscal Council will closely monitor the results of the tax administration reform, an increase in the collection efficiency both in terms of revenue collection, but also in terms of the associated costs being able to generate fiscal space in the medium term. However, the adoption of decisions related to potential tax cuts or increase of expenditures based on potential efficiency gains must occur *ex post*, only after the reform process is proving irreversible and capable of generating long-term results.

V.4. Public expenditure – structure and sustainability

In Romania, the structure of the budgetary expenditures is characterized by the dominance of personnel and social assistance expenditure (pensions, social aids), but their relative importance has declined significantly in 2010 – 2012 as a result of the fiscal consolidation (*Figure 58*). After a relatively stable evolution of these items of expenditure, as a share of the budgetary revenues, before 2007, the personnel and pensions expenditure strongly increased during 2008 and 2009, to a level much higher than the EU-27 average, then diminishing below the level recorded in the CEE countries, with the exception of Hungary. If the share of personnel expenditure in total budgetary revenues in 2012 is the lowest in the past 14 years, social expenditure represents a significant share of revenues, much higher than during the period 2000 – 2007, even in the context of the adjustments occurred in the last 3 years.

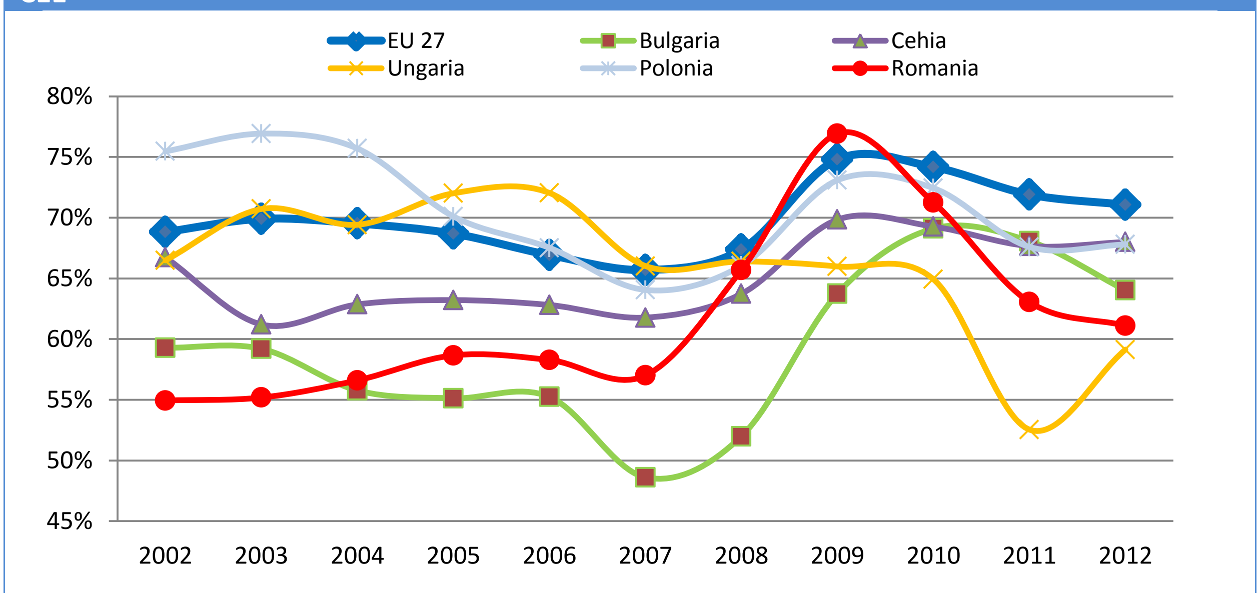
Figure 58: Social assistance and personnel expenditure as share of total budget revenues (%)



Source: EUROSTAT

The precarious state of the public pension system is an important vulnerability of the public finance position and the share of this expenditure category in total revenues is still too high. Applying the new pension law should support the objective of reducing the share of this expenditure category in total budgetary revenues in the medium-term. In terms of medium and long-term sustainability, it is important that any increases of wages in the public sector in the following years to be done only in line with the evolution of economic activity and, especially, with productivity gains.

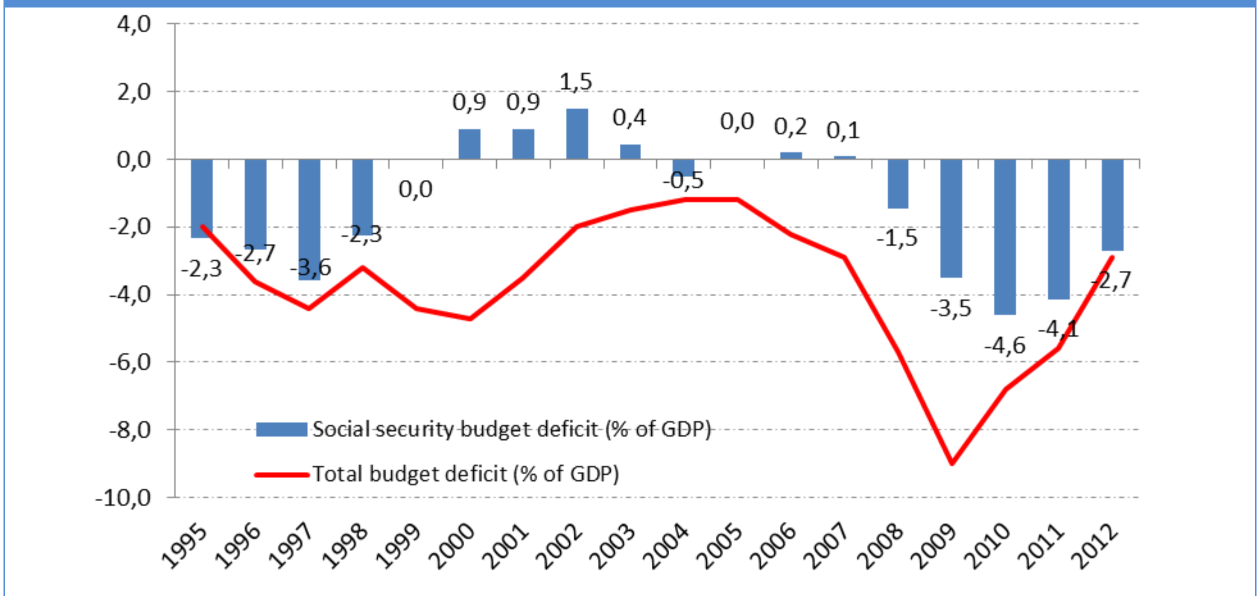
Figure 59: Social assistance and personnel expenditure (including pensions) in EU 27 and CEE



Source: EUROSTAT

If in 2000 – 2007, social security budgets were characterized by a relatively equilibrated or even positive balance, after 2008 the deficits have represented an important component of the general consolidated budget deficit, respectively between 68% and 93% in the period 2010 – 2012. Basically, in the latter year, Romania would have had a budget deficit close to zero compared to 2.9% of GDP, if the social security budget had been in equilibrium. Thus, the deficit recorded in the public pension system significantly affects the public finance position, representing a relevant risk to the sustainability of fiscal policy in the medium and long-run.

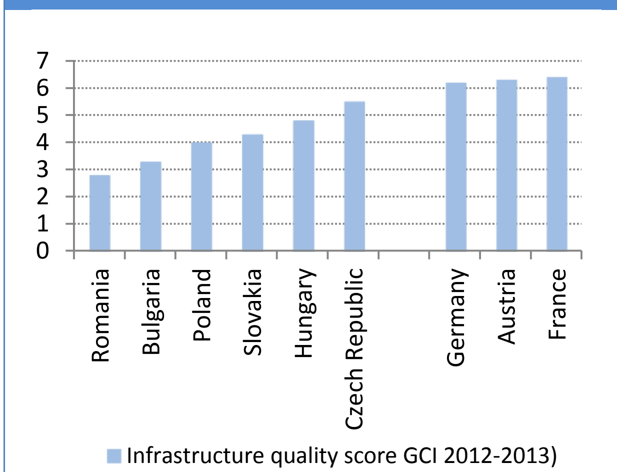
Figure 60: Social security budget deficit and total budget deficit



Source: EUROSTAT

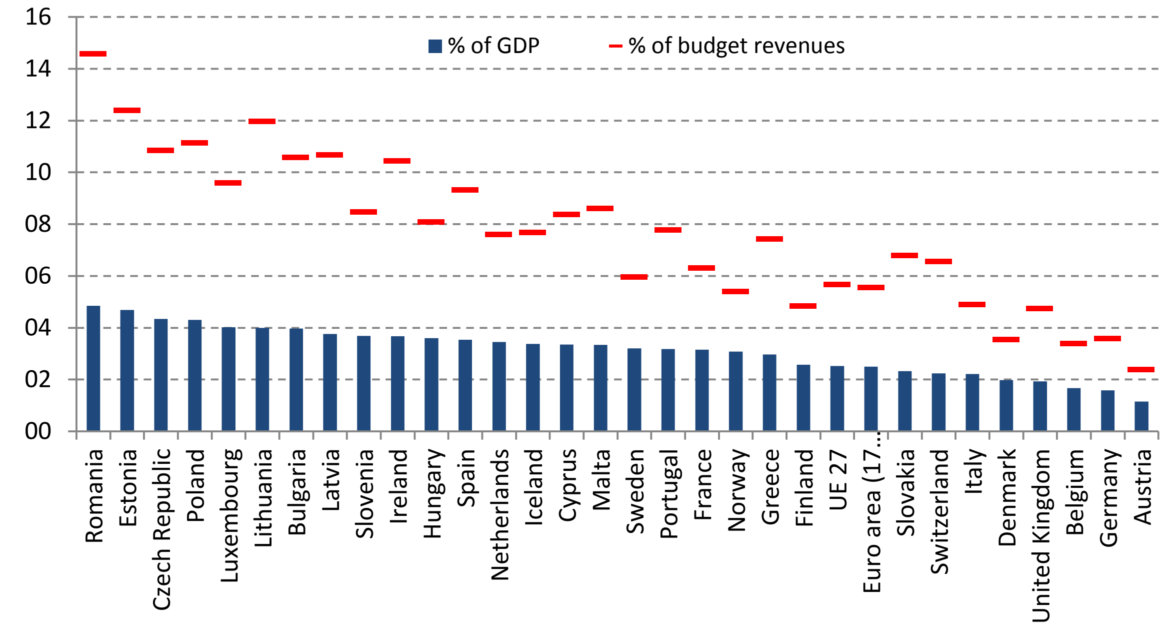
The efficiency reserves on the side of budgetary expenditure are very high. For instance, Romania had the largest allocation for investment expenditure as a share of GDP (and also as share of total budgetary revenues) of all European countries during 2002 – 2012; however, the results were modest, as Romania is still characterized by the poorest infrastructure in the EU. This example clearly shows that the resources were spent inefficiently. Among the mitigating circumstances can be listed: the low level of GDP and initial quality of infrastructure.

Figure 61: Infrastructure quality



Source: EUROSTAT, World Economic Forum, The Global Competitiveness Report 2012-2013

Figure 62: Investment expenditure



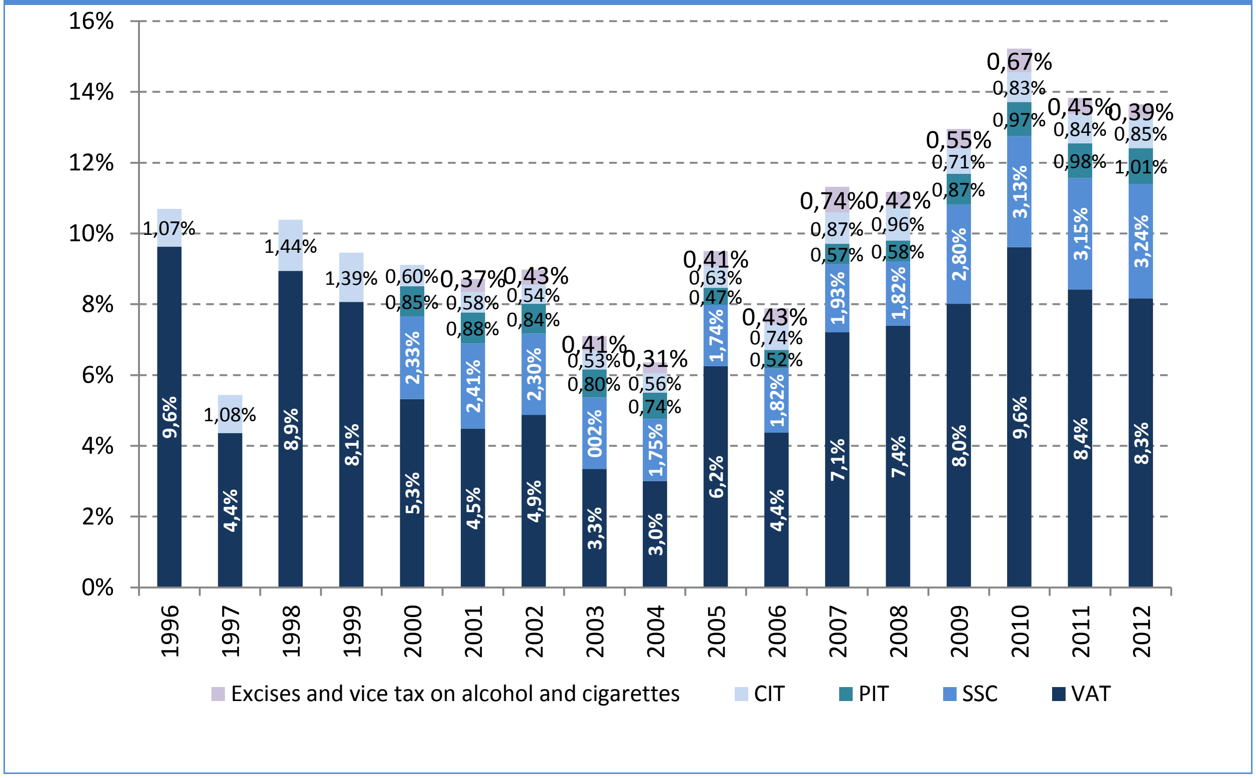
Source: EUROSTAT, World Economic Forum, The Global Competitiveness Report 2012-2013

V.5. Tax evasion

According to the Fiscal Council's calculations based on NIS data, tax evasion has a large share in the Romanian economy, accounting for 13.8% of GDP in 2012. If Romania would collect the taxes at their maximum potential, the budgetary revenues as a percentage of GDP would be higher than the European average. Consequently, a profound reform of the tax administration targeted towards increasing the degree of tax collection is essential.

About 60% of the tax evasion is generated by VAT fraud, which reached a maximum of 9.6% of GDP in 2010 (similar to the 1996 level), but in 2011-2012 the VAT tax evasion decreased to 8.3% of GDP. It is to be noticed that in 2010, when the legal VAT rate was increased from 19% to 24%, tax evasion rose from 8% of GDP in 2009 to 9.6% of GDP.

Figure 63: Development of tax evasion for the main tax categories (% of GDP)



Source: Fiscal Council's calculations based on data from the National Institute of Statistics

Box 4: VAT tax evasion computation[23]

VAT tax evasion represents the difference between the theoretical level of the implicit VAT from of the economic activity, including the unobserved economy, and the VAT revenues collected by the State according to ESA95 methodology. This assessment for the VAT tax evasion is not necessarily the result of tax evasion exclusively, and can be explained by other factors such as: (i) legal practices of VAT elusion, (ii) the entry of companies into insolvency, leading to a reduction of VAT revenues collected by the State, and (iii) the accuracy of the national accounts data, on which the theoretical VAT was estimated.

The theoretical VAT is calculated by identifying those categories of expenditures that should generate final non-refundable VAT. At the macroeconomic level, these expenditures can be divided into three categories :

- ✓ *Final consumption of households and government*. Households' final consumption expenditure includes all expenditures for goods and services made by households to meet their specific needs. The main items included in the households' final consumption expenditure are:

[23] In the Fiscal Council's previous reports were presented calculations for VAT fraud only for "undeclared" work, as sufficient data in order to assess the overall VAT fraud were not available at that time. In this report, VAT fraud is calculated for the whole economy, based on detailed data provided by the NIS.

- the acquisition of goods, excluding self-consumption and farmhouse market;
- the expenditures for services destined for the market;
- the production for the public administration needs, meaning purchases of goods and services from administration, at a price economically insignificant;
- food and clothing purchased by the public administration for soldiers.

From the National Accounts we consider the sales of goods and services to the population, which constitute the main acquisitions of goods and services. To separate the transactions subject to non-deductible VAT from those exempted from VAT, a pro-rata is applied to each product and service. The result is added to other elements of the households' final consumption that are entirely subject to a not-deductible VAT:

- food and clothing purchased by government for free distribution to soldiers;
- social benefits in kind;
- hidden economy;
- market production of public and private administrations;
- sales on farmhouse market;
- custom taxes paid by the population;
- social transfers in kind.

✓ *Intermediate consumption of goods and services required to produce other goods and services* (i) exempted from VAT or (ii) offered by companies which are not subject for VAT (for firms with turnover below the legal ceiling that opted to not pay VAT and are not entitled to deduct their intermediate consumption) or (iii) if the procurement is not used for intermediate consumption for production of goods subject to VAT;

✓ *Gross fixed capital formation (GFCF) (investments)* made by companies (i) not subject to VAT or (ii) that produce goods and services exempted from VAT. GFCF is the value of durable goods purchased by resident producer units to be used in production for more than one year and the amount of goods and services included in the capital goods procured.

The total volume of non-deductible VAT transactions is obtained by adding non-deductible VAT transactions calculated for each type of utilization (final consumption, intermediate consumption and GFCF).

Table 19: Development of tax evasion for main taxes

Million lei	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Tax evasion for undeclared work:					1353	2310	2989	3905	4278	4546	5891	7671	8973	14652	16665	17528	18299
- PIT					362	618	799	1106	1273	969	1313	1763	2183	3473	3950	4155	4338
- SSC					991	1693	2190	2799	3005	3577	4578	5908	6790	11179	12715	13373	13962
Tax evasion for informal sector (households):					1225	1565	1784	1645	1877	1855	2174	2736	3393	3766	4821	5447	6629
- PIT					328	418	477	466	558	396	485	629	825	893	1143	1291	1571
- SSC					897	1146	1307	1179	1319	1460	1689	2107	2567	2873	3678	4156	5058
Total tax evasion for PIT					689	1036	1276	1572	1831	1365	1798	2392	3009	4366	5093	5446	5909
Total tax evasion for SSC					1889	2839	3497	3978	4324	5037	6267	8015	9357	14052	16393	17529	19019
Tax evasion for VAT	1096	1113	3314	4450	6198	9468	10712	12763	18683	18050	15067	29487	38228	40233	50190	46693	48899
Tax evasion for CIT	122	276	535	770	489	680	815	1043	1375	1814	2556	3638	4917	3563	4370	4664	5008
Tax evasion for vice tax for cigarettes and alcohol						432	658	813	769	1197	1482	3075	2163	2762	3518	2481	2308
TOTAL tax evasion						14455	16958	20168	26982	27462	27170	46607	57674	64976	79563	76812	81144
Gross value added in unobserved economy*	2095	4749	8634	11149	14642	21163	26763	30381	35814	47849	66117	83063	100741	104667	129769	135450	143906

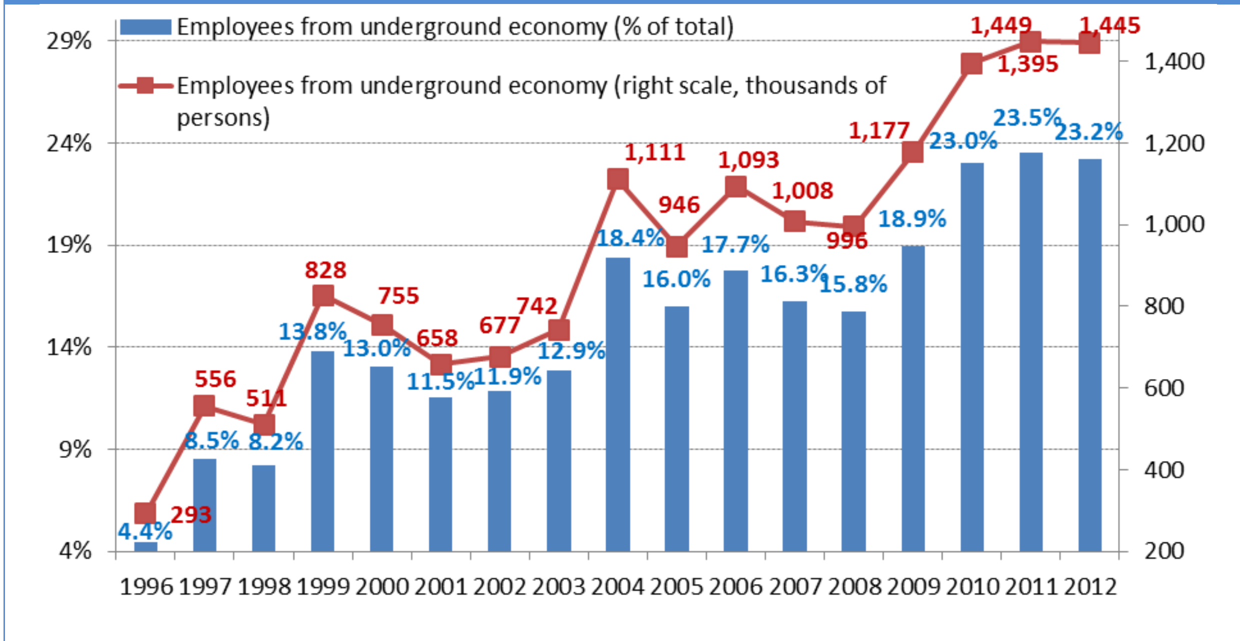
% of GDP					2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Tax evasion for undeclared work:					1.67	1.96	1.97	1.98	1.73	1.57	1.71	1.84	1.74	2.92	3.18	3.15	3.11
- PIT					0.45	0.52	0.53	0.56	0.51	0.34	0.38	0.42	0.42	0.69	0.75	0.75	0.74
- SSC					1.22	1.44	1.44	1.42	1.21	1.24	1.33	1.42	1.32	2.23	2.43	2.40	2.38
Tax evasion for informal sector (households):					1.51	1.33	1.17	0.83	0.76	0.64	0.63	0.66	0.66	0.75	0.92	0.98	1.13
- PIT					0.40	0.35	0.31	0.24	0.23	0.14	0.14	0.15	0.16	0.18	0.22	0.23	0.27
- SSC					1.11	0.97	0.86	0.60	0.53	0.51	0.49	0.51	0.50	0.57	0.70	0.75	0.86
Total tax evasion for PIT					0.85	0.88	0.84	0.80	0.74	0.47	0.52	0.57	0.58	0.87	0.97	0.98	1.01
Total tax evasion for SSC					2.33	2.41	2.30	2.01	1.75	1.74	1.82	1.93	1.82	2.80	3.13	3.15	3.24
Total tax evasion for VAT	9.63	4.40	8.90	8.10	5.32	4.49	4.87	3.35	3.01	6.25	4.37	7.09	7.43	8.03	9.58	8.39	8.32

Total tax evasion for SSC	**1.07**	**1.08**	**1.44**	**1.39**	**0.60**	**0.58**	**0.54**	**0.53**	**0.56**	**0.63**	**0.74**	**0.87**	**0.96**	**0.71**	**0.83**	**0.84**	**0.85**
Tax evasion for vice tax for cigarettes and alcohol						**0.37**	**0.43**	**0.41**	**0.31**	**0.41**	**0.43**	**0.74**	**0.42**	**0.55**	**0.67**	**0.45**	**0.39**
TOTAL tax evasion						**8.72**	**8.98**	**7.10**	**6.36**	**9.50**	**7.88**	**11.20**	**11.21**	**12.97**	**15.19**	**13.80**	**13.81**
Gross value added in unobserved economy*	**18.40**	**18.60**	**23.30**	**20.20**	**18.08**	**17.94**	**17.61**	**15.39**	**14.48**	**16.56**	**19.18**	**19.97**	**19.57**	**20.89**	**24.78**	**24.33**	**24.50**

Source: Fiscal Council's estimations based on NIS data
** NIS estimations*

Social contributions contribute with around 24% to the total tax evasion, mainly through the phenomenon of "undeclared work" (employees in the informal economy). This can be estimated based on NIS data regarding the number of employees according to the Household Labor Force Survey (HLFS) and the number of employees according to the statistical Survey on labor cost in economic and social entities. In 2012, in Romania were about 1.45 million employees in the unobserved economy, representing roughly 23% of all employees in the economy.

Figure 64: The evolution of employees from shadow economy



Source: Fiscal Council's calculations based on data from the National Institute of Statistics

Note: Employees in the informal economy are calculated as the difference between the number of employees based on Household Labor Force Survey (HLFS[24]) and the number of employees from the Survey on labor cost in economic and social entities[25] except the public sector. The Structural Business Survey does not include the public sector (public administration, health, education) and a share of the services. For the year 2012, the number of employees according to the Survey on labor cost in economic and social entities is estimated based on the assumption

[24] Statistical surveys based on samples.

[25] In the survey, economic units with 50 or more employees are exhaustively researched. The public sector units (public administration, education, health and social assistance, entertainment, cultural and recreation activities) are exhaustively summarized in the survey, except local government units for which the data in the local communal councils are collected based on a representative sample at county level. In the case of the economic sector regarding companies with 1-49 employees there are selectively included in the research, based on samples.

that the share of employees in companies larger than 4 employees in total employees reported by employers was maintained in 2012 at the 2007-2011 average.

BOX 5: Identification of unobserved economy in Romania[26]

In order to identify the unobserved economy in Romania, the economy is divided into two sectors: formal and informal.

For the formal sector, it is considered the underreporting of labor force employment and also the tax evasion in the case of non-financial corporations, with an impact on gross value added underreporting.

The assessment of the undeclared work is the most important component of the informal economy. The method used is based on the comparison of labor demand and supply in order to identify individuals who work in the formal sector, but are not registered by the authorities. For the estimation of the labor supply we used Household Labor Force Survey (HLFS) data and other administrative sources regarding population participation in the labor market. The survey provides information on the number of people who declared that they have worked during the reference period. The estimation of the labor supply is achieved by considering homogeneous branches of activity, respectively two-digit NACE, excluding agriculture and public administration. The agricultural production is calculated using national accounts quantitative data, while for the public sector an assumption of non-underreporting the performed activity is used.

The annual structural survey is used as the data source for labor demand. Therefore, data on the average number of employees from homogeneous 4-digit NACE activities are used.

The difference between the number of people who declared that they were working in an enterprise and the number of people employed by enterprises represents "the undeclared work". The undeclared work is assessed in the same conditions as legal work: average gross salary, social security contributions, etc. The intermediate consumption is computed using the same weight in production as obtained in small enterprises that operate in the same economic branch.

Romanian national accounts also include estimates regarding VAT evasion. Tax evasion is obtained as the difference between the theoretical and the actual VAT collected. The theoretical level of VAT is estimated using intermediate consumption, household final consumption, public and private administration final consumption and GFCF, based on VAT legal rates. The fiscal fraud is included in the value of production, and also in the gross value added for each corresponding

[26] Extracted from the methodology regarding computation of non-financial national accounts, National Institute of Statistics, Official Journal no. 292 of May 5, 2009 (Official Journal no. 292/2009).

branch.

In the case of the informal sector, the evaluation of the unobserved economy is achieved for all activities performed by family associations and self-employed population. Information about these activities is provided by the Ministry of Finance. The estimation does not include only underreporting because the method suffers also a problem of non-registration and lack of surveys regarding this sector of the economy.

The assessment regarding the number of people working in family associations and entrepreneurs is based on the data coming from labor force surveys. The estimates are based on the principle that the income of the self-employed cannot be lower than the average income of employees working in small enterprises within the same economic branch. Income statements of family associations and self-employed, submitted to Ministry of Finance, are compared and adjusted based on such calculations. Thus, with the adjusted incomes, tax evasion in the informal sector registered units is totally eliminated.

Another important category of the unobserved economy arises from the economic activity carried out by the unregistered units from the informal sector. This includes: tailors, car mechanics, hairdressers, painters, plumbers, teachers giving private lessons, people who rent houses during the holiday etc. For such activities, separate assessments are made, using specific assumptions and data sources for the following industries: hotels, construction and education.

In calculating the SSC and personal income tax evasion, it was taken into account the employees' remuneration appropriate to the added value related to undeclared work and to the informal sector (population). Regarding the tax evasion on corporate income tax, it was taken into account the NIS estimate on gross operating surplus of the unobserved economy (as a proxy for the profit corresponding to the unobserved economy) and its share in total gross operating surplus of the economy.

Regarding the excise and "vice tax"[27] on alcohol and cigarettes evasion, according to the estimates of the Fiscal Council, the largest contribution to the evasion is attributable to cigarettes as the average of the illicit trade with cigarettes constitutes around 20% of the market in the period 2003 - 2012. The evasion in the cigarettes market increased in 2006 to over 36%, along with the introduction of the "vice tax" and the increase of the excise duty (from 16.5 euro/1000 cigarettes in the first half of 2005 to 24.5 euro/1000 cigarettes in 2006), a

[27] According with the Article 363 of Law 95/2006 on the establishment of a contribution to finance health expenditures.

new recrudescence of the illicit trade being registered in 2009-2010 given the increase in excise duty from 31.5 euro/1000 cigarettes in the first half of 2008 to 64 euro/1000 cigarettes in 2010.

Regarding the alcohol, the evasion was on average about 45% of the market, with a much higher value in ethylic alcohol and distillates and intermediate products and significantly lower in the beer sector. It is to be noted that in the case of intermediate products, the evasion is very high at the moment, and it rose very quickly after the increasing of the excise from 51.8 euro/hl at the beginning of 2009 to 165 euro/hl in 2011, this leading to a collapse of excise revenues from this category from 106 million lei in 2008 to net repayments of excise in 2012. In addition, at the level of the alcohol excise tax, although in the period 2006 – 2012 the amount of excises has grown very rapidly (from 465.35 euro/hl of pure alcohol in the case of ethylic alcohol and distilled products at the beginning of 2006 to 750 euro/hl of pure alcohol in 2010, and then remained constant until 2012, recording in this period an increase of 60%), the revenues from excises collection slightly increased (only by 9% in the period 2006 – 2012).

Table 20: Fiscal Council's estimations regarding tax evasion for excises and vice tax for cigarettes and alcohol

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1. Tax evasion for alcohol excises, out of which*:	million lei	98	395	280	404	613	421	550	660	732	1.025	918	863
	% of market	29.50%	54.20%	32.70%	37.10%	42.20%	30.00%	38.70%	39.10%	44.00%	50.90%	48.40%	45.70%
a. ethyl alcohol and distilled beverages	million lei							370	586	603	754	445	368
	% of market							55.30%	61.50%	68.30%	68.70%	54.30%	47.30%
b. intermediate products	million lei							36	9	36	174	382	408
	% of market							37.60%	8.10%	23.10%	68.00%	96.80%	104.30%
c. beer	million lei							144	66	93	97	90	87
	% of market							22.20%	10.60%	15.10%	15.00%	13.50%	12.30%
2. Tax evasion for alcohol vice tax	million lei						231	74	275	268	173	76	86
	% of market						79.70%	32.00%	71.40%	73.00%	59.30%	34.30%	39.20%
3. Total tax evasion for alcohol	million lei	98	395	280	404	613	652	624	936	1.000	1.198	993	948
	% of market	29.50%	54.20%	32.70%	37.10%	42.20%	38.50%	37.90%	45.30%	49.50%	52.20%	47.20%	45.30%
	% of GDP	0.08%	0.26%	0.14%	0.16%	0.21%	0.19%	0.15%	0.18%	0.20%	0.23%	0.18%	0.16%
4. Tax evasion for cigarettes excises **	million lei	334	263	533	365	584	675	1.750	944	1.436	1.999	1.294	1.185
5. Tax evasion for cigarettes vice tax	million lei						156	702	284	326	321	194	175
6. Total tax evasion for cigarettes	million lei	334	263	533	365	584	831	2.452	1.228	1.762	2.319	1.488	1.360
	% of market	29.10%	18.50%	23.90%	14.00%	18.30%	20.80%	36.00%	19.60%	22.00%	25.80%	15.20%	13.30%
	% of GDP	0.28%	0.17%	0.27%	0.15%	0.20%	0.24%	0.59%	0.24%	0.35%	0.44%	0.27%	0.23%
7. Total tax evasion for alcohol and cigarettes (excises and vice tax)	million lei	432	658	813	769	1.197	1.482	3.075	2.163	2.762	3.518	2.481	2.308
	% of GDP	0.37%	0.43%	0.41%	0.31%	0.41%	0.43%	0.74%	0.42%	0.55%	0.67%	0.45%	0.39%

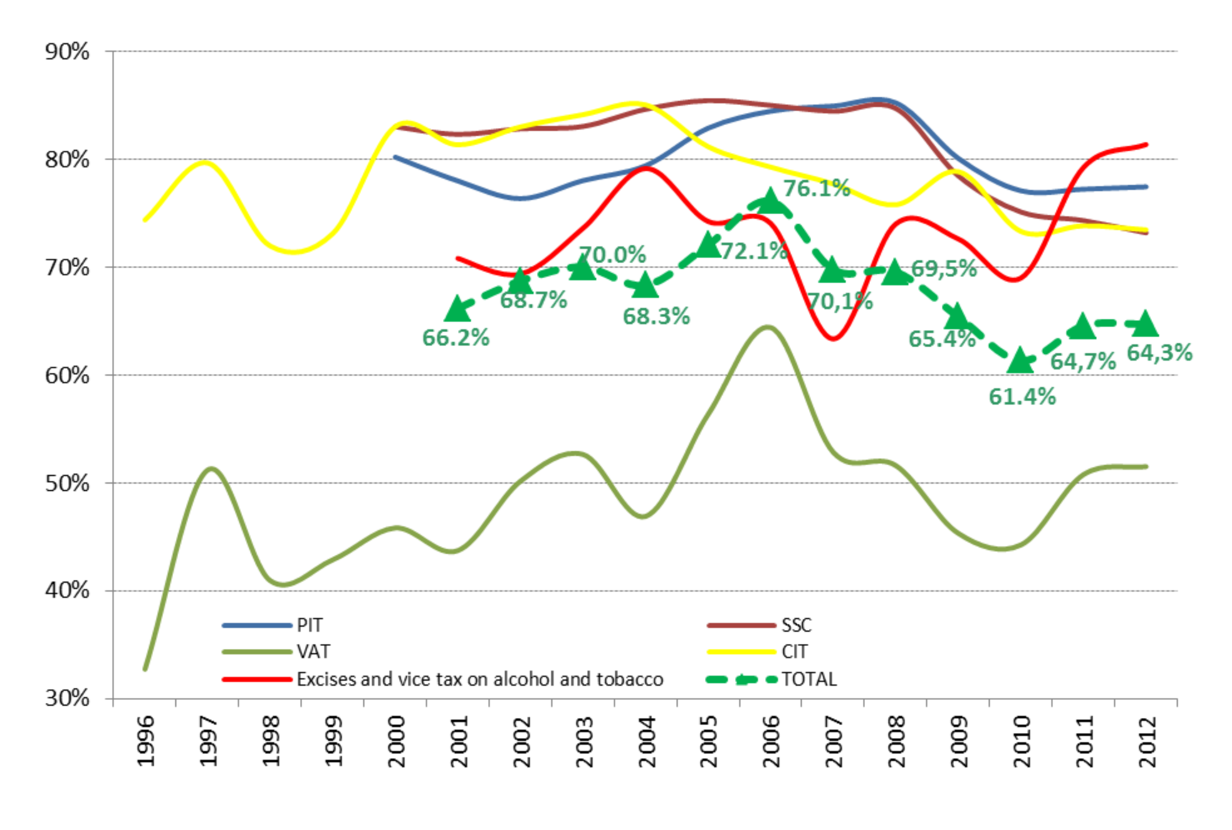
Source: Fiscal Council's calculation based on National Institute of Statistics and Ministry of Finance data

** Fiscal Council's calculation based on National Institute of Statistics data on the average annual consumption per capita, for the main food and beverages. Average annual consumption of beverages (the available consumption) per capita is the amount of alcoholic and nonalcoholic beverages consumed by a resident in the reporting period, regardless of the source of supply (wholesale, retail, restaurants, canteens, own production, etc.), and of the place where it is consumed (households, restaurants, canteens, bakeries, institutional households, etc.).*

*** Fiscal Council's calculation based on data from market research company Novel Research (www.novelsearch.ro) on the illicit cigarettes trade, cigarettes consumption data per capita available on the World Health Organization (WHO), TobaccoAtlas.org (World Lung Foundation and the American Cancer Society) and NIS data available on consumption expenditure of the households for the previous period of the year 2008.*

Based on the Fiscal Council's calculations for tax evasion, a degree of compliance with the major taxes can be calculated as a ratio between the actually collected revenues to the budget and the theoretical revenues (including tax evasion and actually collected revenue). Overall, the degree of compliance regarding the payment of taxes was in 2012 at the level of 64.3%, a slight improvement over 2010 when the minimum of the last 12 years was recorded. The highest collection rate during 2001-2012 was reached in 2006, respectively 76.1% taxes collected compared to the theoretical payment obligations. The lowest degree of compliance is registered for VAT, of only 50.0% VAT collected from theoretical obligations for the payment of VAT in 2012. However, it can be observed a slight improvement of the compliance degree in the case of VAT, excise duty and vice tax on alcohol and cigarettes during the period 2011-2012. On the other hand, in the case of SSC and corporate tax it can be observed a deterioration of the compliance during 2011-2012. Also, in the case of the personal income tax and, to a lesser extent, of corporate tax, there is an improvement of the compliance degree during 2005-2006 after the introduction of a flat tax of 16%. During 2007-2012 it can be observed a stagnation of the compliance degree followed by deterioration to lower levels than before 2005. It can, also, be observed deterioration in the level of compliance for the SSC during 2009-2012, after increasing the SSC rates in 2008.

Figure 65: Evolution of compliance degree for major taxes



Source: Fiscal Council's calculation

VI. 2013 - Risks and perspectives

VI.1. The macroeconomic framework

In the spring forecast published in May 2013, the European Commission anticipates a marginal economic decline of 0.1% for the EU economy compared to the 0.1% economic advance earlier projected, mainly due to the downward revision of the domestic demand dynamics. This is adversely affected by the deleveraging process continuation, but also by the additional measures of fiscal consolidation, while the positive effect on growth driven by the lower tensions in the financial markets as a result of the measures taken to tackle the sovereign debt crisis manifested slower than expected. However, uneven developments of the member states economies are expected. On the one hand, in Germany is expected only a slowdown of the economic advance (0.4% forecasted growth in 2013), while in France, Italy, Spain, and Netherlands GDP will slightly shrink. In the euro area as a whole, the economy will decrease by 0.4%. Greece and Cyprus will face a severe economic contraction of 4.2%, respectively 8.7%, while the economies of Portugal and Slovenia will contract by about 2%, the estimates being also negatively revised compared to the winter forecast. The projection for the global economic growth in 2013 is 3.1%, and the demand from outside the EU is expected to partially compensate the negative dynamics of the domestic demand.

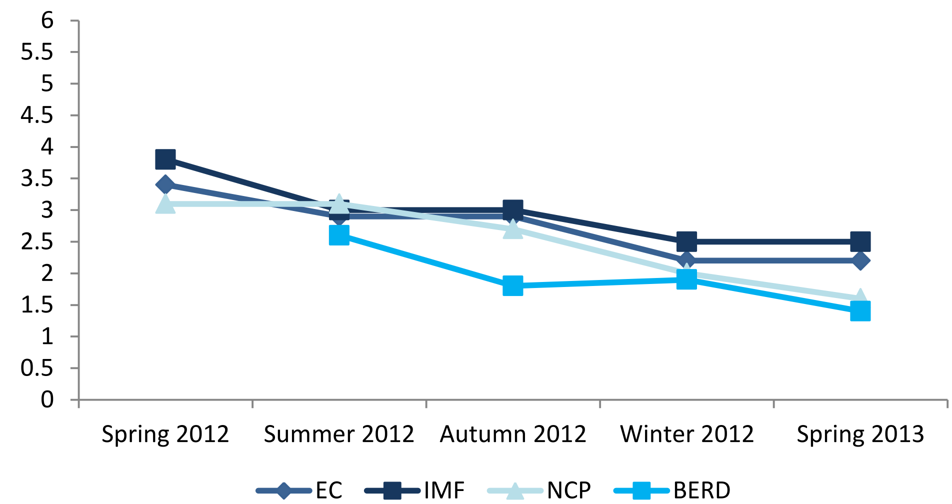
For 2013, inflation was revised downwards, for both the EU and the euro area, and is expected to reach 1.6%, respectively 1.8%. The downward revision was due to the dissipation effect of the administered prices, energy prices and indirect taxes increases in many Member States.

In Central and Eastern Europe (CEE), the economic activity will probably advance at a pace close to that of 2012. According to the European Commission's forecasts, the economic recovery in this region will be driven mainly by the external demand, which is expected to have a higher contribution due to the gradual recovery of the EU economy.

The domestic demand remains weak in most of the CEE countries as a result of the still difficult conditions in the labor market, rising raw materials prices, negative effects of the fiscal consolidation and the deleveraging process in companies, public and banking sector. In the spring forecast, the economic growth projection of the European Commission have been downwards revised compared to the winter forecast 2013 for Bulgaria (0.9% versus 1.4%), Czech Republic (-0.4% versus economic stagnation) and Poland (1.1% versus 1.2%), while in Hungary it is estimated a marginal economic advance (0.2% versus -0.1%).

In Romania, the growth projection is maintained at 1.6%, while the unfavorable external economic environment is expected to negatively affect both the exports, through the commercial channel, and the domestic demand, through the investment channel. Capital flows channel will probably be negatively affected by the increasing capital requirements for financial institutions in the EU (see capital requirements of the European Banking Authority – EBA), which involves, at least in part, an accelerated reduction of debt (deleveraging) in banks and their branches in CEE. Analyzing the dynamic of the economic growth forecasts, we can observe a significant downward revision in the recent quarters, similar to the situation in most EU countries.

Figure 66: The evolution of economic growth forecasts for 2013



Source: EC, IMF, NCP, BERD

According to the European Commission, the domestic demand is likely to be the main driver of economic growth. Public investment can provide an important contribution in the context of significant improvements of EU funds absorption. It is expected that both public and private consumption to gradually recover, although in the case of the private consumption persistent constraints still exists, derived from consumer balance sheet restructuring.

According to the European Commission's forecasts, inflation in Romania, calculated using the Harmonized Index of Consumer Prices, is expected to decline in the second half of 2013. If in January compared to the same period of the previous year it reached 5.1%, the average inflation projection for 2013 is 4.3%.

VI.2. The fiscal framework and risks

In the agreements with the IMF and European Commission, the Government committed to a reduction of the consolidated budget deficit for 2013 to 2.15% of GDP according to cash methodology (target that was later revised at 2.3% of GDP), or 2.4% of GDP according to ESA 95, the size of fiscal consolidation being significantly lower than in the previous years. However, the fiscal targets are quite ambitious considering that the budget for 2013 includes on the expenditure side the full recovery of wage cuts implemented in 2010, the increase of pensions according to the legal indexation scheme, the gradual reduction of the period for invoices payment within 60 days, while the announced measures on the revenue side do not have a clear impact, also including some exceptional elements. However, the Government's commitment to keep the budget deficit below 3% of GDP seems to be strong and a possible underperformance of revenues probably will generate adjustments also on the expenditure side - in this regard, there is some room for maneuver. Moreover, the fiscal consolidation initiated in 2010 was a success, reducing the budget deficit by 6 percentage points of GDP in just three years representing a very good performance. The fiscal adjustment rate was very fast, being motivated partly by the extent of the imbalances accumulated, maintaining the budget deficit below the threshold specified by the Maastricht criteria being essential for the sustainability of public finances and preservation of investors' confidence.

If the fiscal policy performance was generally positive, as regards the implementation of structural reforms, the pace was very slow in key areas such as health, education and the management of state owned enterprises, Romania registering significant delays. Thus, the targets set with the IMF were not met on time, being repeatedly postponed which is likely to affect the investors' confidence on the short-term and limit the potential growth over the long-term.

The budget execution in the first 6 months of 2013 raise more concerns about compliance with the deficit target given the poor performance of revenues, especially at the level of corporate income tax (decrease of 5.27% yoy compared with a forecasted growth rate of 8.94% for the whole year 2013) at the level of excises (increase of 4.2% in the first 6 months compared to the expected dynamic of 10.4% for 2013) and social security contributions (dynamic of 4.3% yoy versus an advance of 6.06% forecasted for 2013). Also, the absorption of European funds is extremely low, the pre-accession funds being approximately by 1.3% lower than in the first 6 months of 2012, while the Government relies on an increase of 40.62% in current year. Thus, it cannot be excluded the situation from 2012 when the budget deficit was significantly affected by the continued funding of projects in the absence of actual reimbursement from European Commission. The significant underperformance on the revenue side of the budget was balanced during the first 6 months of 2013 primarily by reducing investment expenditure, by maintaining goods and services expenditure at a level well below the planned one, by interest expenditure under the half-year program and by social assistance expenditure well below expectations. In this context, there are persistent risks regarding the budget deficit target, and its achievement represents a challenge given the failure to meet the revenue projection.

In the Fiscal Council's opinion, the risks associated to the macroeconomic indicators are tilted rather on the positive side, respectively a higher than projected economic growth. This may come as a result of a higher foreign demand, especially considering the relationship with non-EU countries, the growth of 2.2% of GDP registered in the first quarter being attributable solely to net exports. It is also expected a good agricultural production while the one from 2012 was severely affected by drought, the positive base effect being significant.

Also, the balance of risks regarding the stance of the fiscal policy seems to be tilted on the negative side (a higher effective deficit compared to estimations). The evolution above expectations of the economic growth is unlikely to generate significant additional revenue to the state budget, given that taxes are lower for exported goods and the agricultural sector remains very low taxed. With budgetary revenues well below expectations in the first 6 months of the year, there are doubts about the government's ability to operate on the expenditure side in order to compensate the revenues failure. The budget execution provides some clues about a possible fiscal space at the level of social assistance and interest expenditure. The fiscal policy slippages (like reversing some of the already implemented austerity measures) have the potential to worsen the risk perception regarding Romania and contribute to a high volatility of interest rates and exchange rate, especially given that the share of government securities held by nonresidents significant increased. However, maintaining the deficit below 3% of GDP according to ESA95 methodology seems to be likely, considering the information available at this time.

Inflation is expected to return within the target band at the end of the year, considering the good agricultural year, the persistent negative output gap and the favorable evolution in fuel prices. Moreover, this latter factor contributed significantly to the improvement of the trade balance, given that Romania is a net importer of energy. Thus, the favorable shock of the terms of trade (the price of exports relative to imports) together with the export markets diversification for Romanian goods, particularly to non-EU countries will likely contribute to an improvement in the trade balance and in the current account compared to the initial estimates.

Also, considering the EU funds absorption, the year 2013 is vital. A new failure in this area may result in the loss of significant amounts because of automatic decommitment procedure and may adversely affect the budget deficit if the projects will be again financed using budgetary resources.

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Appendix - Glossary of terms

Adjustment program - a detailed economic program, usually supported by use of IMF resources, that is based on an analysis of the economic problems of the member country and specifies the policies implemented or that will be implemented by the country in the monetary, fiscal, external, and structural areas, as necessary to achieve economic stabilization and set the basis for self-sustained economic growth.

Aggregate demand - total expenditures of internal and external users for acquiring final goods and services produced in an economy. It is computed as the sum between internal demand and exports of goods and services.

Aggregate supply - represents all goods and services offered on the domestic market by all domestic and foreign operators. In other words, the aggregate supply is total domestic production of economic goods plus foreign countries offer (imports).

Arrears - delayed payments as result of contractual terms' violations

Automatic stabilizers - features of the tax and transfer systems that tend to offset fluctuations in economic activity without direct intervention by policymakers. Examples are unemployment compensation and progressive taxation rates.

Balance of payments - accounting record describing the transactions concluded between a country and its external partners in a specified period of time

Budget balance - indicator computed as the difference between overall budget revenues and budget expenditures.

Capital account- account which reflects the evolution of capital transfers and acquisitions/ sale of non-financial assets

Cash methodology - involves recording revenues when they are actually received and recording expenses at the time of payment.

Conditionality - Economic policies that members intend to follow as a condition for the use of IMF resources. These are often expressed as performance criteria (for example, monetary and budgetary targets) or benchmarks, and are intended to ensure that the use of IMF credit is temporary and consistent with the adjustment program designed to correct a member's external payments imbalance.

Contagion - the transmission of shocks to several economic sectors, internally and abroad

Contribution - compulsory imputation of a share from the revenues of employees or firms, with or without the possibility of obtaining a public service in exchange

Countercyclical fiscal policy - is a fiscal policy behavior which has the role of stabilizing the economic cycle and helps to reduce cyclical fluctuations and inflationary pressures from excess demand.

Current account deficit - occurs when total imports of goods, services and transfers of a country are greater than exports of goods, services and transfers of that country; in this case, that country becomes a net debtor to the rest of the world.

Cyclically adjusted budget balance - general budget balance, net of cyclical component. CABB is a measure of fundamental trend in the budget balance. The structural budget balance is the CABB without the impact of "one-off" measures.

Cyclical adjustment of budgetary revenues - elimination of the budgetary revenues component dependent to the demand excess/deficit (economic expansion/contraction), eliminating trend deviations; the level of budgetary revenues cyclically adjusted is the level that would have been collected if the GDP reached its potential growth.

Direct Public Debt - total public debt, except guaranteed public debt.

Disinflation - process of reducing inflation.

Economic classification - expenditure structuring based on their economic nature and effect

Economic growth - annual growth rate of the real GDP

ESA 95 methodology (European System of Accounts) - The European System of National Accounts is an accounting reporting framework used internationally for an systematic and detailed description of an economy (of a region, a country or group of countries), or its components and its relations with other economies; The main differences between ESA95 methodology and cash methodology are revenues and expenditures recording in "accrual" system (based on commitments, not actual payments like in cash system) and treatment of EU funding (EU is considered in ESA95 system a separate sector).

Euro Plus Pact - it is also known as the Competitiveness Pact and its objective is the stability of euro area, member states committed themselves to take measures to encourage competitiveness, employment and consolidation of public finances.

European semester - additional tool for preventive surveillance of economic and fiscal policies of the Member States; the European Semester is a six-months period every year during which the Governments of the member states have the opportunity to collaborate and discover the experiences and opinion of their EU homologues in order to detect any inconsistencies and emerging imbalances of economic and fiscal policies that could violate the rules of the Stability and Growth Pact.

Euro system - the central banking system of the euro area. It comprises the ECB and the national central banks of those EU Member States whose currency is the euro.

Exchange rate mechanism II (ERM II) - the exchange rate arrangement established on 1 January 1999 that provides a framework for exchange rate policy cooperation between the Euro system and EU Member States whose currency is not the euro. Although membership in ERM II is voluntary, Member States with derogation are expected to join. This involves establishing both a central rate for their respective currency's exchange rate against the euro and a band for its fluctuation around that central rate. The standard fluctuation band is ±15%, but a narrower band may be agreed on request.

Expansionary fiscal policy - is a fiscal policy behavior that has an accelerating effect in aggregate demand growth and possible amplification of inflationary pressures.

Expansionary monetary policy - the monetary policy behavior has effect in stimulating aggregate demand and a possible amplification of inflationary pressures.

Fee - the price one pays as remuneration for services provided by an economic agent or a public institution.

Final consumption - component of the aggregate demand which includes private consumption and government expenditures for public good and services

Financial account - account which presents the transactions associated with ownership change on assets or liabilities of a country and includes foreign direct investments, portfolio investments, financial derivatives, other capital investments and reserve assets.

Fiscal compact – part of the Treaty on Stability, Coordination and Governance signed on March 2, 2012 by all EU member states, excepting the United Kingdom and Czech Republic. The treaty is aimed at strengthening fiscal discipline by introducing an automatic correction mechanism and stricter surveillance. The fiscal compact establishes a requirement for national budgets to be in balance or in surplus. This criterion would be met if the annual structural government deficit does not exceed 0.5% of GDP at market prices. If public debt is significantly below 60% of GDP and risks addressing long-term public finance sustainability are low, the structural deficit may reach a maximum level of 1% of GDP.

Fiscal consolidation - the policy aimed to reduce budgetary deficits and the accumulation of public debt

Fiscal impulse - the impact of discretionary fiscal policy on aggregate demand. It is computed as change of structural balance from the previous period; a positive value corresponds to an expansionary fiscal policy and a negative value - to a restrictive fiscal policy.

Fiscal policy - a policy that wants to influence the economy using the system of taxes as instrument.

Fiscal revenues - budget revenues collected through taxation. Fiscal revenues include: personal income taxes, corporate income taxes, capital gain taxes, property taxes and fees, good and services taxes and fees, taxes on foreign trade and international transactions, other taxes and fiscal fees, social contributions.

Fiscal space – 1. The difference between current public debt and a threshold of public debt, a threshold level that does not involve increasing costs for financing the deficit and which takes into account historical evolution of fiscal adjustment; 2. Financial resources available for additional expenditure required to implement development projects.

Fiscal strategy - public policy document designed to set out fiscal objectives and priorities, revenue and expenditure targets of the Consolidated General Budget and its components and the evolution of the budget balance for a three-year period.

Fiscal sustainability - a set of policies is said to be sustainable if the state is able to meet its debt payments without any major additional correction in the budget balance.

Functional classification - expenditure structuring based on their destination in order to assess public funds allocations

GDP deflator - an indicator that reflects the change in prices of the goods and services composing GDP; it is computed as a ratio of GDP in current prices and GDP in prices of the base year.

Guaranteed public debt - loans guaranteed by the Ministry of Finance and local government authorities.

Harmonized Index of Consumer Prices - Consumer price index whose methodology has been harmonized between European Union countries; the inflation objective of the European Central Bank and the euro area inflation rate are expressed based on this index.

Implicit tax rate - the ratio between revenue collected for a particular type of tax and its associated tax basis.

Inflation - reflects the widespread and persistent increase in prices and it is typically measured by the consumer price index. Inflation erodes the purchasing power of money: the same amount is used to buy fewer goods.

Inflation target - inflation target set by central banks that have adopted inflation targeting strategy. The target can be set as a fix-level of inflation and/or as a range. The National Bank of Romania sets the target as a midpoint within a target band of +/- 1 percentage point.

Informal Economy - legal economic activity, but hidden from public authorities in order to avoid paying taxes, social contributions or to avoid compliance with legal standards on labor and with other administrative procedures.

Medium Term Objective (MTO) - is the medium-term objective for the budgetary position and differs for each EU member state. For states that have adopted the euro or are in the Exchange Rate Mechanism II, it is -1% of GDP or a budget surplus. Reassessment of medium-term objectives is done every four years or when major structural reform is adopted.

Monetary policy interest rate - represent the interest rate used by NBR in order to achieve its monetary policy objectives. At present this is defined as the interest rate used for deposit within a week, developed by auction at fixed interest rate.

Nominal convergence criteria (Maastricht) - the four criteria set out in Article 140 (1) TFEU that must be fulfilled by each EU Member State before it can adopt the euro, namely: 1) the inflation rate must not exceed by more than 1.5 percentage points the average of the three best performing EU countries in this respect; 2) the long-term nominal interest rate must not exceed by more than 2 percentage points the average interest rate in the first three member states with the best performance in terms of price stability; 3) the public budget deficit must be less than 3% of GDP, public debt to GDP ratio must be less than 60%; 4) exchange rate fluctuations must not exceed + / - 15 percent in the last two years preceding the examination.

Non-fiscal revenues - other budget revenues that do not include taxation, such as royalties, payments from SOE' profit, fines, charges.

Output gap - an indicator that measures the difference between actual GDP of an economy and potential GDP; the term "excess demand" is also used.

Potential GDP - real GDP that can be produced by the economy without generating inflationary pressures; Potential GDP is determined by long-term fundamental factors as organization of the economy and the productive capacity of economy determined by technology and demographic factors that affect the labor, etc.

Primary balance of the Consolidated General Budget - the difference between budget revenues and budget expenditure, excluding the interest payments with regard to public debt.

Pro-cyclical fiscal policy - the fiscal policy behavior does not fulfill its stabilizing role of economic cycle but rather contribute to amplify cyclical fluctuations and inflationary pressures from excess demand.

Quasi-fiscal deficit - takes into account public sector expenditure not recorded into the budget; particularly, it refers to the losses of state owned enterprises which translate in the defaults of their financial obligations to the public budgets and public utilities.

Real convergence - in the process of adhesion to a single currency area, it is necessary to achieve also a real convergence, respectively a high degree of similarity and cohesion of economic structures of the candidate countries; although the Maastricht treaty does not mention real convergence criteria, these can be summarized by a series of economic indicators like GDP per capita, the degree of openness, the share of the commerce with member states, economic structure.

Real GDP - represent the value of final goods and services produced in an economy in a given period, adjusted with price increases. Real GDP dynamics is used to measure the economic growth of a country.

Reference interest rate - represent the average interest rate at which the central bank takes deposits on the interbank market during a month.

Restrictive monetary policy - the monetary policy behavior constrain the aggregate demand in order to reduce inflation.

Royalty - payment to the holder of a patent or copyright or resource for the right to use their property.

S1 - indicator of the sustainability gap that shows increasing taxes or reducing expenditure (as a percentage of GDP) required subject to a debt level of 60% of GDP at the end of the period.

S2 - indicator of the sustainability gap that indicates the fiscal effort (as a percentage of GDP) required subject to the inter-temporal budget constraint on an infinite time horizon.

Seasonality - periodic pattern in the evolution of an economic variable that systematically appear at certain times of the year.

Stability and Growth Pact - The Stability and Growth Pact consists of two EU Council Regulations, on "the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" and on "speeding up and clarifying the implementation of the excessive deficit procedure", and of a European Council Resolution on the Stability and Growth Pact adopted at the Amsterdam summit on 17 June 1997. More specifically, budgetary positions close to balance or in surplus are required as the medium-term objective for Member States since this would allow them to deal with normal cyclical fluctuations while keeping their government deficit below the reference value of 3% of GDP. In accordance with the Stability and Growth Pact, countries participating in EMU will submit annual stability programs, while non-participating countries will provide annual convergence programs.

Stand-by Arrangement - A decision of the IMF by which a member is assured that it will be able to make purchases (drawings) from the General Resources Account (GRA) up to a specified amount and during a specified period of time, usually one to two years, provided that the member observes the terms set out in the supporting arrangement.

Stock-flow adjustment – process that ensures consistency between changes in debt stock and net lending flows. It takes into account accumulation of financial assets, changes of foreign currency debt and statistical adjustments.

Structural budget deficit - 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.

Taxes - compulsory and non-refundable levy charged by a government with the purpose of financing public goods and services.

Trade balance - section of the balance of trade which presents the difference between exports and imports of goods and services recorded in a specified period of time