The new fiscal code – economic context and impact on the budget

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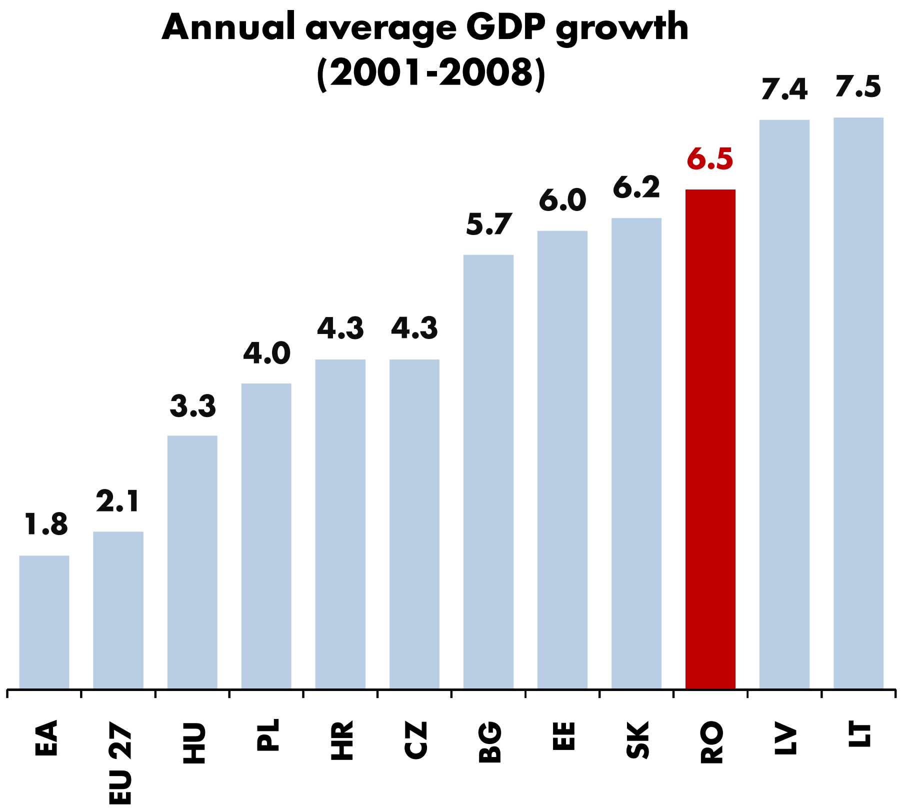
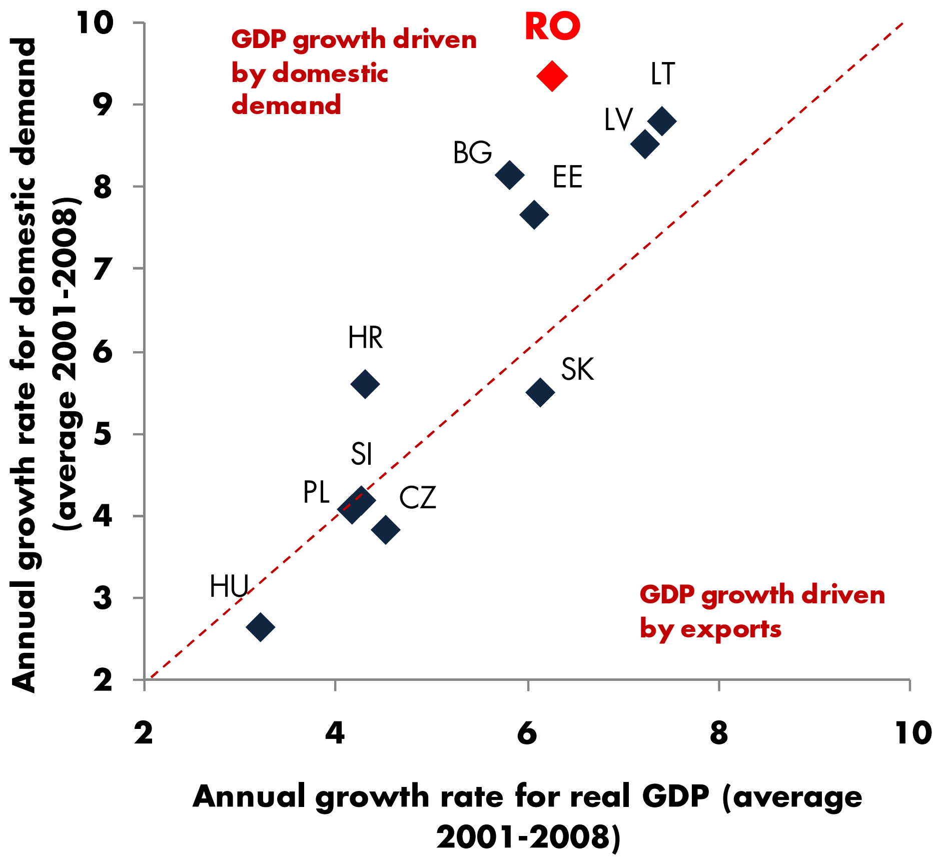
President of the Fiscal Council
June 2015

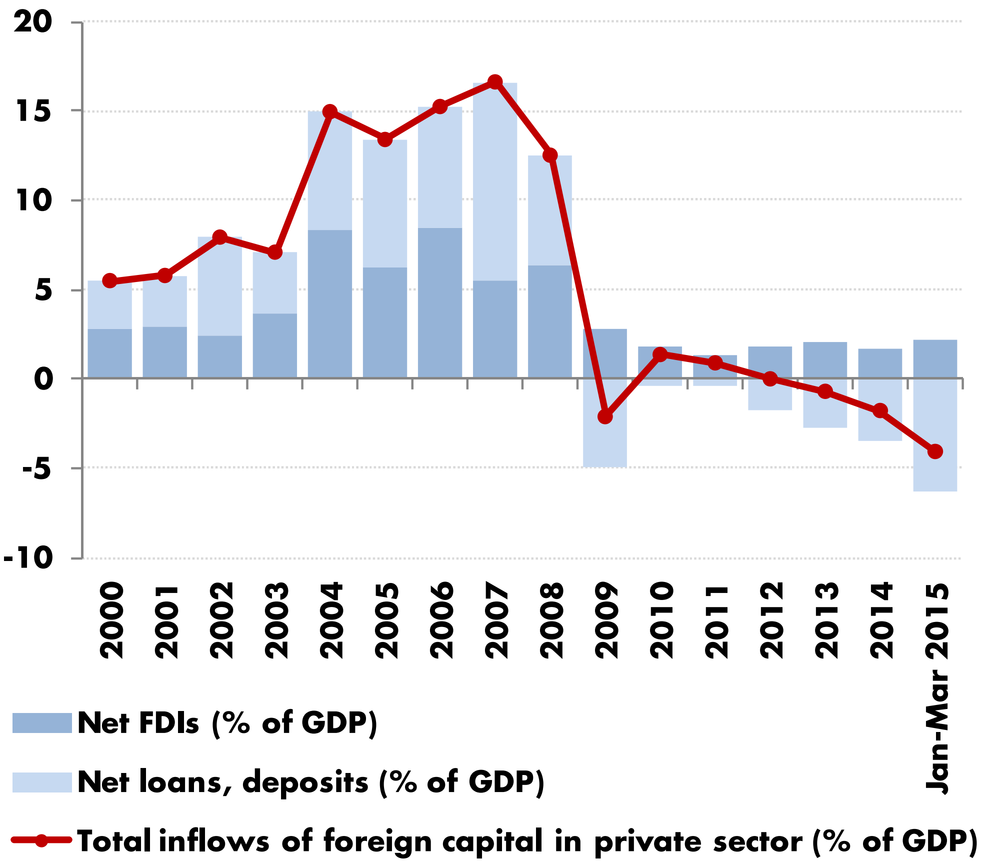
A booming economy before the crisis

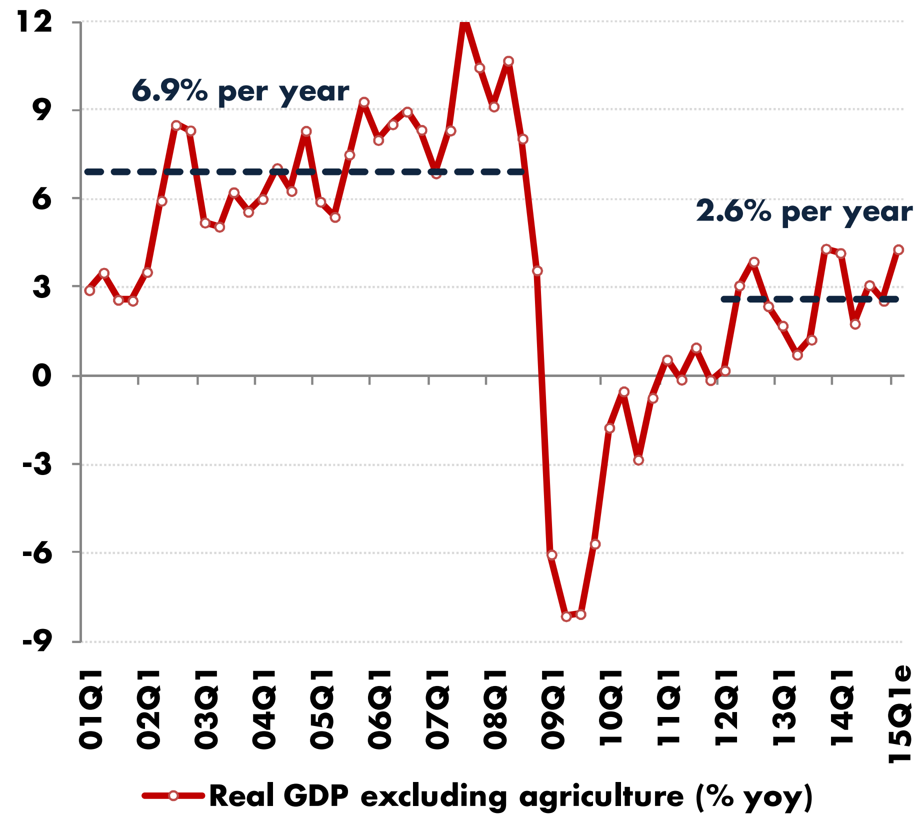




Source: Eurostat

Scarce net inflows of foreign capital to private sector, slow recovery pace



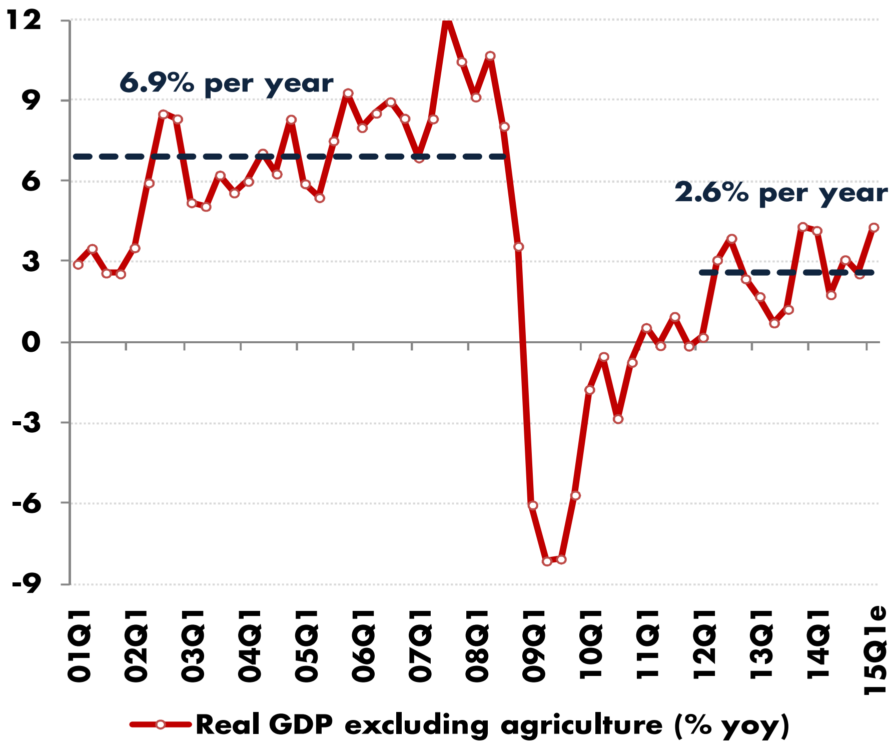


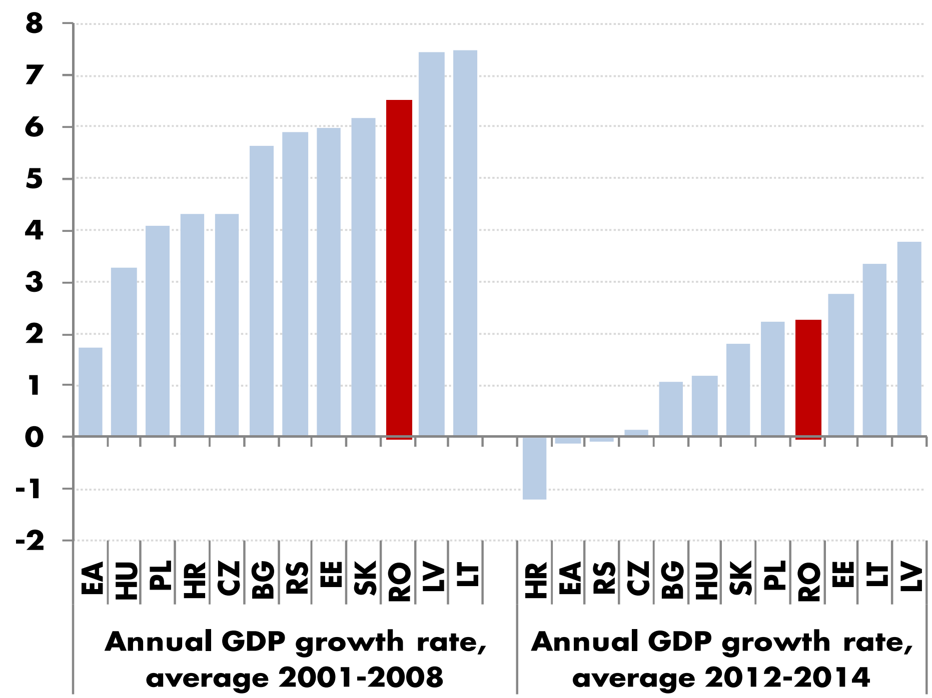
Note: net inflows of foreign capital in the private sector; portfolio inflows excluded

Source: National Bank of Romania, National Institute of Statistics

Economic growth is strengthening

- Economic activity re-entered on an upward trend in 2011, but GDP growth rates were much below pre-crisis' levels.
- Pace of economic growth strengthened in 2014 and GDP dynamics in Q1 2015 (1.6% qoq, 4.3% yoy) came in much above our expectations and analysts' consensus.

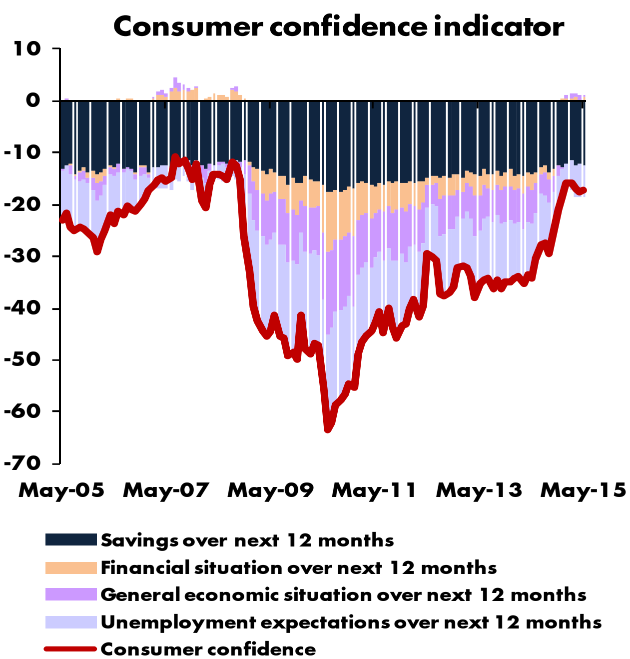


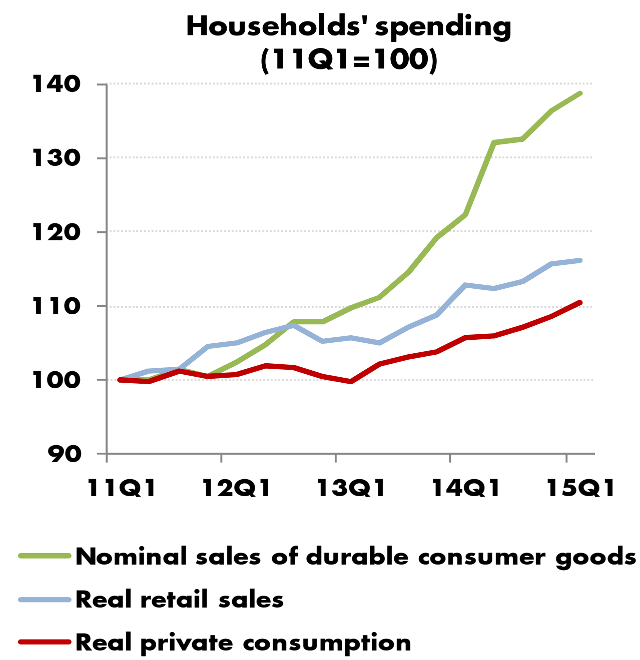


Source: National Institute of Statistics, Eurostat

Improving consumption drives GDP

- In 2014, households started to show an increasing appetite for consumption after several years in which they were quite prudent in spending.
- Improving labor market conditions (lower unemployment rate, decent growth of real wages and of real disposable income) fuelled a rapid increase in the consumer confidence index starting Q4 2014.
- Fast increase of private consumption (4.9%) was the key driver of GDP growth in 2014. Private consumption should remain the major driver of GDP growth in 2015 as well.



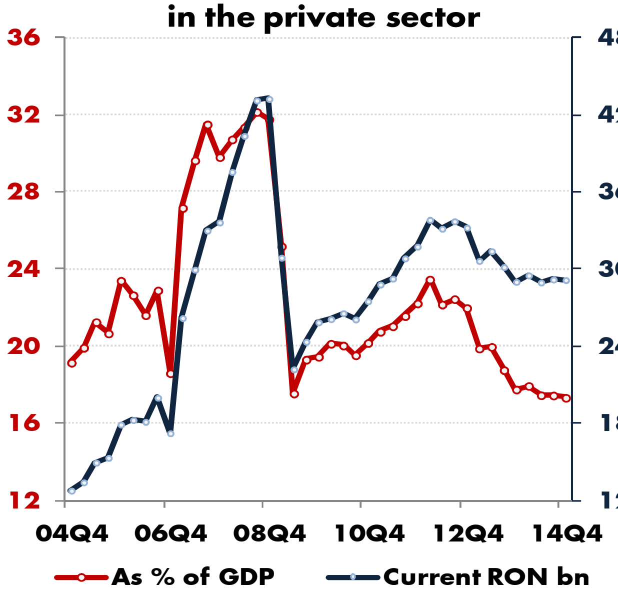


Note: Net wage fund = (number of employees * net wage) in private companies with at least four employees and in the public sector
Source: National Institute of Statistics, European Commission, GfK

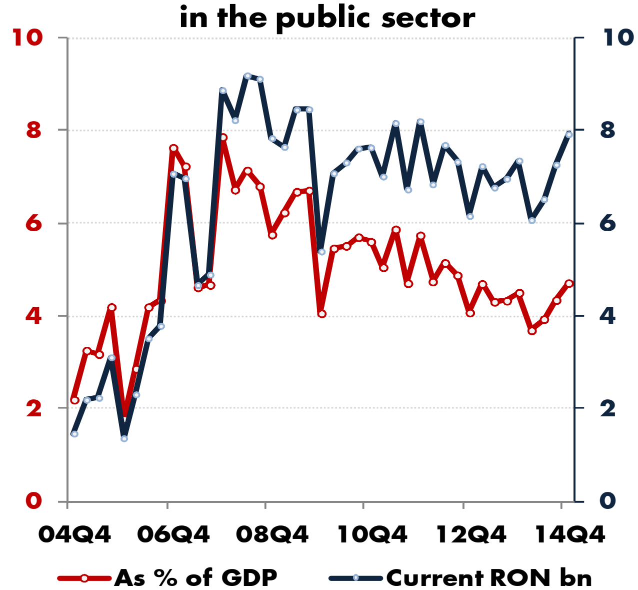
Investments are lagging behind

- Private fixed capital formation had a very poor performance starting mid-2012, while the government has also restrained investment spending as to keep the public budget deficit at a low level.
- Private investments have a large potential to rebound if the investors' confidence would improve, due to: their current low base, low interest rates, and favorable taxation conditions (profits reinvested in equipments are tax exempted, social contributions paid by employers were reduced in Q4 2014).
- Public authorities should increase the use of EU Funds, as 2015 is the last year to use 2007-2013 allocations.

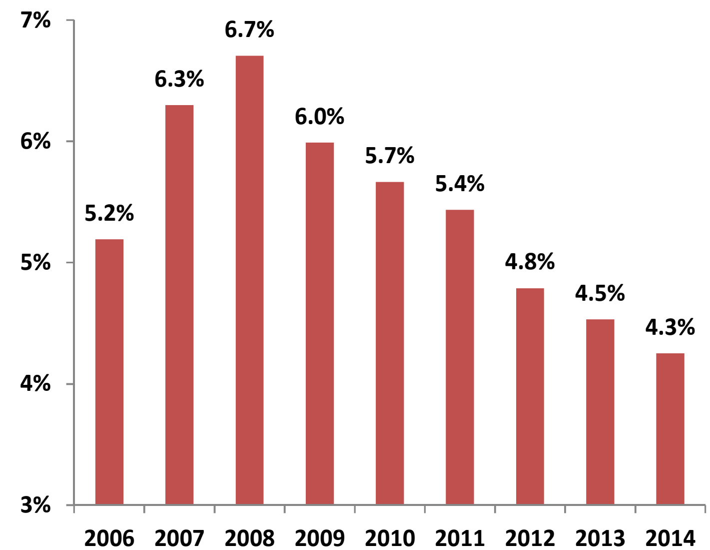
Gross fixed capital formation in the private sector



Gross fixed capital formation in the public sector



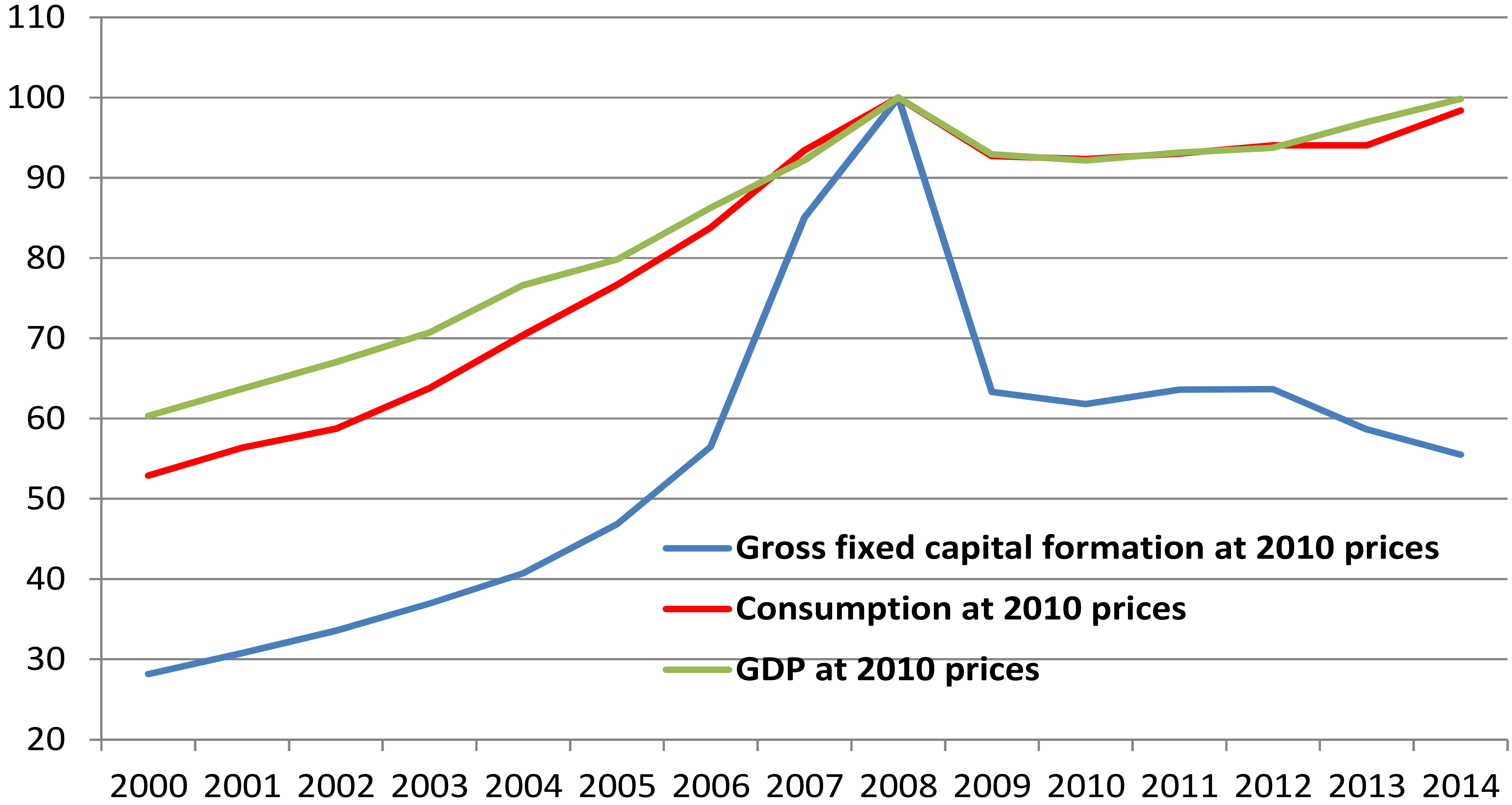
Public sector investments (% of GDP)



Note: In-house seasonally adjusted data for gross fixed capital formation in the private sector and in the public sector

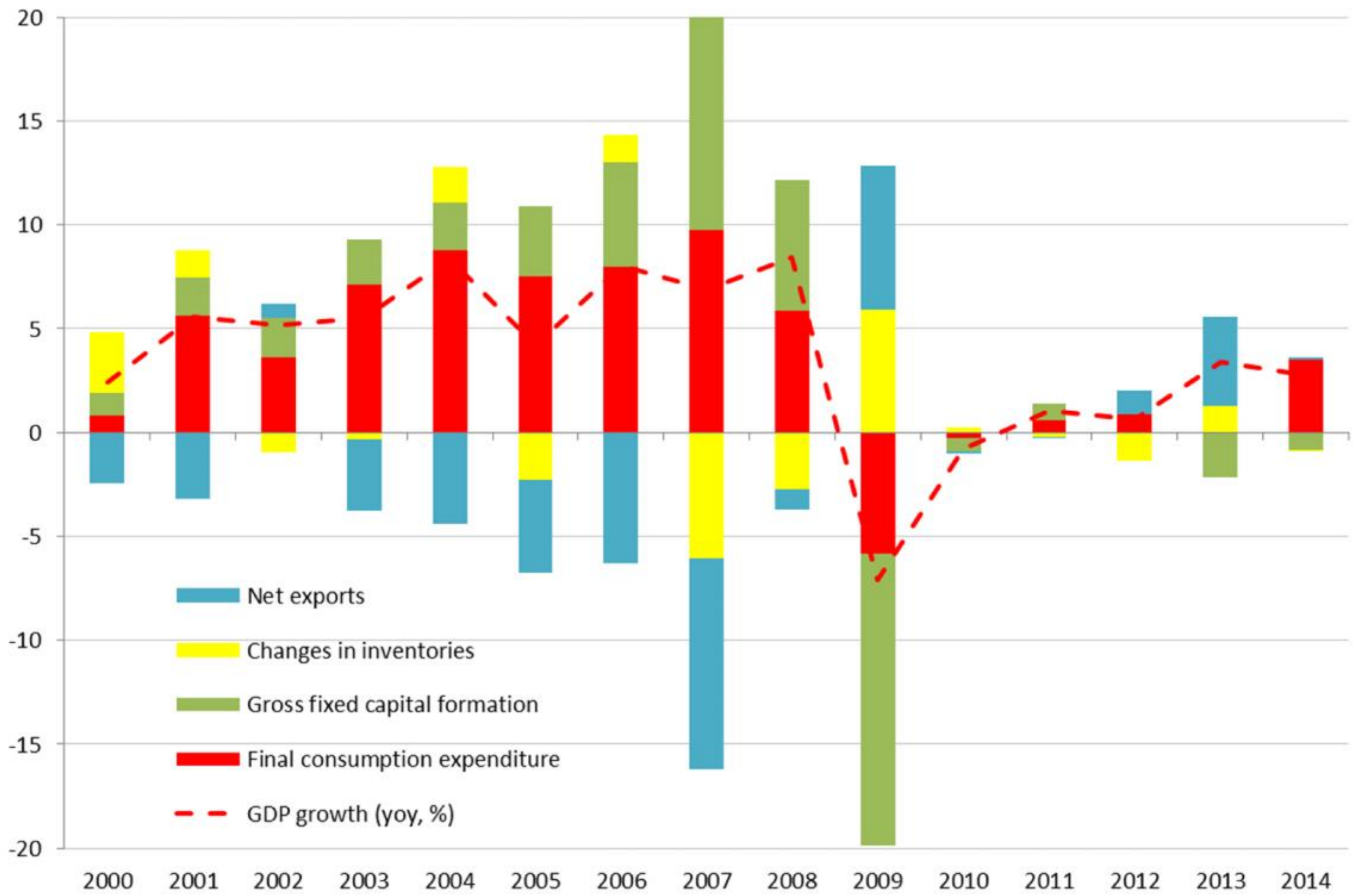
Source: Eurostat, National Institute of Statistics, Ministry of Finance

Very week performance of investment activity (2008=100)



Source: EUROSTAT

Contribution to GDP growth by uses (pp)



Source: EUROSTAT

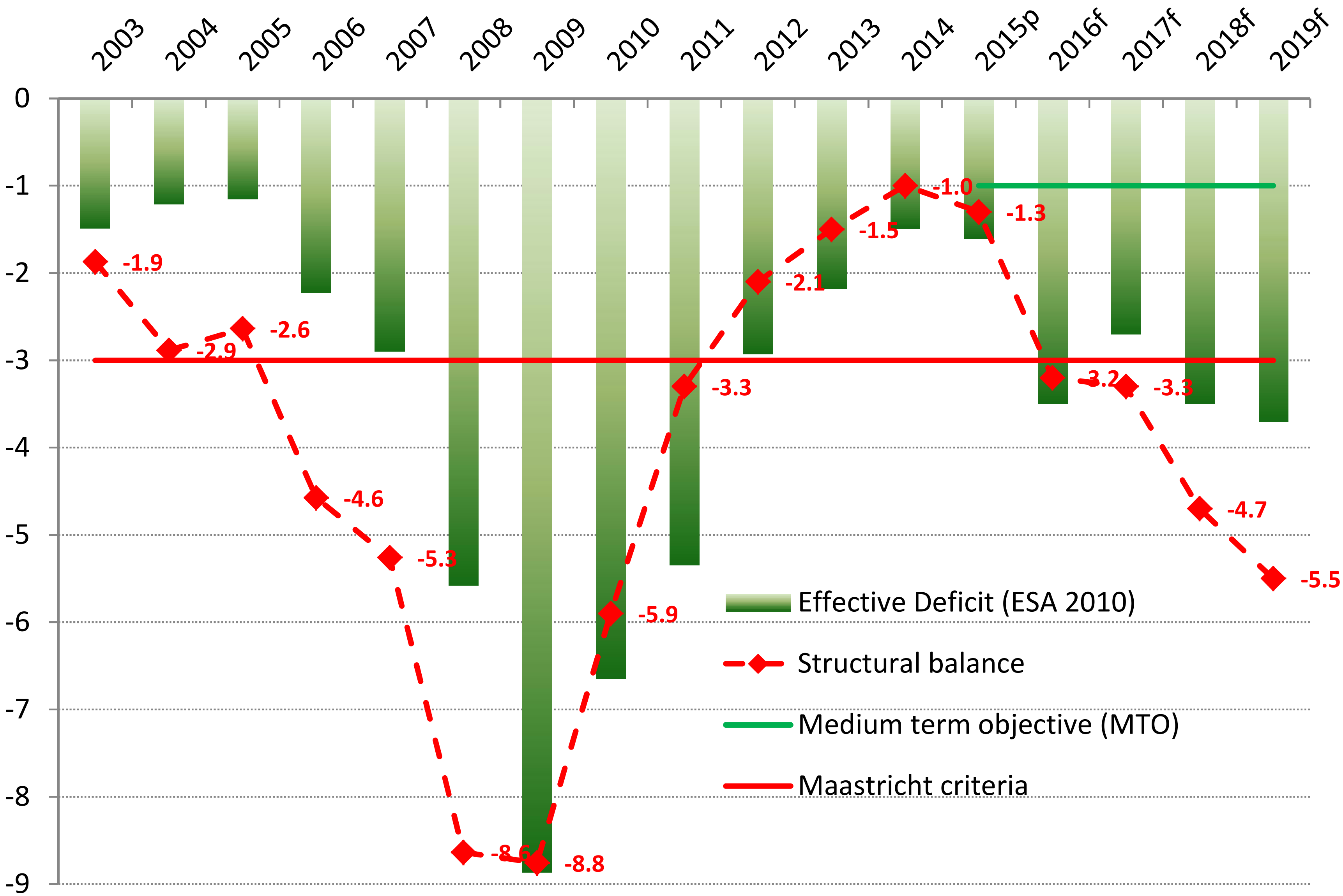
Cut of taxes to help domestic demand, but likely to increase macro imbalances

- Measures aimed to cut taxes that were already enforced in 2014-2015:
  - Profits reinvested in equipments are tax exempted
  - Social contributions paid by employers were reduced by five percentage points
  - Tax on special constructions was reduced from 1.5% to 1.0%
  - VAT rate for food products was cut to 9%

- The new Fiscal Code that is under debate in Parliament aims for broad based cut of taxes during 2016-2019:
  - Among the measures planned to be implemented in 2016 there are:
    - Cut of standard VAT rate from 24% to 20%
    - Removal of tax on special constructions
    - Cut of tax on dividends from 16% to 5%
    - Adjustment of excises for fuels and alcoholic beverages
    - Change in taxation of microenterprises (as to take into account the number of employees)
    - Adjustment of local taxes (increase)
    - Enlargement of taxation base in case of social contributions, while capping the payments (the maximum level of contributions will be determined based on amount of five gross wages in the economy)
  - Among the measures planned to be implemented in 2017-2019 there are:
    - Cut of social contributions in 2018
    - Cut of VAT rate from 20% to 18% in 2018
    - Cut of flat tax on profit and income from 16% to 14% in 2019

- Full enforcement of the draft of the new Fiscal Code should generate upward pressures on the public budget deficit, reversing the consolidation trend from the past years

The impact of the new fiscal code on budget deficit (% of GDP)



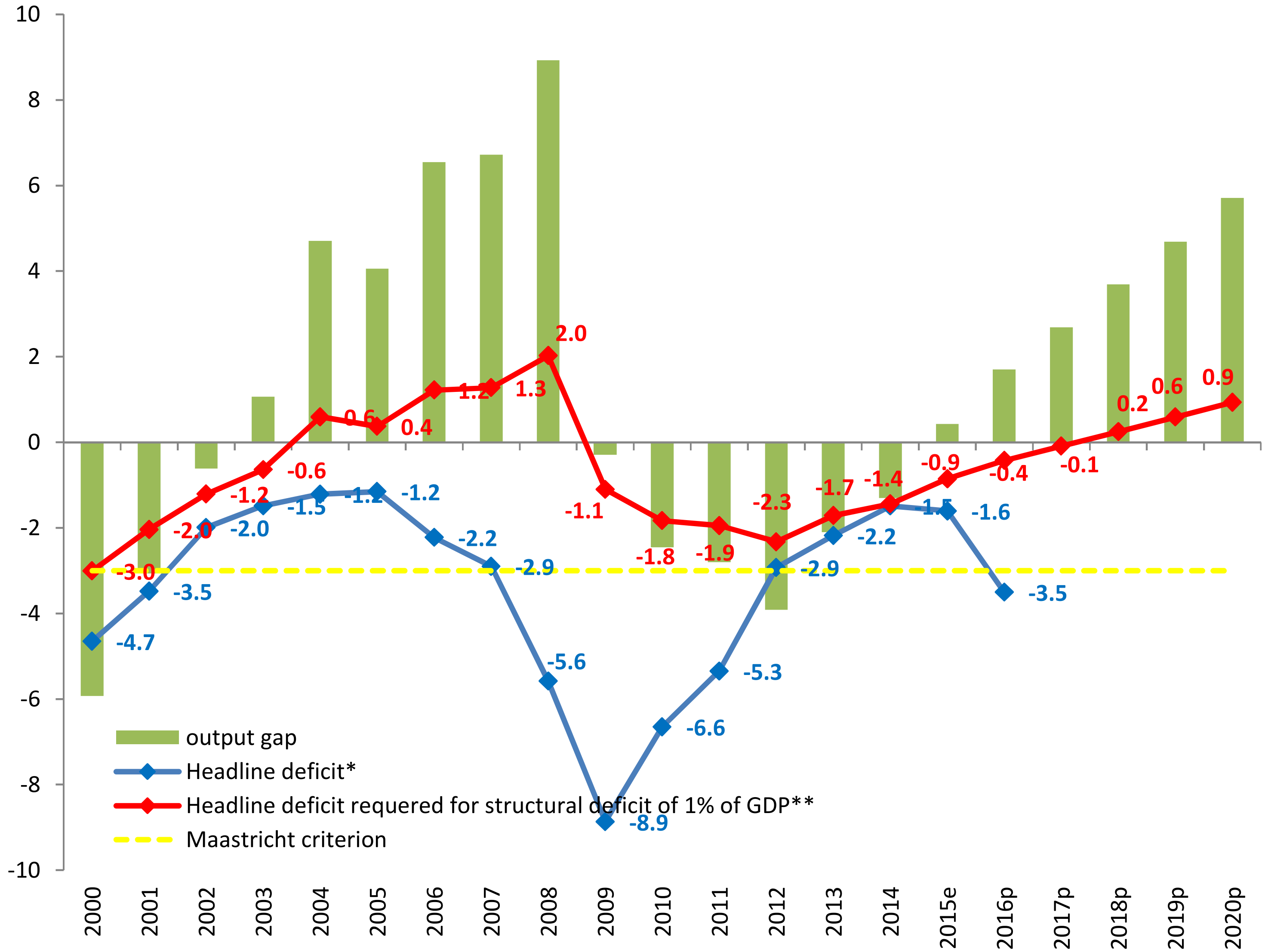
Source: Fiscal Council

Unrealistic assumptions of the Government on second – round effects

Table 1: Second-round effects of the Fiscal Code amending proposal on real GDP and on general consolidated budget during 2016-2019				
	2016	**2017**	**2018**	**2019**
Additional increase in real GDP if the impact multiplier is 0.4 (pp.)	0.9	0.9	1.2	1.2
Aggregate budgetary effects of the second round if the fiscal multiplier is 0.4 (billion lei)	1.6	3.5	6.2	9.3
Aggregate second round effects according to MPF (billion lei)	7.0	7.0	10.6	18.0

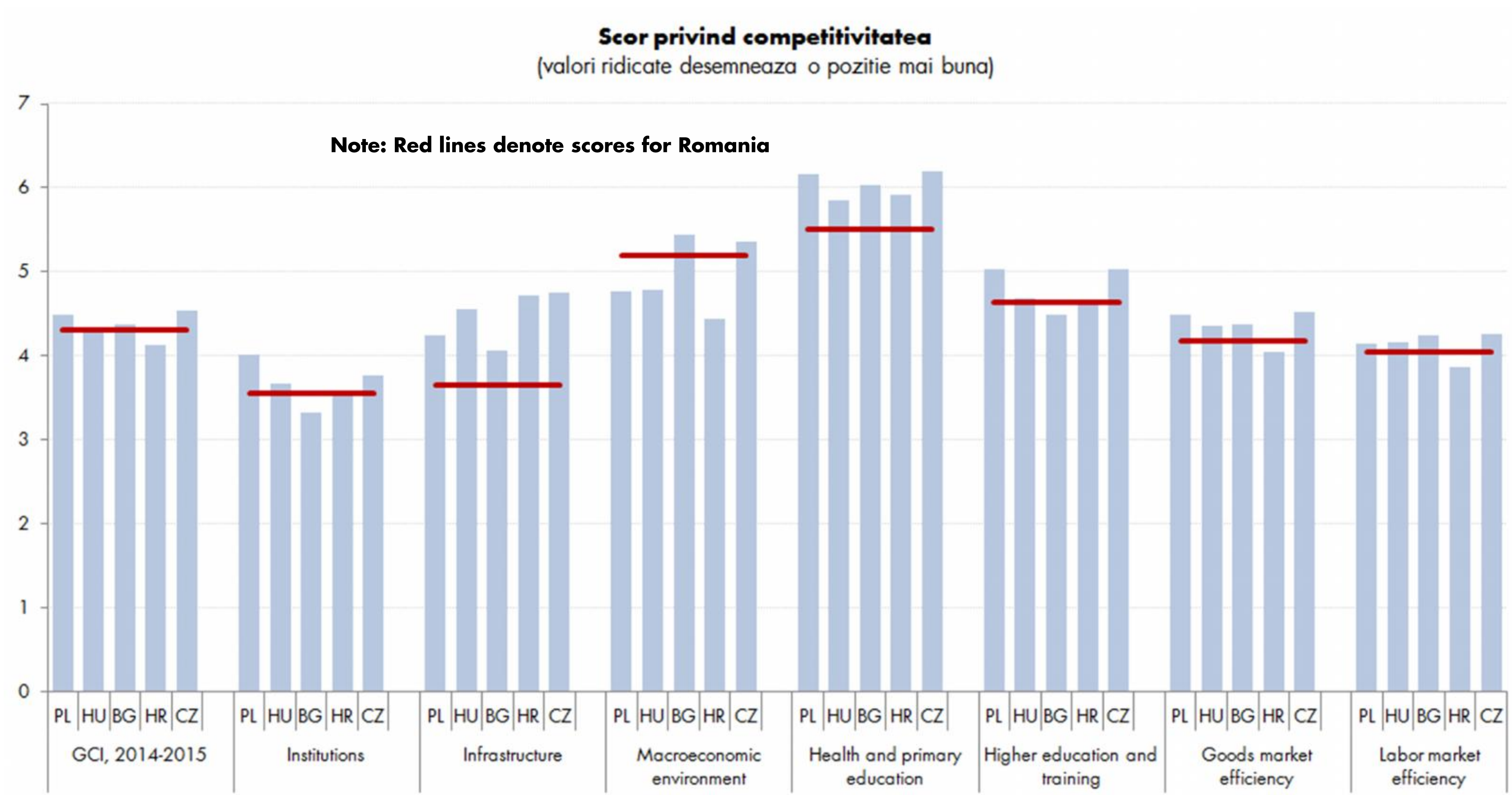
Source: Fiscal Council's calculations

Medium term objective is very challenging for Romania



Source: AMECO, Fiscal Council
* For 2015-2016 – European Commission
** Fiscal Council calculation (average economic growth at 4% during 2015-2020, potential growth at 3%)

Low level of competitiveness



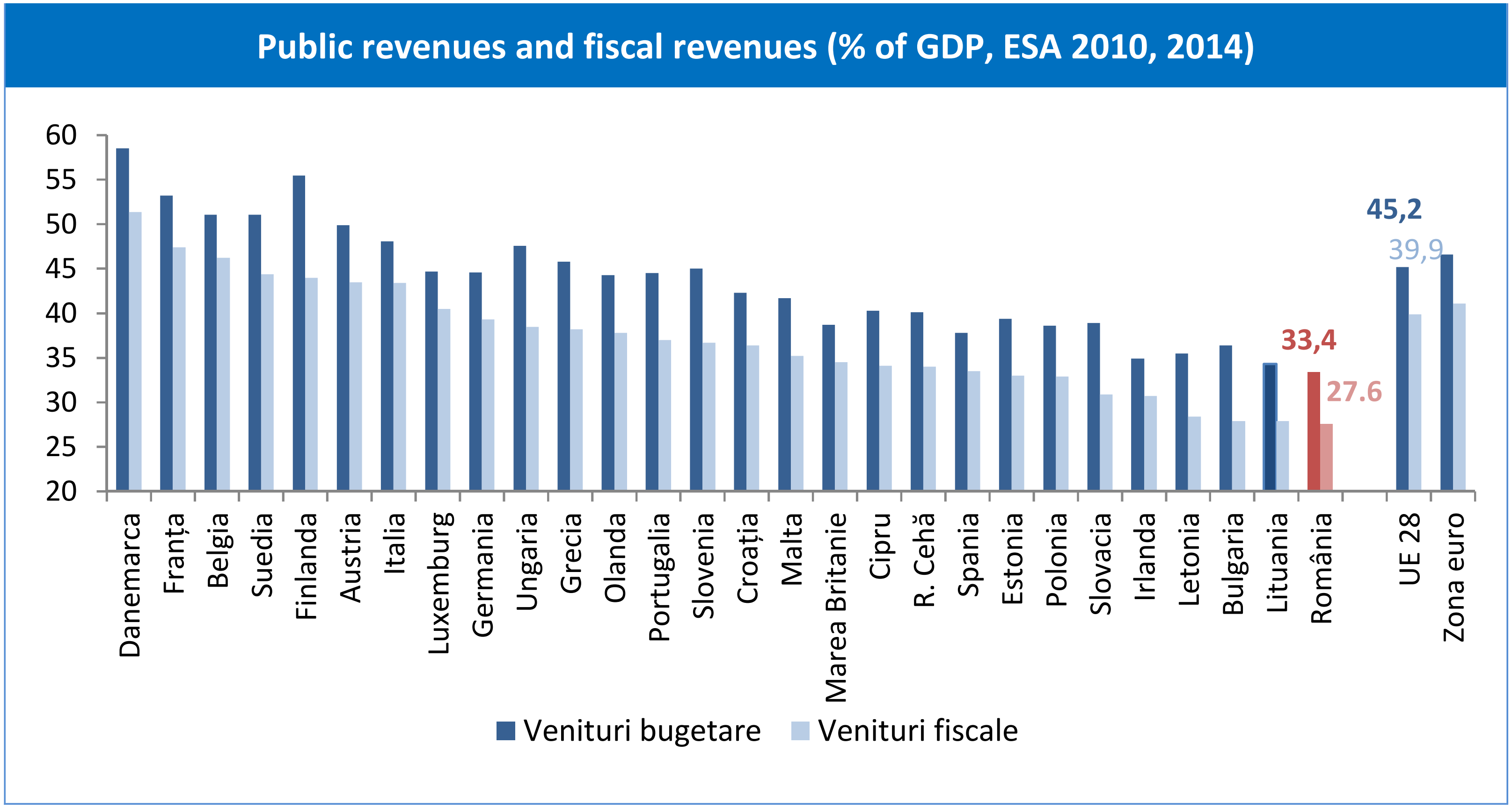
Source: The Global Competitiveness report, World Economic Forum, 2014-2015

World Economic Forum World Competitiveness Report – Ranking (out of 144 countries)

		Romania	Bulgaria	Czech Republic	Hungary	Poland	Slovak Republic
WORST	**7.05 Effect of taxation on incentives to work, 1-7 (best)**	**140**	**91**	**110**	**128**	**88**	**119**
	6.04 Effect of taxation on incentives to invest, 1-7 (best)	**128**	**81**	**107**	**133**	**102**	**114**
	7.08 Country capacity to retain talent, 1-7 (best)	**128**	**142**	**80**	**122**	**117**	**130**
	7.07 Reliance on professional management, 1-7 (best)	**126**	**113**	**47**	**114**	**71**	**74**
	7.01 Cooperation in labor-employer relations, 1-7 (best)	**125**	**111**	**52**	**71**	**100**	**105**
	2.02 Quality of roads, 1-7 (best)	**121**	**106**	**81**	**58**	**89**	**82**
	6.01 Intensity of local competition, 1-7 (best)	120	75	17	47	51	32
	6.09 Prevalence of trade barriers, 1-7 (best)	117	99	72	30	66	38
	1.08 Wastefulness of government spending, 1-7 (best)	116	98	7	96	85	126
	7.09 Country capacity to attract talent, 1-7 (best)	115	142	93	118	124	117
	1.07 Favoritism in decisions of government officials, 1-7 (best)	114	134	106	122	67	141
	4.10 Primary education enrollment, net %*	114	66	55	95	49	n/a
	1.17 Ethical behavior of firms, 1-7 (best)	112	101	94	96	57	123
	1. Corporate ethics	112	101	94	96	57	123
	....						
BEST	5.06 Internet access in schools, 1-7 (best)	53	45	27	35	50	31
	2.09 Fixed telephone lines/100 pop.*	52	42	63	37	78	68
	9.03 FDI and technology transfer, 1-7 (best)	49	91	36	19	68	18
	6.07 No. days to start a business*	**48**	**84**	**92**	**14**	**111**	**87**
	1.21 Strength of investor protection, 0–10 (best)*	**45**	**45**	**83**	**105**	**45**	**98**
	10.01 Domestic market size index, 1–7 (best)*	**44**	**66**	**48**	**56**	**20**	**61**
	9.05 Fixed broadband Internet subscriptions/100 pop.*	40	39	41	31	46	47
	6.06 No. procedures to start a business*	32	22	106	22	22	78
	5.04 Quality of math and science education, 1-7 (best)	**31**	**54**	**74**	**60**	**50**	**75**
	9.06 Int'l Internet bandwidth, kb/s per user*	**19**	**27**	**25**	**75**	**37**	**93**
	8.08 Legal rights index, 0–10 (best)*	11	11	63	43	11	29
	7.04 Redundancy costs, weeks of salary*	7	21	95	61	89	89

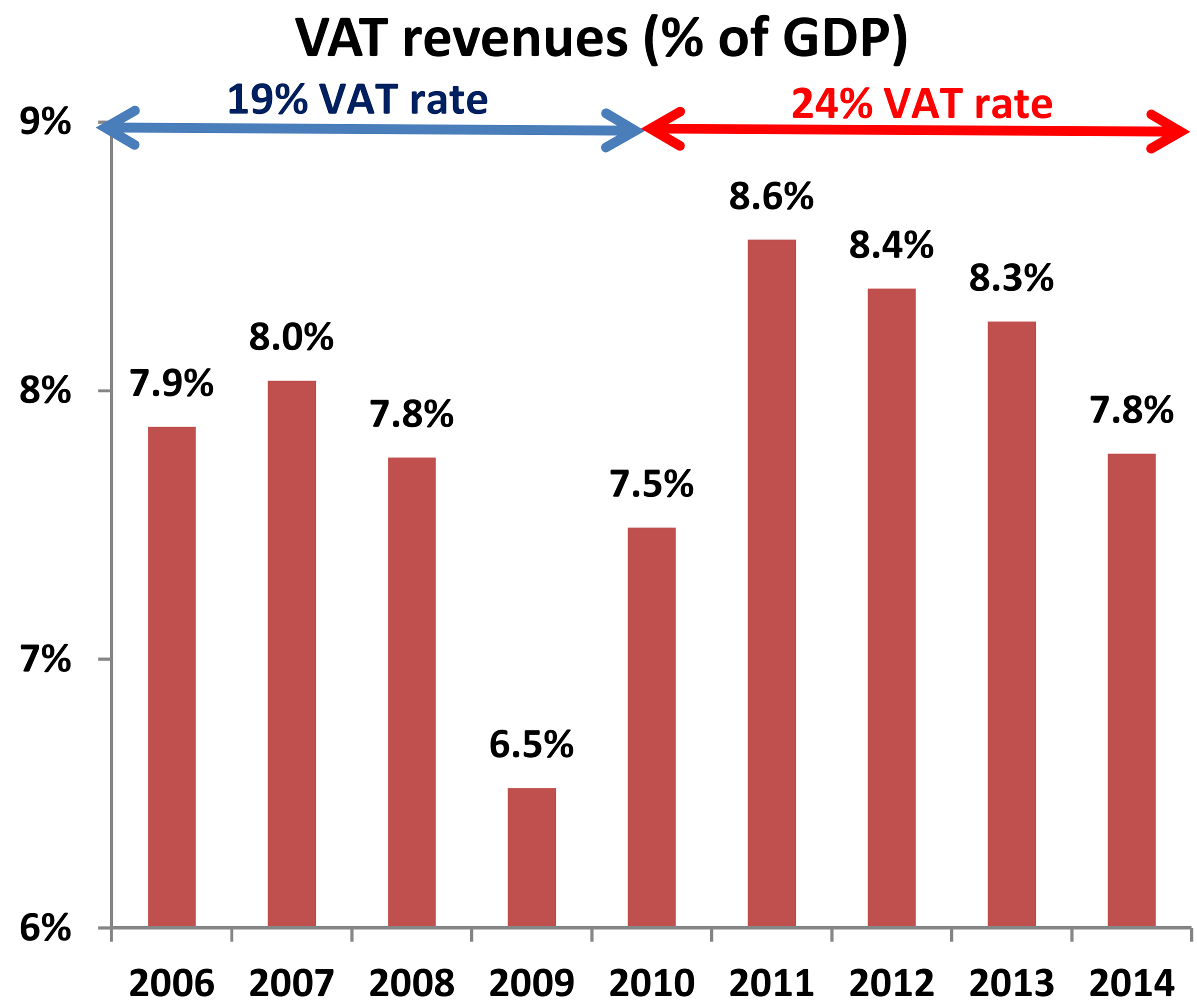
Source: The Global Competitiveness report, World Economic Forum, 2014-2015

Very low public revenues. . .

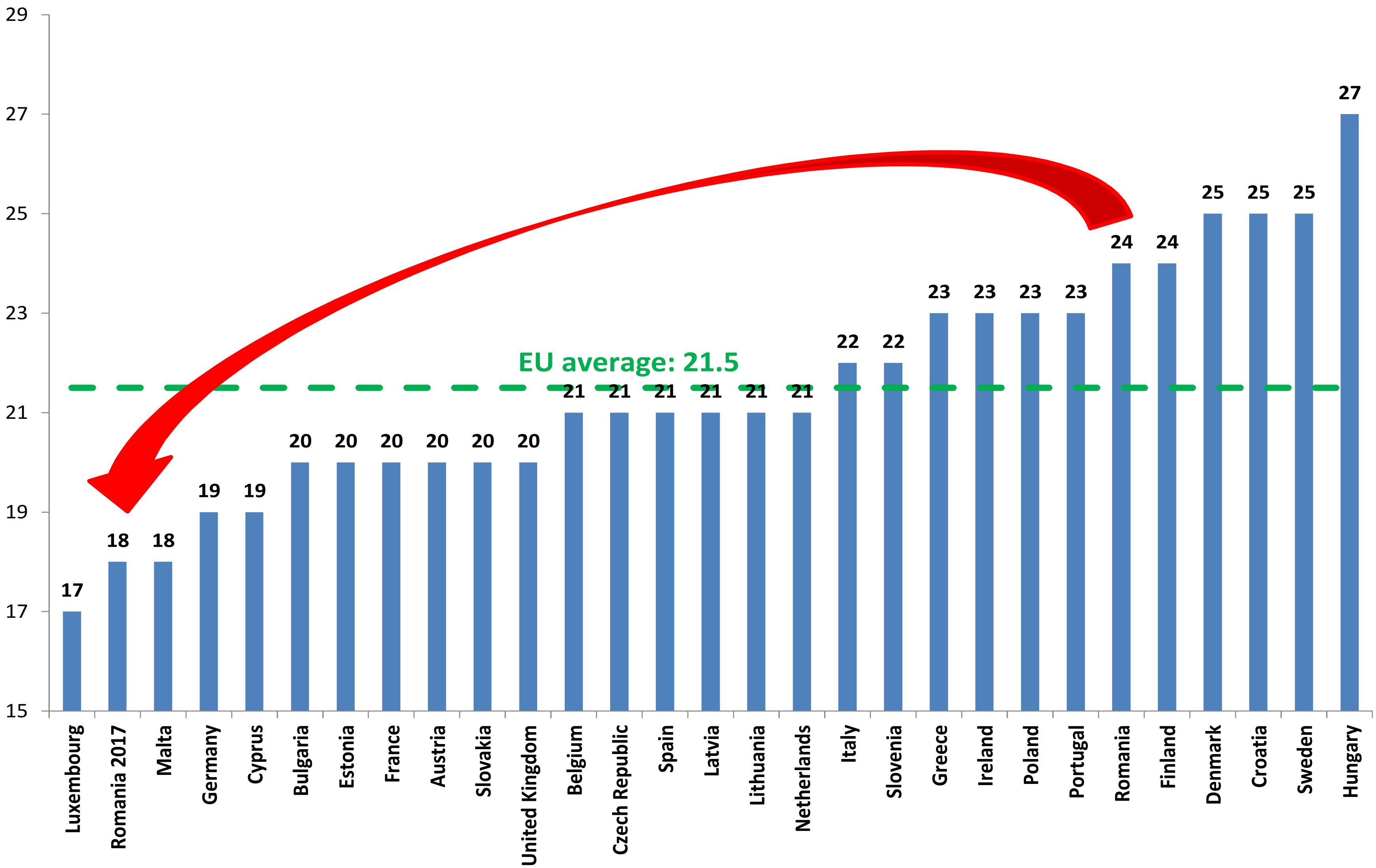


Source: EUROSTAT

… and very poor tax collection

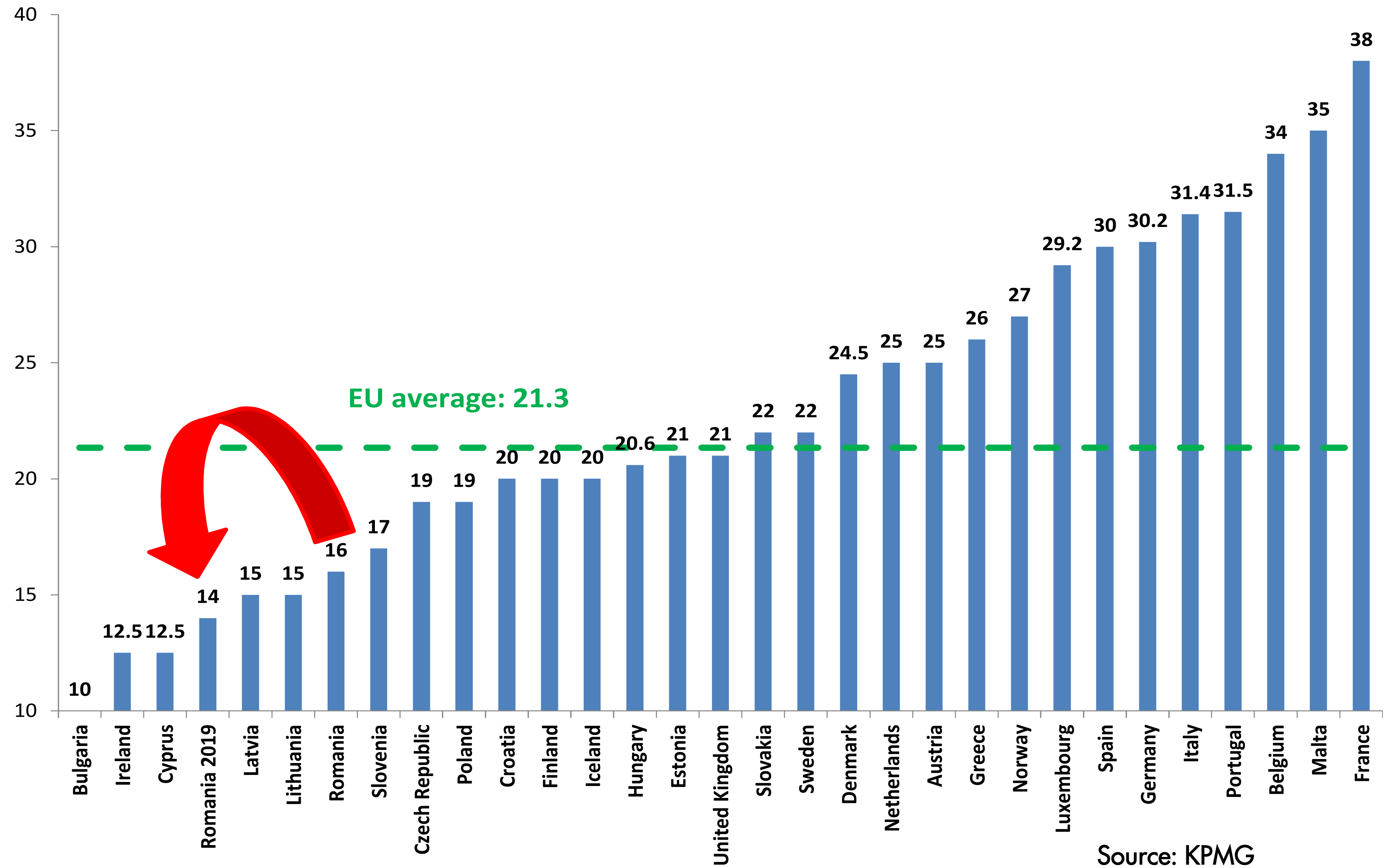


VAT rate (2015)



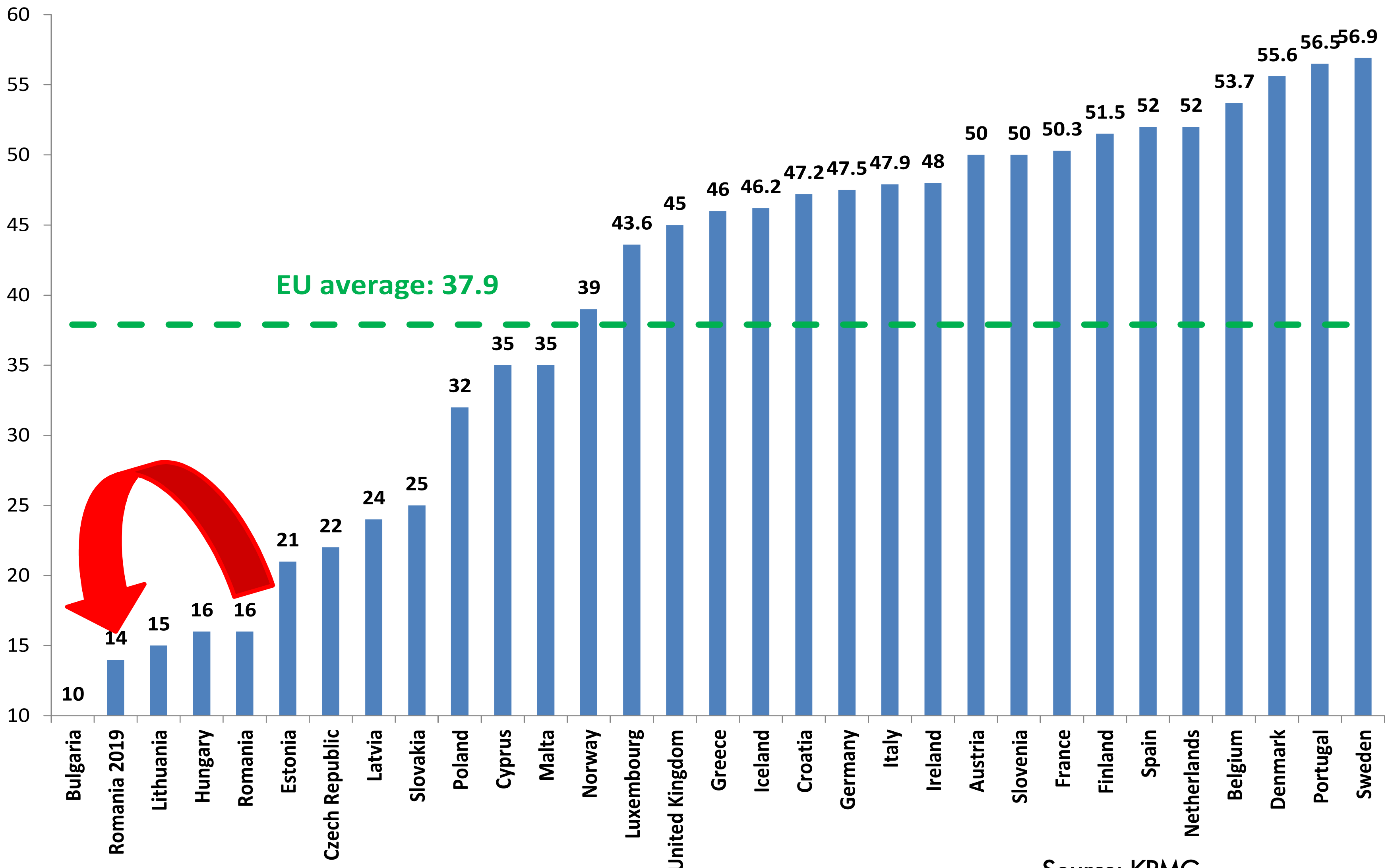
Source: European Commission

Top corporate income tax (2014)



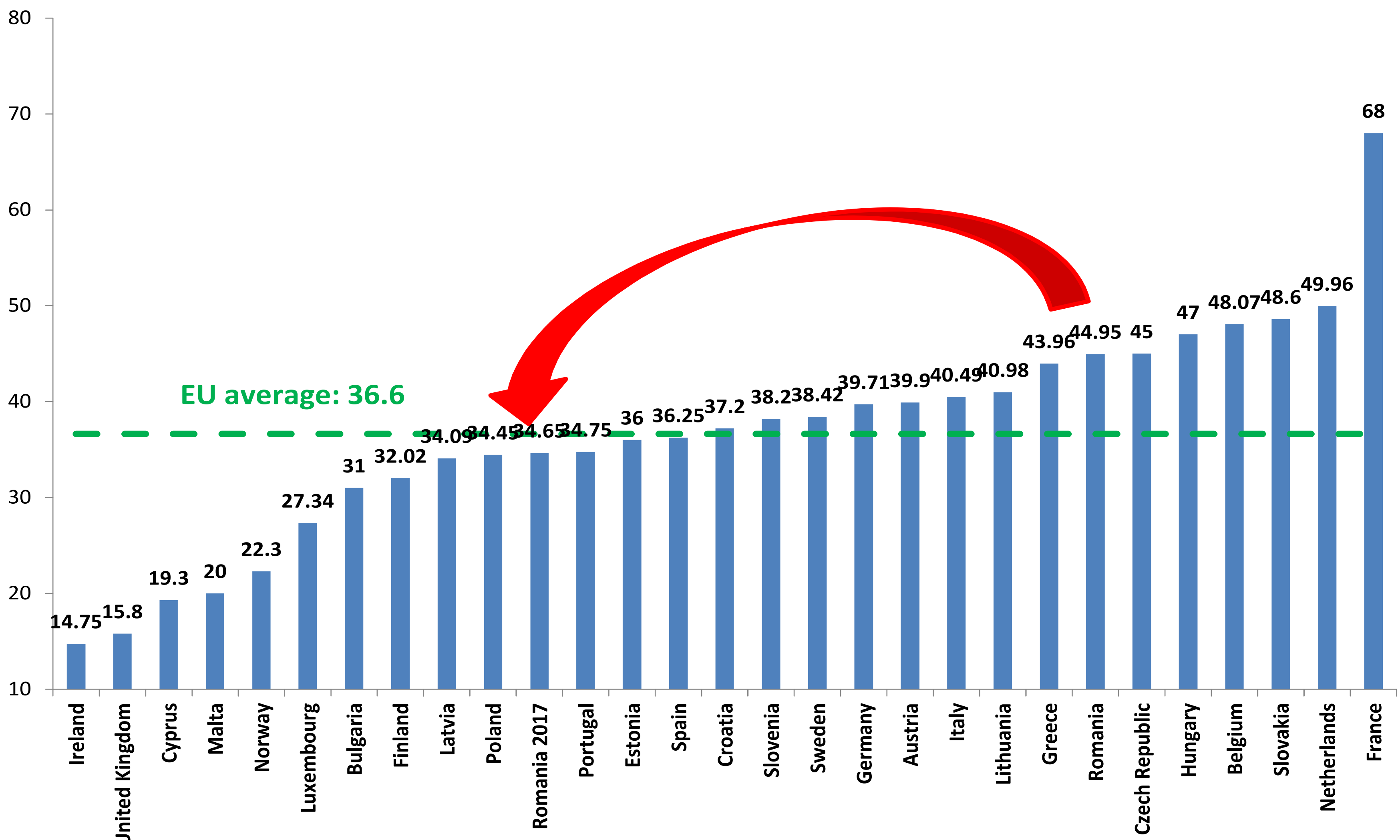
Source: KPMG

Top personal income tax (2014)



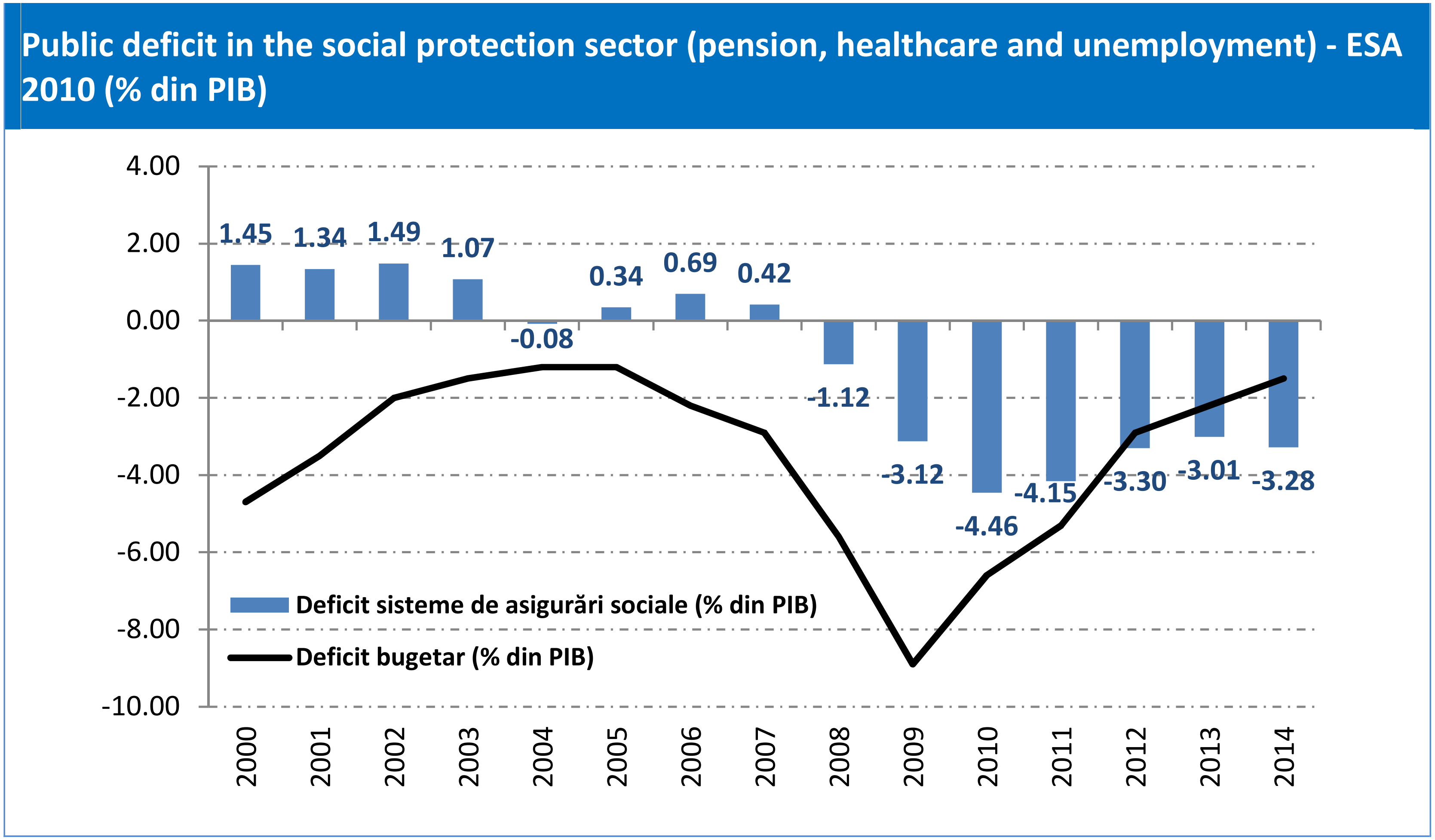
Source: KPMG

Top social security contributions (2014)



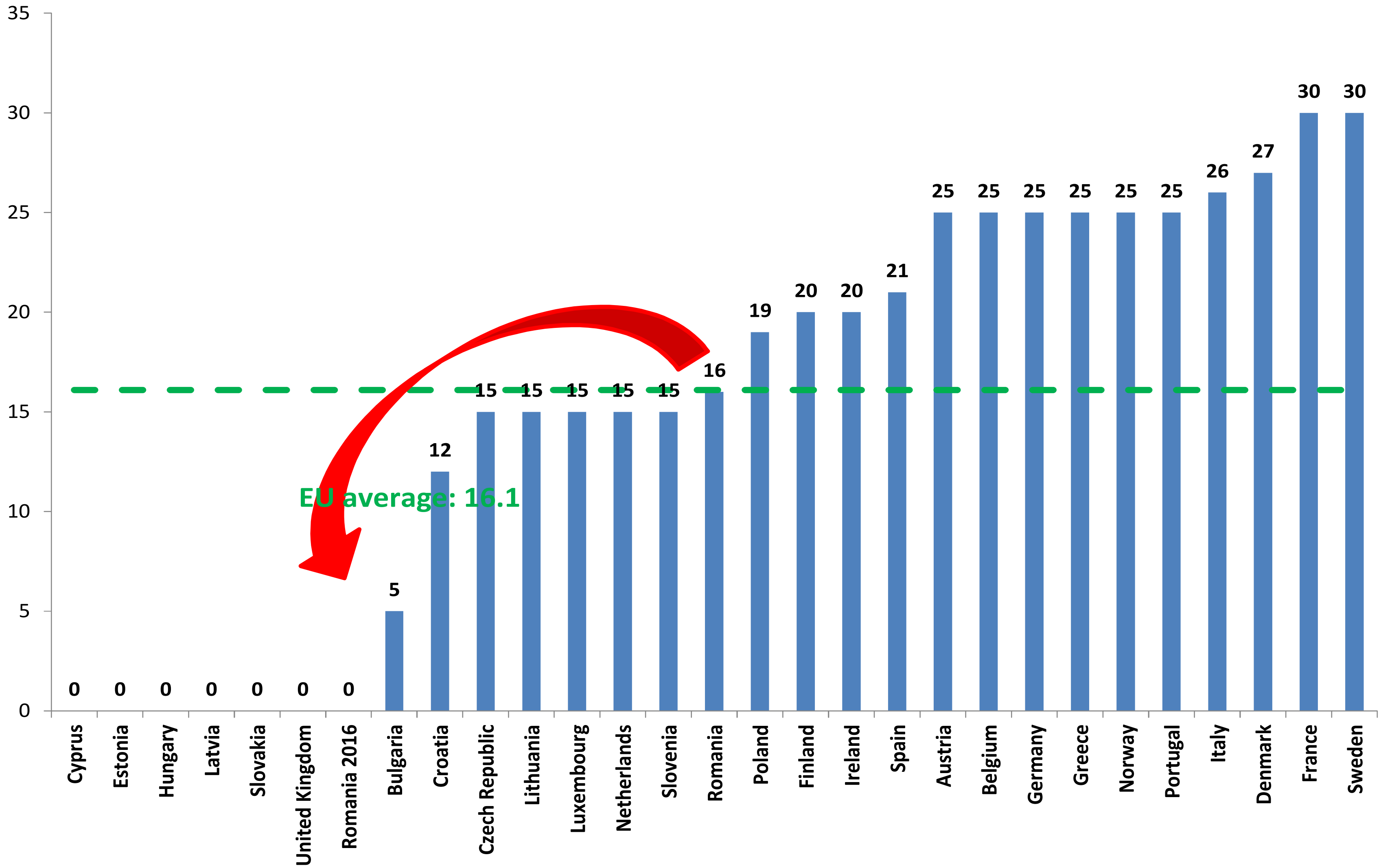
Source: KPMG

Unsustainable deficit in the social protection sector



Source: EUROSTAT, Ministry of Finance

Dividend tax (2014)



Source: Deloitte