Fiscal Council's Opinion on the Second Supplementary Budget Draft for 2015

On October 21st 2015, the Fiscal Council received from the Ministry of Public Finance by letter no. 419367/20.10.2015, the second supplementary budget draft for 2015, the explanatory note and the draft Government Ordinance project regarding the second budget revision for 2015, as well as the explanatory note and the Government Ordinance project regarding the draft of the revised social security budget for 2015, requesting the Fiscal Council's opinion under article 40, paragraph (2) of the Fiscal Responsibility Law (FRL) no. 69/2010[1] (FRL).

The coordinates of the Second Supplementary Budget Draft – the compliance with the fiscal rules

Compared with the budget approved on the occasion of the first budget amendment, the general consolidated budget (GCB) revenue and expenditure increase by 3.03 billion lei, so that the budget deficit is projected to remain to the level of 13,004 million lei. Article 12 letters b) and c), article 24 and article 26 paragraph (5) of the FRL state as mandatory the ceilings established by the Fiscal Strategy and by the accompanying law regarding the ceilings for the following indicators: the nominal level of the GCB deficit, the GCB primary deficit, the total spending excluding the financial assistance from the EU and other donors and also for the personnel spending - limiting the possibility of increasing total expenditure of the GCB during revisions exclusively for paying the debt service and Romania's contribution to the EU budget.

The first budget amendment already projected major breaches of the above mentioned mandatory ceilings established by the Law no. 182/2014 (Law for the approval of ceilings for certain indicators specified in the fiscal framework for 2015), both in the case of the personnel expenditures (by 1,481 million lei) and total spending excluding the financial assistance from the EU and other donors (by 4,932 million lei). Moreover, at that moment it was noted the non-compliance with fiscal rules stated by art. 12 paragraph (2) (which prohibits increasing the personnel expenses during the budgetary revisions) and by art. 24 (which prohibits the increase of the GCB expenditures, net of financial assistance from the EU and other donors during the budget revisions, unless it is due to the supplementing of the interest expenses or those related to Romania's contribution to the EU budget). The changes introduced by the draft of the second budget revision significantly increase the size of these ceilings overruns in the case of personnel expenses (by 2,286 million lei), total expenses excluding financial assistance from the EU and other donors (by 3,788 million lei) in the context of increasing the total spending by 3,027 million lei and also the reduction of the projection regarding the amounts from EU funds by 781

[1] Corresponding to article 53, paragraph (2) of the Law no. 69/2010 republished

million lei. Furthermore, a small deepening is added (+109 million lei) for the exceeding of the primary deficit ceiling, already registered on the occasion of the first budget revision (204.5 million lei). In addition to the breaking of ceilings, the second supplementary budget violates the provisions of art. 17 paragraph (2) and art. 24 which prohibits the increase of personnel expenditures and GCB expenditures, net of financial assistance from the EU and other donors during the year. The draft law provides again the already usual exemption from the above described fiscal rules, diminishing their credibility.

The Fiscal Council has commented extensively in its opinion on the first draft budget revision for 2015 about the *de facto* inoperability of the fiscal rules associated to the one related to budget deficit stated in FRL, in the sense that this rules by no means constrain the behavior of the authorities according to the legislator's intention, and proposed either a law enforcement aiming at limiting the possibility to recourse to derogation only under a precisely defined set of circumstances and the introduction of motivating penalties for breaking the fiscal rules (the optimal solution), or putting together the *de jure* with the *de facto* situations by affirming the supremacy of the fiscal rule regarding the budget deficit (in accordance with the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) and the formal abandonment of the related rules' set. Given that the second draft budget revision comes with a new round of derogations from almost all the associated rules except the budget deficit related one, the considerations expressed during the first revision remain valid in this case also.

The coordinates of the second budget revision - budgetary revenues

GCB revenues are downwardly revised by 3.03 billion lei compared to the programmed level from the first budget revision, but a part of this review (+688.8 million lei) is due to the new swap compensation scheme, so that the budgetary revenues, net of the impact of the swap schemes, are projected to grow by 2.34 billion lei. The budgetary revenues which register major changes relative to the values expected during the first budget revision, considering the net value of the swap are as follows:

- *Corporate income tax*: +155 million lei. Updating the programmed level for the whole year appears to be justified compared to the up to date budget execution, caracterized by a exceeding of revenue program
- *Personal income tax*: +123 milioane lei. Updating the programmed level for the whole year appears to be prudent given the decision to pay in advance compared to the originally programmed scheduling of salary related rights earned by court decisions, as well as the recent decisions to increase wages for some categories employeesin the public sector which are likely to generate additional revenue from the personal income tax.

- *VAT*: +1,236 milioane lei. In its opinion on the first draft budget revision of 2015, The Fiscal Council emphasized that the estimate of VAT revenues appeared to be prudent, which did not entirely included the over performance compared to the initial program for this revenue category, of 9.6% at the end of the first semester, even taking into account the application of reduced VAT rate on food products from first of June 2015, so the projection change appears to be justified. Regarding the impact seen in the VAT revenues of the extended scope of the reduced VAT rate for food products and restaurant services, although the time period elapsed is not sufficient to draw strong conclusions, first round impact seems to be approximately equal to the originally estimated one (about 5.5 billion lei per year). Thus, as can be seen in the first chart of the annex, if in the first 6 months the average annual growth rate of VAT collected monthly flows stood at about 10%, during the period July to September it dropped to 1.8% suggesting a monthly measure impact of about 400-500 million lei. If we analyze the values of VAT receivable (those observed in the monthly budget execution, which are equal to the VAT collected less VAT refunded, influenced thus by the dynamic of repayments that can undergo significant monthly variations), the average growth rate in the first 6 months of over 18% experienced a significant slowdown of up to about 7%, being likely to lead to a similar conclusion, namely a monthly impact of the measure concerned of about 400-500 million lei.
- *Excise duties*: +360 million lei. Increasing the projection for this budgetary category appears as optimistic in terms of the budget execution at 8 months, which does not point to an overperformance compared to the programmed levels.
- *Social Contributions*: +204 million lei. The revision may appear as prudent given the significant increase in personnel expenses (2,140 million), which will generate additional social contributions revenue of about 684 million lei, but it must be taken into account the fact that the large increase at the level of this budgetary aggregate, operated at the first budget amendment (1,671 million lei) appeared at that time as overly optimistic. The Fiscal Council has reserves on the figure presented in the Draft of the Second Supplementary Budget, given the up to date budget execution, consideering that the receipts at the end of the year will be most likely below the target by about 500-800 million.
- *Non-tax revenues*: +651 million lei. The change in the projection is given by the increase in the revenues from the sale of greenhouse gas emission certificates (188.5 million lei) and by the amounts collected at 8 months that exceed the program.

- *Taxes on using goods, authorizing the use of goods or on carrying activities*: 413 million lei due to additional receipts from taxes on gambling.
- *Amounts received from the EU in the account of payments made and prefinancing*: -781 million lei. The amount projected for the end of the year appears, however, as highly unlikely to be achieved given the receipts at 8 months (6,181 million lei), which represents less than a third compared to the budget target for the whole year (19,976 million lei). For reference, the budget execution for the year 2014, with a similar profile, recorded an increase in the amounts drawn from EU funds in the last 4 months of the year by about 37% compared to an increase of 223% required this year to converge towards the current budgeted levels.

The coordinates of the second budget revision – budgetary expenditure

The budgetary expenditure are also reviewed upward by 3.03 billion lei or by 2.34 billion lei if we eliminate the influence of the new swap scheme, the sources of this change being as follows:

- *Personnel expenses*: +2,140 million lei. This increase is explained mainly by the decision to pay in advance some salary rights established by court decisions (1,000 million lei), in contrast to the initial scheduling, to which is added the budgetary impact of higher wages in the health sector by 25% since October the 1st (300 million lei), the impact of local executive authorities staff higher wages by 12% since August the 1st (300 million lei) and the impact of the rise in the defense and public order sector food norm (250 million lei).
- *Goods and services*: +941 million lei, especially for the defense sector.
- *Subsidies*: +1,255 million lei, in the context of the funds allocated for the farmer losses compensations, caused by drought (300 million), for the increase in the subsidy for the diesel fuel and for the public transportation service by rail.
- *Projects funded by external post-accession non-reimbursable grants*: -897 million lei. The decrease represents the counterpart of the downward revision of the program in term of the amounts received from the EU. The reserves expressed there, with respect to the pace that EU funds inflows should perform in order to be provided the convergence with the programmed levels, is applied in the case of the associated expenses, as well.
- *Social assistance*: +439 million lei.
- *Capital expenditures*: -2,349 million lei, the adjustment being in line with the substantial underperformance registered in the first 8 months for the investment spending category.

- *Contingency reserve fund*: +841 million lei. This change appears as surprising given the previous years' pattern, according to which the contingency reserve fund amounts actually spent were not necessary those established via CGB successive amendments, as the financial sources consisted mainly of the allocations for some line credit officers which were not used. The Fiscal Council has previously elaborated exhaustive analyses of the manner the contingency reserve fund amounts are used showing the lack of transparency of their utilization, the nonexistence of explicit criteria identification of expenditure that can be made from the contingency reserve fund, the absence of a Parliamentary or of other institution's control of the money utilization and formulated strong recommendations regarding amending the legislation that regulates the contingency reserve fund use. The figure no. 2 in the Annex shows the allocations of the contingency reserve fund in the period 2007-2014, for the previous year being observed a deterioration of the contingency reserve fund utilization, as the amounts spent were significantly higher compared to the previous years.

In essence, at the level of the budgetary expenditure, is envisaged a significant increase of current spending (personnel, goods and services, subsidies) alongside with a massive reduction in the investment spending that are programmed to be reduced by 3,155 million lei compared to the first budget revision in 2015. This evolution is in line with the first 8 months' execution that shows an investment spending level of 15.13 billion lei (about 2.1% of GDP) in the context of an initial target of 47.36 billion lei (6.72% of GDP), that was modified on this occasion at 44.2 billion lei (6.27% of GDP), which would be equivalent nevertheless to an increase of 37% compared to 2014. The figure no. 4 in the Annex examines the execution of the investment spending compared to the planned spending according to the initial and revised budgets in the period 2012-2014, showing constant major deviations, in the sense that the executions are with no exceptions lower than the estimated amounts both in the initial and revised budgets, and the development registered in the current year indicates a similar pattern.

This evolution is not a desirable one, being well known from the international competitiveness rankings that the low quality of infrastructure represents the main challenge influencing the incentive to invest in Romania. However, the investment spending was continuously reduced over the last years, and probably will reach the minimum of the last 10 years in 2015 as a share in GDP. In this context, decreasing the investment spending without accompanying it by a significant efficiency improvement in order to offset the tax reductions and increased personnel spending in the budgetary sector, is counterproductive and will negatively affect the potential economic growth over the medium term. Moreover the current investment reduction represents only a postponement, and the necessity of carrying out the investments in the future will put a pressure on the budget over the medium and long term. In addition, reducing investment can only mean their postponement, the need of carrying out the investments in the future being likely to put a pressure on the budget over the medium and long-term.

In the Fiscal Council's opinion, for 2015 the risks are rather tilted towards recording a lower budget deficit than the target due to the inability to execute the expenditure program. However, in the medium term, engaging additional significant expenses of a permanent nature (such as personnel expenses), simultaneously with a massive reduction of taxes provided in the new Fiscal Code (especially in the case of taxes on goods and services: VAT and excises) are likely to bring the deficit in 2016, in the absence of compensatory measures, close to the 3% of GDP limit simultaneously with the significant deviation from the medium-term objective of 1% structural deficit. Moreover, the year 2017 could record exceeding the limit of 3% of GDP, mainly due to the fact that the second series of measures under the new Fiscal Code will enter into force. Therefore, the budgetary slippage would have a structural nature and would make the public finance position more vulnerable during the next downward phase of the economy, the subsequent adjustment costs exceeding the short term benefits in terms of real convergence generated by the higher budgetary deficit from the upward economic phase.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of the Fiscal Council, according to article 56, paragraph (2), letter d) of the Law no. 69/2010 republished, after being approved by the Council members through vote, on 23rd October, 2015.

23rd October, 2015

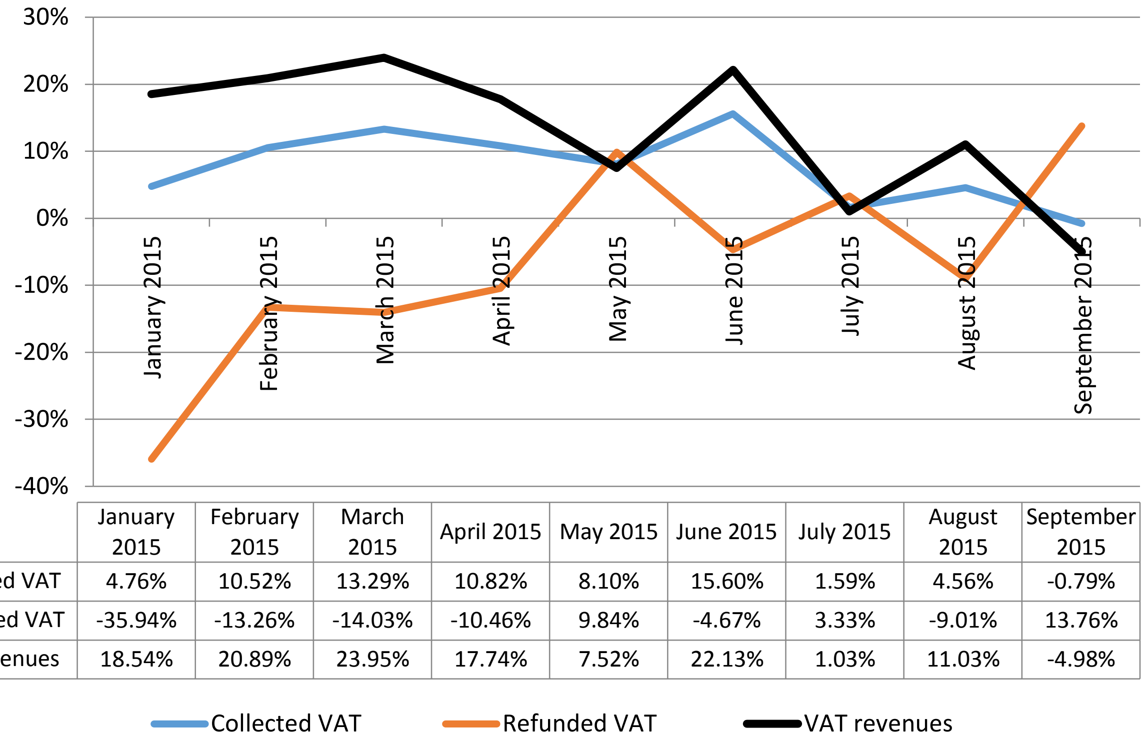
Chairman of the Fiscal Council

IONUŢ DUMITRU

ANNEX I	Initial budget 2015	Swap program	Initial budget 2015 without swap	First budget revision (R1)	Swap	R1 without swap	Second budget revision (R2)	Swap	R2 without swap	R1-Initial budget	R2- Initial budget	R2-R1
										Adjusted values for swap impact		
	1	2	3=1-2	4	5	6=4-5	7	8	9=7-8	10=6-3	11=9-3	12=9-6
TOTAL REVENUE	226,360.5	850.0	225,510.5	233,277.0	850.0	232,427.0	236,303.7	1,538.7	234,765.0	6,916.5	9,254.5	2,338.0
Current revenue	206,732.3	850.0	205,882.3	211,646.7	850.0	210,796.7	215,389.6	1,538.7	213,850.9	4,914.4	7,968.6	3,054.2
Tax revenue	133,391.8	850.0	132,541.8	135,170.1	850.0	134,320.1	137,911.4	1,538.7	136,372.7	1,778.3	3,831.0	2,052.7
Taxes on profit, wages, income and capital gains	39,567.7		39,567.7	41,177.9		41,177.9	41,410.9		41,410.9	1,610.2	1,843.2	233.1
Corporate income tax	12,670.0		12,670.0	13,486.8		13,486.8	13,641.6		13,641.6	816.8	971.6	154.9
Personal income tax	25,314.7		25,314.7	26,098.9		26,098.9	26,222.0		26,222.0	784.2	907.3	123.1
Other taxes on goods and services	1,583.0		1,583.0	1,592.2		1,592.2	1,547.3		1,547.3	9.2	-35.7	-44.9
Property tax	6,354.0		6,354.0	5,820.4		5,820.4	5,757.4		5,757.4	-533.6	-596.6	-63.0
Taxes on good and services	86,402.1	850.0	85,552.1	87,034.5	850.0	86,184.5	89,560.6	1,392.7	88,167.9	632.4	2,615.8	1,983.4
VAT	55,537.2	850.0	54,687.2	55,284.6	850.0	54,434.6	57,063.0	1,392.7	55,670.3	-252.6	983.1	1,235.7
Excises	25,531.0		25,531.0	25,799.3		25,799.3	26,159.5		26,159.5	268.3	628.5	360.2
Other taxes on goods and services	2,738.4		2,738.4	3,040.1		3,040.1	3,014.5		3,014.5	301.7	276.1	-25.6
Taxes on using goods, authorizing the use of goods or on carrying activites	2,595.5		2,595.5	2,910.5		2,910.5	3,323.6		3,323.6	315.0	728.2	413.1
Tax on foreign trade and international transactions (customs duty)	675.0		675.0	726.4		726.4	775.3		775.3	51.4	100.3	48.9
Other tax revenue	393.0		393.0	410.9		410.9	407.2		407.2	17.9	14.2	-3.7
Social security contributions	55,311.0		55,311.0	56,982.0		56,982.0	57,332.4	146.0	57,186.4	1,671.0	1,875.4	204.4
Nontax revenue	18,029.5		18,029.5	19,494.7		19,494.7	20,145.8		20,145.8	1,465.1	2,116.2	651.1
Capital revenues	853.8		853.8	871.5		871.5	916.5		916.5	17.7	62.7	45.0
Grants	2.3		2.3	2.3		2.3	22.1		22.1	0.0	19.8	19.8
Amounts received from the EU in the account of payments made and prefinancing	18,772.1		18,772.1	20,756.5		20,756.5	19,975.6		19,975.6	1,984.4	1,203.5	-780.9
Financial operations	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
Amounts collected in the single account(State budget)	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
Other amounts received from the EU for operational Programmes funded under the convergence objective	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
Amounts received from the EU/other donors in the account of payments made and pre-financing for financial framework 2014-2020	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
TOTAL EXPENDITURE	239,364.4	850.0	238,514.4	246,280.9	850.0	245,430.9	249,307.6	1,538.7	247,768.9	6,916.5	9,254.5	2,338.0
Current expenditure	220,937.4	850.0	220,087.4	226,970.2	850.0	226,120.2	231,803.1	996.0	230,807.1	6,032.8	10,719.7	4,686.9
Personnel	48,373.3		48,373.3	49,854.2		49,854.2	52,139.8	146.0	51,993.8	1,480.9	3,620.5	2,139.6
Goods and services	40,037.3		40,037.3	40,926.0		40,926.0	41,867.3		41,867.3	888.7	1,830.0	941.3
Interest	10,529.3		10,529.3	10,324.8		10,324.8	10,216.1		10,216.1	-204.5	-313.2	-108.7
Subsidies	5,488.8		5,488.8	5,776.6		5,776.6	7,031.5		7,031.5	287.8	1,542.7	1,254.9
Total Transfers	115,711.7	850.0	114,861.7	119,314.3	850.0	118,464.3	118,985.3	850.0	118,135.3	3,602.6	3,273.6	-329.0
Transfers for public entities	1,498.5	850.0	648.5	1,562.2	850.0	712.2	1,665.9	850.0	815.9	63.6	167.3	103.7
Other transfers	12,040.3		12,040.3	12,142.8		12,142.8	11,958.8		11,958.8	102.5	-81.5	-184.0
Projects funded by external post-accession grants	24,176.0		24,176.0	25,708.5		25,708.5	24,811.6		24,811.6	1,532.5	635.6	-896.9
Social assistance	74,095.0		74,095.0	75,382.3		75,382.3	75,821.3		75,821.3	1,287.3	1,726.3	439.0
Projects funded by external post-accession grants 2014-2020	482.3		482.3	519.7		519.7	537.9		537.9	37.4	55.6	18.3
Other expenditure	3,419.6		3,419.6	3,998.9		3,998.9	4,189.9		4,189.9	579.3	770.3	191.0
Reserve funds	0.6		0.6	151.0		151.0	992.1		992.1	150.4	991.5	841.1
Expenditure funded from reimbursable funds	796.4		796.4	623.3		623.3	570.9		570.9	-173.1	-225.5	-52.3
Capital expenditure	18,427.0		18,427.0	19,310.8		19,310.8	17,504.5	542.7	16,961.8	883.7	-1,465.2	-2,348.9
Financial operations	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
Payments made in previous years and recovered in the current year	0.0		0.0	0.0		0.0	0.0		0.0	0.0	0.0	0.0
SURPLUS(+) / DEFICIT(-)	-13,004.0		-13,004.0	-13,004.0		-13,004.0	-13,004.0		-13,004.0	0.0	0.0	0.0

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

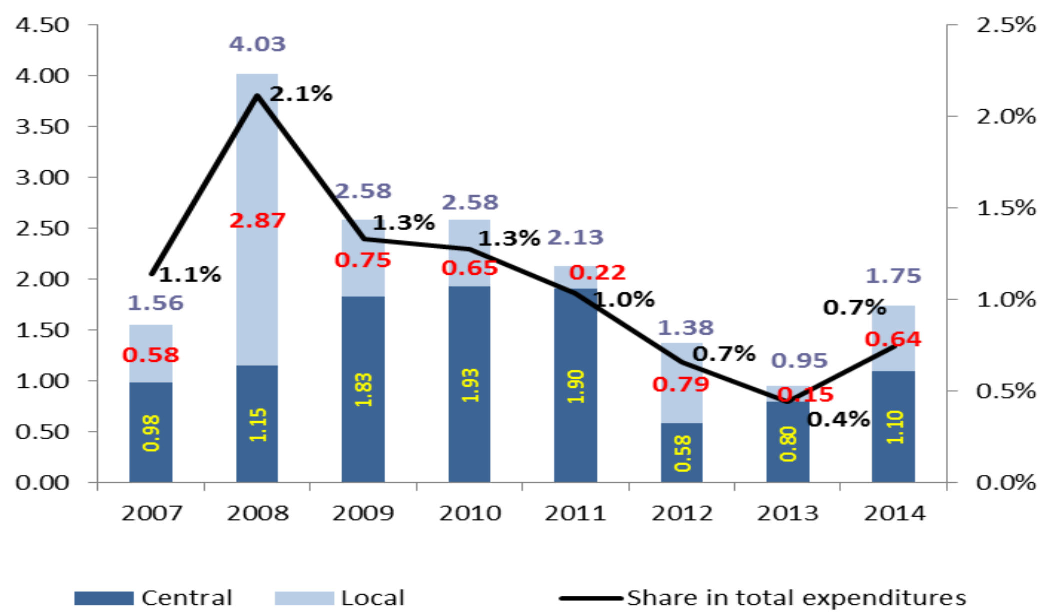
Figure 1: Growth rate of VAT, compared to the same period of the last year



	January 2015	February 2015	March 2015	April 2015	May 2015	June 2015	July 2015	August 2015	September 2015
Collected VAT	4.76%	10.52%	13.29%	10.82%	8.10%	15.60%	1.59%	4.56%	-0.79%
Refunded VAT	-35.94%	-13.26%	-14.03%	-10.46%	9.84%	-4.67%	3.33%	-9.01%	13.76%
VAT revenues	18.54%	20.89%	23.95%	17.74%	7.52%	22.13%	1.03%	11.03%	-4.98%

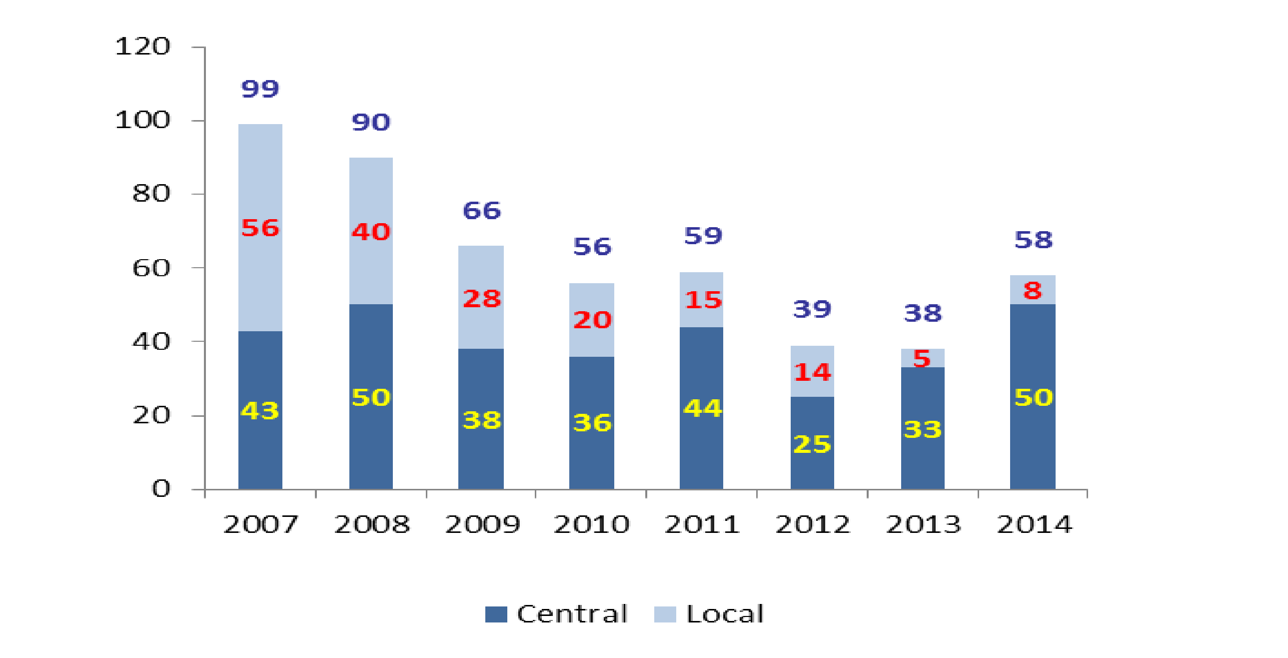
Source: Ministry of Public Finance, Fiscal Council's calculations

Figure 2: Total contingency reserve fund allocations (billion lei)



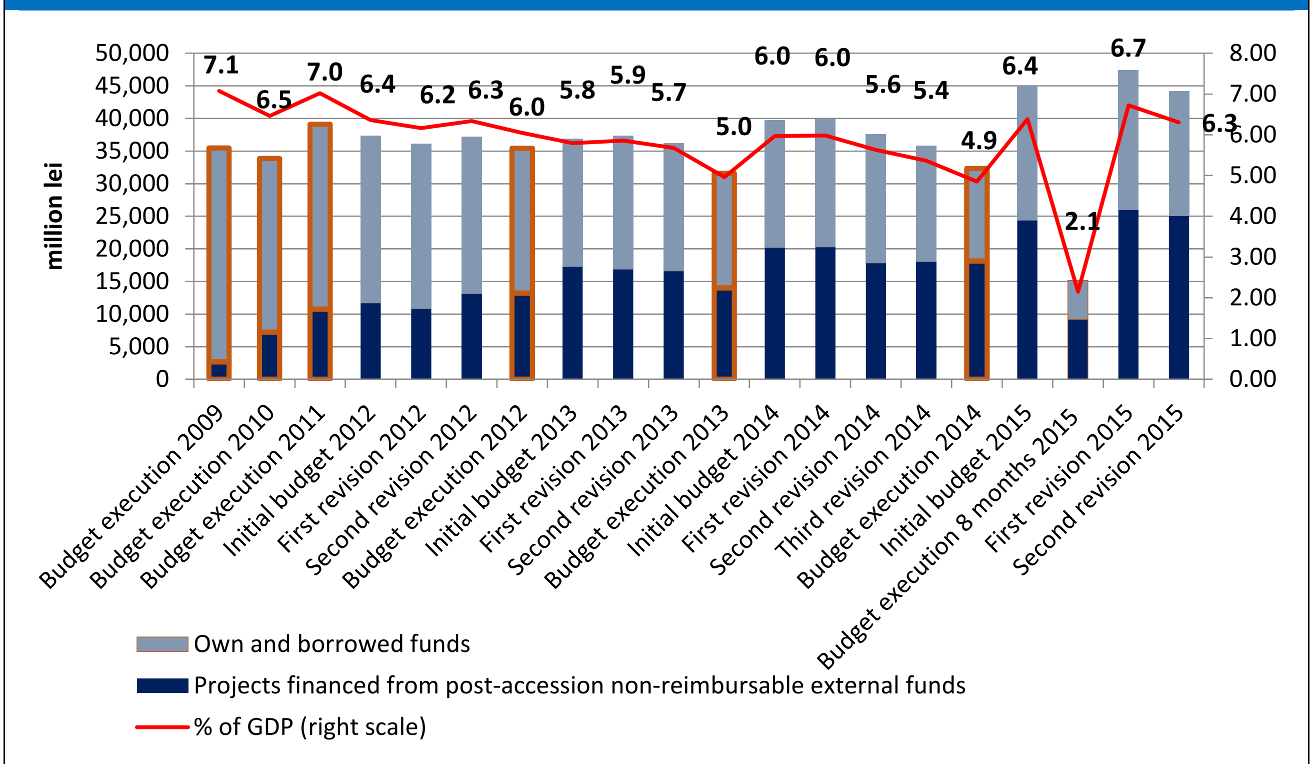
Source: Fiscal Council's calculations based on Government's decisions regarding the contingency reserve fund allocations

Figure 3: Number of Government decisions regarding contingency reserve fund allocations



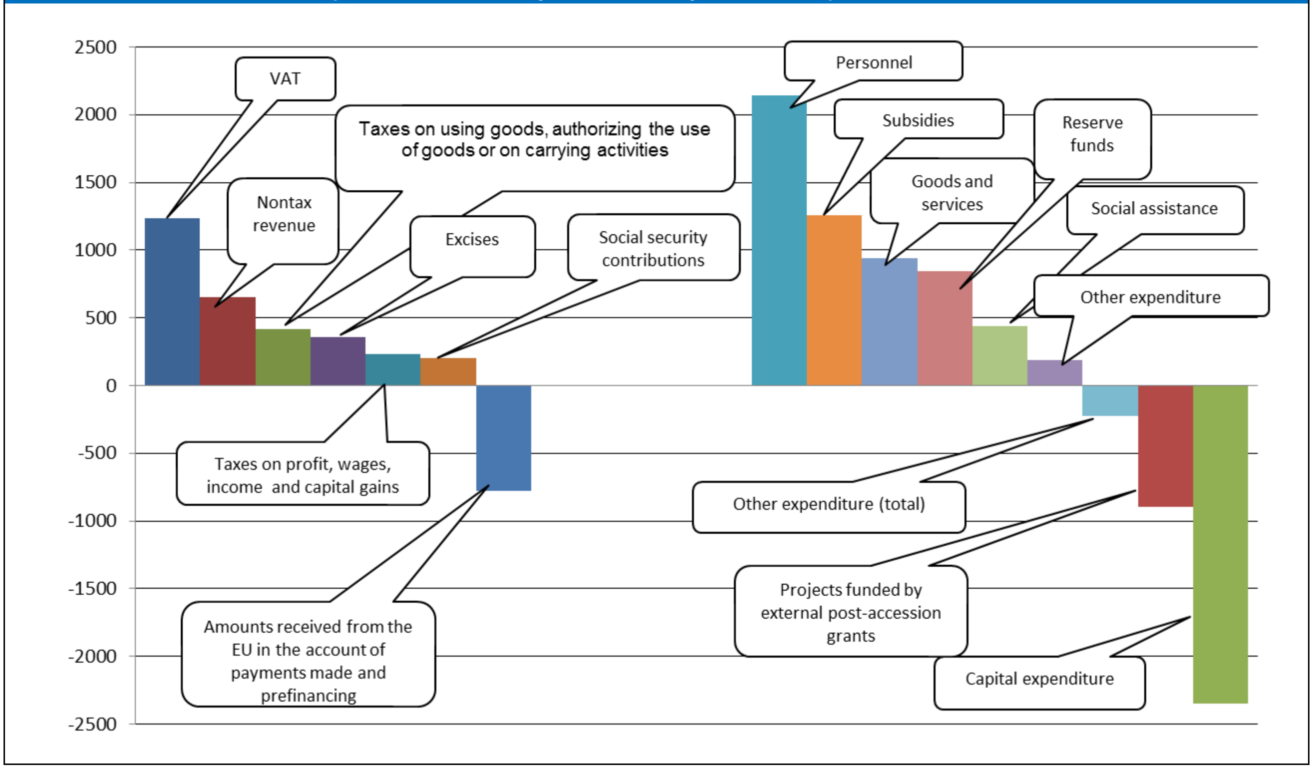
Source: Fiscal Council's calculations based on Government's decisions regarding the contingency reserve fund allocations

Figure 4: The evolution of investment expenses between 2009-2015 – planned level vs. execution (million lei)



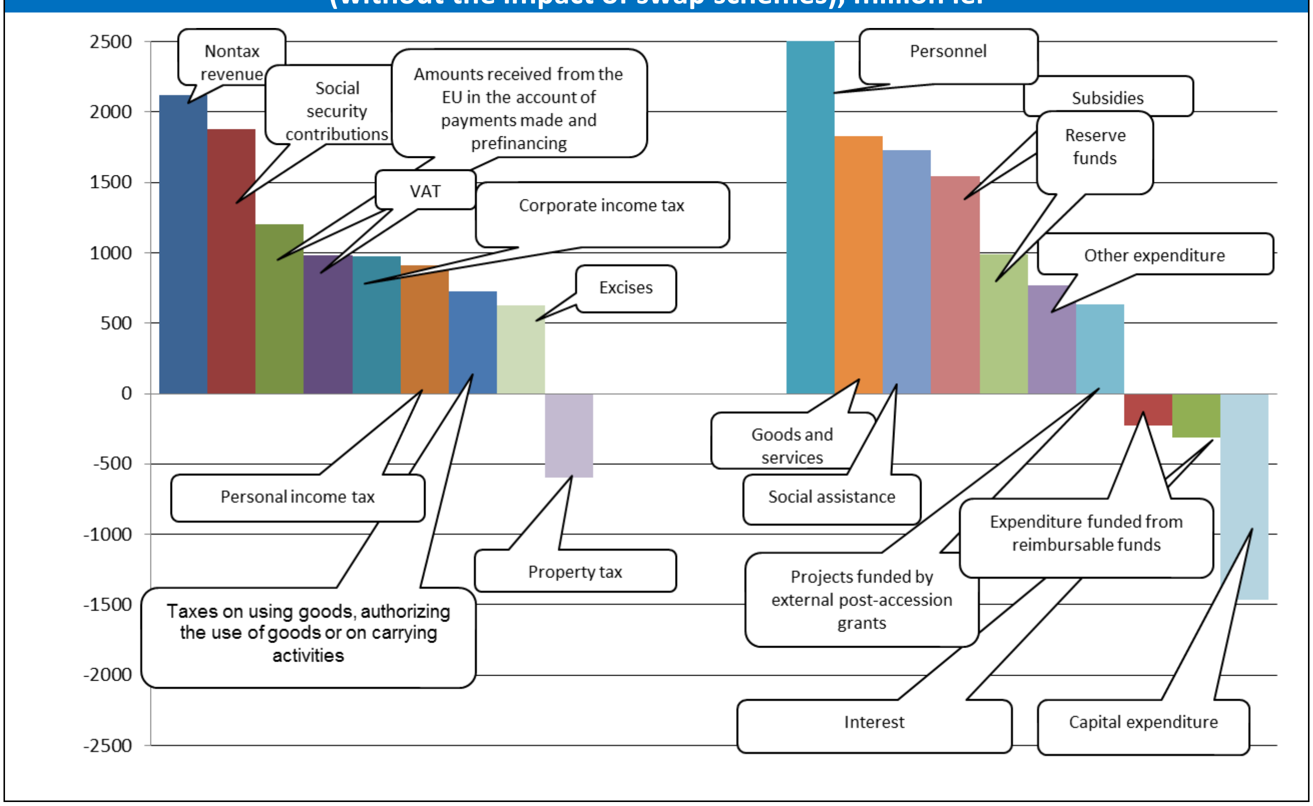
Source: Ministry of Public Finance, Fiscal Council's calculations

Figure 5: The main changes in expenditures and revenues compared to first budget revision (without the impact of swap schemes), million lei



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

Figure 6: The main changes in expenditures and revenues compared to initial budget (without the impact of swap schemes), million lei



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