Fiscal Council of Romania

Preliminary opinion of the Fiscal Council on the State Budget Law and the Social Security budget Law for 2020

Summary

- The year 2020 is critical for the budget construction during the 2020-2022 periods. The way of applying the pension law in 2020 has a decisive role for the 2021 budget;
- The biggest risk is that the budget deficit will rise steeply if no corrective measures are taken in 2020, which would affect the overall economic stability;
- The preliminary assessment of the FC on the budget deficit for 2020 indicates significant risks of exceeding the target of 3.6% of GDP;
- A fragile budgetary construction for 2020 and particularly for 2021 would most likely lead to a deterioration in the sovereign rating and entry into the Excessive Deficit Procedure (EDP);
- Initiatives regarding tax cuts and spending increases when the budget situation is so tense are not justified, being contrary to the logic of budgetary consolidation;
- The state of the public budget remains extremely tense due to insufficient resources and very high pressures, both in the present and in the future;
- The slowdown tendency of economic growth, manifested at an international level, and potential external shocks pose risks to the budgetary consolidation process.

Preliminary opinion of the Fiscal Council on the State Budget Law and the Social Security budget Law for 2020

The Fiscal Council (FC) received in electronic form from the Ministry of Public Finance (MPF) the address no. 467417 / 16.12.2020, by which it is requested, based on art. 53, paragraph 2 of the Fiscal-Responsibility Law no. 69/2010 (FRL) republished, formulating its opinion on the Report on the macroeconomic situation for 2020 and its projection in the period 2021-2023, the draft law of the state budget for 2020, the draft law of state social insurance for 2020 and the Substantiation Note related to it. The Fiscal Council mentions that it initially received, on December 16, at 4.48 pm, an incomplete first set of documents necessary to prepare its opinion. Subsequently, at the FC's request, some of the documents were sent; at the same time with an update of the initial documents, at 01.13 am on December 17th.

It is to be mentioned that, according to article 53, paragraph (4) of the FRL, **the Government and the Parliament have the obligation to take into consideration the opinions and recommendations of the FC when drafting the Fiscal Strategy, the annual budget laws and in the case of elaborating and approving other measures determined by the application of this law**. Considering the Government's intention to approve the aforementioned documents at the meeting scheduled for <u>December 18th 2019</u>, it is obvious that the FC did not dispose of sufficient time to analyze them and elaborate a complete opinion, an *in extenso* opinion being impossible to be done. Under these circumstances, FC decided to draw up a preliminary opinion that assesses the compliance of the draft budget revision with the fiscal rules stated by the FRL, while the detailed opinion will be finalized subsequently.

Moreover, the data requested from the Ministry of Public Finance are still only partially available, a new situation compared to the previous years, especially regarding the lack of the annex regarding the fiscal-budgetary policy measures and their impact assessment. In these circumstances, the Fiscal Council decided to elaborate a preliminary opinion, which will be limited to general considerations and to the evaluation of the conformity of the budget proposal with the fiscal rules stipulated by the FRL, while a complete opinion will be finalized later.

The FC reiterates the requests made over time in its Opinions, in the sense that the decision makers offer a reasonable period of time for analysis, appropriate to the complexity and scope of the documents on which the opinion is requested, as well as a complete set of documents and explanations to which the FRL refers in art. 54 paragraph 2. These would lead to increased transparency and better analytical support for the construction and execution of public budgets.

General considerations concerning the 2020 annual budget

Main findings:

- The year 2020 is pivotal for the 2020-2022 periods. The implementation of the pension law plays a decisive role for the 2021 budget, the impact of social assistance expenditures being much higher than the one estimated for 2020, relative to the level projected for 2019 (according to FC calculations, 2.7% of GDP in 2021 compared to 0.7% of GDP in 2020);
- The biggest risk is that the budget deficit could slide significantly if no corrective measures are taken in 2020, which would affect the overall economic stability;
- The preliminary evaluation of the FC on the budget deficit for 2020 indicates significant risks of exceeding the target of 3.6% of GDP;
- The budget deficit in 2019 is equivalent to about 80% of the current account deficit expected for the same year (over 5% of GDP); this shows not only the excess demand, but also the fact that the necessary macroeconomic consolidation is largely dependent on reducing the budget deficit;
- Initiatives regarding tax cuts and spending increases when the budget situation is so tense are not justified, being contrary to the logic of budgetary consolidation;
- The state of the public budget remains extremely tense due to insufficient resources and very high pressures, both in the present and in the future;
- The slowdown tendency of economic growth, manifested at an international level, and potential external shocks pose risks to the budgetary consolidation process;
- A fragile budgetary construction for 2020, and especially for 2021, would most likely lead to the deterioration of the sovereign rating and to the entrance into the Excessive Deficit Procedure (EDP).

The new Government elaborated the draft law of the state budget for 2020, and the draft law of the state social security budget for 2020, 5 days after it had elaborated the Fiscal Strategy (FS) for 2020-2022 and the accompanying ceilings law, although the deadline for submitting these documents by MPF to the Government is set, according to the FRL, at July 31st of each year.

A brief analysis of the current budgetary construction - in the absence of the time and information needed for a more elaborate opinion - highlights the following aspects:

- The project of the general consolidated budget for 2020 targets a deficit of 3.6% of GDP in cash terms, which represents a reduction of 0.83 pp of GDP compared to the level estimated for the end of 2019 (4.43% of GDP);

- In what concerns the macroeconomic scenario that underpins the current budgetary construction, FC reiterates the considerations from its previous Opinion - the one regarding the FS for 2020-2022 and the accompanying law for approving the ceilings of some indicators specified in the fiscal-budgetary framework - which points out the following: (i) the revision of the macroeconomic framework by harmonizing it with the effective evolution of the economy in 2019; (ii) the possible overvaluation of the GDP dynamics - by anticipating a higher real growth rate than in the projections of other domestic and international institutions - which induces the risk of a lower GDP dynamics - especially in the context of possible corrections imposed by macroeconomic consolidation and by unfavorable influences of the international environment; (iii) the overestimation of the evolutions related to the labor market, the increase of the average wage across the economy being significantly higher in the case of the projections made by the National Commission of Strategy and Prognosis compared to those of other institutions (*e.g.* the EC autumn 2019 forecast) and, moreover, the gap being significant and persistent. It must be mentioned that the assumptions regarding the labor market have a major impact on the forecast of budgetary revenues - mainly social security contributions and personal income tax - due to their high sensitivity to the increase in the number of employees and to the wage dynamics. Consequently, taking into account the dynamics of the macroeconomic bases, there is a possible overestimation of the budgetary revenues for 2020;

- The starting point for the 2020 budget takes into account the parameters related to the budget for 2019, more specifically the budgetary aggregates estimated through the second revision of November 2019. It is worth mentioning the change operated after the elaboration and publication of the FC's Opinion on the second budget revision[1], respectively the increase of the budget deficit from 4.3% to 4.43% of GDP;

- FC identifies a possible under-execution of budgetary revenues for 2019, located mainly at the level of non-tax revenues, but also at VAT. This may generate additional risks regarding the projected revenues for 2020. In the absence of the fiscal policy measures list and their estimated impact for 2020, FC has reservations about the projected level for certain aggregates of tax revenues (especially VAT and excise duties) and about the 60% increase of the anticipated entries from EU structural and cohesion funds whose final beneficiary is the public sector (from 10.4 billion lei in 2019, to 16.6 billion lei in 2020);

- The budgetary construction accommodates large pressures from social assistance expenditures (they are expected to increase by 16.6 billion lei, respectively by 0.61 pp of GDP compared to their level from 2019), partially offset by the reduction of capital expenditures;

- On the other hand, investment expenditures, which include as sources of financing capital

[1] The changes are presented in Annex 1.

expenditures and European funds, are estimated to increase by about 0.2 pp of the GDP due to the substantial increase of the projects with financing from non-reimbursable external funds by 0.6 pp from GDP;

- Given that MPF anticipates a less rapid expansion of co-financing and ineligible expenditures (the SCF[2] expenditure/revenue ratio decreases from 1.7 in 2019 to 1.56 in 2020), the budget estimates a substantial increase in expenditures related to investment projects with European financing (+8 billion lei in comparison to the estimate of the previous year). Past budgetary executions constantly registered significant deviations from the amounts initially budgeted (or the amounts approved through budgetary revisions), in the sense of recording investment expenditures that were lower than initial allocations;

- The level of structural adjustment of 0.32 pp of GDP proposed for 2020 is significantly lower than the recommendation of the Council of European Union issued in the context of significant deviation procedure to implement a structural adjustment of 1% of GDP in 2020. It is noted that the trajectory of the structural deficit envisaged in the forecast for 2023 implies a cumulative structural adjustment of 1.54 pp of GDP in 4 years;

- Surprisingly in the FC's opinion, the budget construction does not include elements that are in a final stage of the legislative process – with reference to PLx no. 572/2019 (Draft Law for amending the Law no. 227/2015 on the Fiscal Code) which eliminates the extra excise on fuel and the over taxation of part – time jobs. Thus this legislative initiative was approved in both chambers of the Romanian Parliament, being in the stage of promulgation by the President of Romania. Moreover, the impact of this law draft in not included in the FS, FC considering this decision as risky because: (i) the associated budgetary impact is approximately 0.4 pp of GDP for the first (abandoning the extra excise on fuel) and approximately 0.1 pp of GDP for the second; (ii) this impact is permanent, propagating also in the future budget constructions; (iii) considering that the loss of unrecognized income is updated with the dynamics of the relevant macroeconomic bases, the under estimation of the deficit is more significant;

- Other possible legislative changes consist of:
    - The draft regarding the decreased of VAT standard rate from 19% to 16% and VAT reduced rate for food products to 5% (PL-x no. 597/2019 – Draft Law for amending and supplementing art. 291 of Law no. 227/2015 on Fiscal Code). It is in a relatively advanced stage of the legislative process, the loss of income being considerable and permanent;
    - Within the measures taken into account in the FS is the elimination of bank tax from GEO no. 114/2018 and GEO no. 19/2019 – this being assessed, in the mentioned document,

[2] Structural and Cohesion Funds.

to about 0.05% of GDP in 2020. The adoption of this measure as well as the elimination of other provisions of the legislation mentioned above lead to a potential further reduction of budgetary revenues, which could increase significantly as impact, following the repeal of the provisions regarding the communications, energy and gambling sectors.

Compliance with the fiscal rules stipulated by the Fiscal Responsibility Law

Given that the FS for 2020-2022 and the ceilings law for certain indicators specified in the fiscal framework were introduced in Parliament just a few days before the presentation of the draft budget for 2020, the verification of compliance with the established ceilings becomes a purely formal step, being expected that no overruns will be registered. However, it should be emphasized that this situation is not an exception, but has been perpetuated over the last few years (when the FS was published concurrently with the draft budget), so that monitoring the *ex-ante* compliance with the fiscal rules regarding the ceilings law becomes irrelevant, leading to the erosion of the role that FS should play in guiding fiscal policy in the medium term.

In its Opinion on the FS for 2020-2022, FC identified a series of deviations from the fiscal rules established by the FRL at art. 6, art. 7, art. 14 para. 1, art. 26 para. 3and art. 29, para. 4. At the same time, following the analysis of the draft of general consolidated budget for 2020, the FC notes:

- Art. 30 para. 4 stipulates the obligation for the Government to present to the Parliament an annual budget that respects the principles of fiscal responsibility, the fiscal rules, the fiscal strategy and any other provisions of the FRL, this compliance being attested by a declaration signed by the Prime Minister and the Minister of Public Finance;
- Art. 30 para. 5 stipulates that, in the absence of the compliance conditions set out in the previous paragraph, the declaration should mention the deviations, as well as the measures and deadlines by which the Government will ensure compliance with the principles of fiscal responsibility, with the fiscal rules and with the fiscal strategy.

We mention that in the documents sent by the MPF, the FC does not find the declaration of compliance stipulated in art. 30 para. 4 and 5. Consequently, the FC can not express an opinion according to the obligation established by art. 30 para. 6

The opinions and the recommendations mentioned above by the Fiscal Council were approved by the Chairman of the Fiscal Council, according to art. 56, para. (2) letter d) of the Law no. 69/2010 republished, after being approved by the Council members, through vote, on 18th December, 2019.

18th December 2019 — Charmain of the Fiscal Council,

Professor Daniel DĂIANU

ANNEX I – Differences between the initial second revision budget (R2) and the second revision budget approved in Government	R2 initial	R2 approved in Government	R2 approved in Government - R2 initial	R2 initial	R2 approved in Government	R2 approved in Government - R2 initial
	(million lei)	(million lei)	(million lei)	(% of GDP)	(% of GDP)	(% of GDP)
	1	2	3=2-1	4	5	6=5-4
Total revenue	**326,587.80**	**326,637.80**	**50**	**31.38%**	**31.38%**	**0**
Amounts received from the EU/other donors in the account of payments made and prefinancing for the 2014-2020 financial framework	**26,812.10**	**26,862.10**	**50**	**2.58%**	**2.58%**	**0**
Total expenditure	**371,307.80**	**372,745.30**	**1,437.40**	**35.68%**	**35.81%**	**0.14**
Current expenditure	**341,348.50**	**342,971.60**	**1,623.20**	**32.80%**	**32.95%**	**0.16**
Personnel	101,907.80	102,385.60	477.7	9.79%	9.84%	0.05
Goods and services	48,543.50	49,201.70	658.2	4.66%	4.73%	0.06
Subsidies	7,105.60	7,136.10	30.5	0.68%	0.69%	0
Total transfers	169,701.40	170,284.00	582.6	16.30%	16.36%	0.06
Other transfers	**16,421.40**	**16,434.60**	**13.1**	**1.58%**	**1.58%**	**0**
Social assistance	114,117.10	114,570.70	453.6	10.96%	11.01%	0.04
Projects funded by external post-accession grants 2014-2020	30,173.00	30,265.50	92.6	2.90%	2.91%	0.01
Other expenditure	6,583.50	6,606.80	23.3	0.63%	0.63%	0
Reserve funds	655.3	529.4	-125.9	0.06%	0.05%	-0.01
Capital expenditure	**29,959.40**	**29,773.60**	**-185.7**	**2.88%**	**2.86%**	**-0.02**
EXCEDENT(+) / DEFICIT(-)	**-44,720.00**	**-46,107.40**	**-1,387.40**	**-4.30%**	**-4.43%**	**-0.13**

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

	Draft budget 2020	FS projection 2020	Draft budget 2020 - FS projection 2020	Draft budget 2020 - FS projection 2020	Draft budget 2020	FS projection 2020	Draft budget 2020 - FS projection 2020
	(million lei)	(million lei)	(million lei)	(%)	(% of GDP)	(% of GDP)	(% of GDP)
	1	2	3=2-1	4=3/1	5	6	7=6-5
Total revenue	**360,148.6**	**358,593.0**	**1,555.6**	**0.4%**	**31.9%**	**31.8%**	**0.14**
Current revenue	**329,820.8**	**329,951.9**	**-131.2**	**0.0%**	**29.2%**	**29.2%**	**-0.01**
Tax revenue	**177,017.6**	**177,163.3**	**-145.7**	**-0.1%**	**15.7%**	**15.7%**	**-0.01**
Taxes on profit, wages, income and capital gains	**49,883.7**	**49,883.8**	**-0.1**	**0.0%**	**4.4%**	**4.4%**	**0.00**
Corporate income tax	19,471.8	19,471.8	0.0	0.0%	1.7%	1.7%	0.00
Personal income tax	26,315.2	26,315.3	-0.1	0.0%	2.3%	2.3%	0.00
Other taxes on income, profit and capital gains	4,096.7	4,096.7	0.0	0.0%	0.4%	0.4%	0.00
Property tax	**7,105.7**	**7,105.8**	**-0.1**	**0.0%**	**0.6%**	**0.6%**	**0.00**
Taxes on goods and services	**117,974.8**	**118,120.3**	**-145.5**	**-0.1%**	**10.4%**	**10.5%**	**-0.01**
VAT	72,720.5	72,720.5	0.0	0.0%	6.4%	6.4%	0.00
Excises	33,658.1	33,658.1	0.0	0.0%	3.0%	3.0%	0.00
Other taxes on goods and services	4,903.1	5,048.5	-145.4	-3.0%	0.4%	0.4%	-0.01
Taxes on the use of goods, on authorizing the use of goods and on carrying activities	6,693.1	6,693.2	-0.1	0.0%	0.6%	0.6%	0.00
Taxes on foreign trade and international transactions (custom duty)	**1,253.9**	**1,253.9**	**0.0**	**0.0%**	**0.1%**	**0.1%**	**0.00**
Other tax revenue	**799.5**	**799.5**	**0.0**	**0.0%**	**0.1%**	**0.1%**	**0.00**
Social security contributions	**124,026.8**	**124,013.1**	**13.7**	**0.0%**	**11.0%**	**11.0%**	**0.00**
Nontax revenue	**28,776.4**	**28,775.5**	**0.9**	**0.0%**	**2.5%**	**2.5%**	**0.00**
Capital revenue	**1,000.8**	**1,000.8**	**0.0**	**0.0%**	**0.1%**	**0.1%**	**0.00**
Grants	**8.5**	**2.6**	**5.9**	**69.7%**	**0.0%**	**0.0%**	**0.00**
Amounts received from the EU in the account of payments made and prefinancing	**7.7**	**2.6**	**5.1**	**66.4%**	**0.0%**	**0.0%**	**0.00**
Financial operations	**0.0**	**0.0**	**0.0**	**0.0%**	**0.0%**	**0.0%**	**0.00**
Amounts collected in the single account	**0.0**	**0.0**	**0.0**	**0.0%**	**0.0%**	**0.0%**	**0.00**
Other amounts received from the EU	**0.0**	**0.0**	**0.0**	**0.0%**	**0.0%**	**0.0%**	**0.00**

Amounts received from the EU/other donors in the account of payments made and prefinancing for the 2014-2020 financial framework	**29,310.9**	**27,635.1**	**1,675.7**	**5.7%**	**2.6%**	**2.4%**	**0.15**
Total expenditure	**400,693.7**	**399,226.8**	**1,466.8**	**0.4%**	**35.5%**	**35.4%**	**0.13**
Current expenditure	**373,763.5**	**372,249.8**	**1,513.7**	**0.4%**	**33.1%**	**33.0%**	**0.13**
Personnel	109,163.4	109,754.4	-591.0	-0.5%	9.7%	9.7%	-0.05
Goods and services	50,885.0	50,971.8	-86.7	-0.2%	4.5%	4.5%	-0.01
Interest	13,950.6	13,950.6	0.0	0.0%	1.2%	1.2%	0.00
Subsidies	7,189.2	7,292.2	-103.1	-1.4%	0.6%	0.6%	-0.01
Total transfers	**190,824.4**	**188,836.3**	**1,988.1**	**1.0%**	**16.9%**	**16.7%**	**0.18**
Transfers between public administration entities	2,169.6	1,982.6	187.1	8.6%	0.2%	0.2%	0.02
Other transfers	16,818.5	16,316.5	502.0	3.0%	1.5%	1.4%	0.04
Projects funded by external post-accession grants	198.3	190.5	7.8	3.9%	0.0%	0.0%	0.00
Social assistance	131,220.5	131,138.9	81.6	0.1%	11.6%	11.6%	0.01
Projects funded by external post-accession grants 2014-2020	33,697.0	32,279.3	1,417.6	4.2%	3.0%	2.9%	0.13
Other expenditure	6,720.5	6,928.5	-208.0	-3.1%	0.6%	0.6%	-0.02
Reserve funds	**1,086.5**	**830.0**	**256.5**	**23.6%**	**0.1%**	**0.1%**	**0.02**
Expenditure Funded from reimbursable funds	**569.8**	**519.9**	**49.9**	**8.8%**	**0.1%**	**0.0%**	**0.00**
Capital expenditure	**26,930.1**	**26,977.0**	**-46.9**	**-0.2%**	**2.4%**	**2.4%**	**0.00**
Financial operations	**0.0**	**0.0**	**0.0**	**0.0%**	**0.0%**	**0.0%**	**0.00**
Payments made in previous years and recovered in the current year	**0.0**	**0.0**	**0.0**	**0.0%**	**0.0%**	**0.0%**	**0.00**
EXCEDENT(+) / DEFICIT(-)	**-40,545.1**	**-40,633.9**	**88.8**	**-0.2%**	**-3.59%**	**-3.60%**	**0.01**

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