Romania

Fiscal Council

Annual Report

2013

Note:

The Annual report for 2013 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 11, 2014.

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List of abbreviations

CABB	Cyclically adjusted budget balance
CEE	Central and Eastern Europe
CF	Cohesion Fund
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EMFF	European Maritime and Fisheries Fund
EMU	Economic and Monetary Union
ERM II	European Exchange Rate Mechanism II
ERDF	European Regional Development Fund
ESA95	European System of Accounts 1995
ESF	European Social Fund
EU	European Union
FRL	Fiscal Responsibility Law No 69/2010
FS	Fiscal Strategy
GCB	General Consolidated Budget
GDABT	General Directorate for the Administration of Big Taxpayers
GDFAF	General Direction of Fiscal Anti-Fraud
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
IBL	International Bureau of Labor
IMF	International Monetary Fund
MPF	Ministry of Public Finance
MTO	Medium-term objective
NA	Not Available
NAE	National Agency for Employment
NAFA	National Agency of Fiscal Administration
NIS	National Institute of Statistics
NBR	National Bank of Romania
NCP	National Commission of Prognosis
NMS	New Member States
NPISH	Non-profit institutions serving households
NREF	Non-reimbursable external funds
NRP	National Reform Programme
NTRO	National Trade Register Office

OECD	Organization for Economic Co-operation and Development
pp	Percentage points
PPP	Public Private Partnerships
SGP	Stability and Growth Pact
SSC	Social Security Contribution
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance
VAT	Value added tax
WB	World Bank

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I. Summary

The Fiscal Council is an independent authority established by the Fiscal Responsibility Law No. 69/2010 (FRL), 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 the fiscal policy during the previous year against the framework set out in the Fiscal Strategy and the Annual Budget, to assess the macroeconomic and fiscal developments as well as the objectives, targets and indicators included in the Fiscal Strategy and the Annual Budget.

In 2013, Romania recorded the third consecutive year of economic growth as the GDP advanced by 3.5% in real terms, a dynamics significantly higher than the level of 0.6% achieved the previous year, but also higher than the 2013 autumn forecasts of the European Commission and the National Commission of Prognosis, mainly due to the favorable evolutions registered both in the industry, which contributed with 2.2% to the economic growth and in the agriculture (a contribution of 1.1%). On the other hand, for 2014, it is anticipated a slowdown of the economic growth pace to 2.5%. The real GDP growth is projected to rely especially on the improvement of people's and companies' confidence, a favorable international context, and the positive effects of the structural reforms implemented in recent years such as the new labor code and the energy market liberalization.

The initial budget for 2013 was elaborated considering a budget deficit target of 2.15% of GDP (in cash terms), higher than the level of 1.8% assumed in the Fiscal Strategy for 2013-2015 approved by the Government in June 2012, being based on a significantly more unfavorable macroeconomic development scenario, compared to the one taken into account in preparing the Fiscal Strategy for 2013-2015 (growth forecast of 1.6% in real terms compared with the 3.1% used in the strategy elaboration). Regarding the budget deficit target determined according to the ESA95 methodology, this was increased by 0.2 percentage points (pp) compared to the previous version of the strategy, respectively 2.4% of GDP.

Later, with the first budget amendment in July 2013, the new deficit target in cash terms was fixed at 2.3% of GDP (at a level of 14.7 billion lei, with 1.3 billion lei higher than the ceiling of 13.394 billion lei), the new targets violating the Law No. 4/2013 on approving ceilings for certain indicators specified in the Fiscal Strategy.

The final budget execution recorded the fulfilment of the deficit target expressed according to ESA95 standards (an actual deficit of 2.3% of GDP), Romania confirming the positive developments in terms of fiscal consolidation that led in 2013, to the exit from the excessive deficit procedure initiated in 2009.

In the case of the cash budget execution, the budget deficit registered a level of 2.51% of GDP, the exceeding of the initial target occurring mainly due to the failure of non-tax and European funds revenues, but also because of some goods and services expenses significantly higher than the initial projection. The budget deficit adjustment of about 0.7 pp of GDP according to ESA95 methodology, while maintaining the cash deficit as a percentage of GDP at 2012 level is explained mainly by the implementation of the European Union (EU) Directive No. 7/2011 on combating late payment in commercial transactions (which required additional payments of about 2.5 billion lei in 2013) and the payment of 10% installment from the executory titles regarding the outstanding wage obligations related to certain categories of employees from the public sector (in total amount of about 900 million lei).

In the Fiscal Council's opinion, the risks associated to the macroeconomic indicators in 2014 lies rather on the negative side, respectively a lower than the initially projected economic growth due to a very poor development at the level of investments in the first half of 2014, both public and private, as well as to the unfavorable external environment, the European Union economies having a performance below the expectations.

Under the agreements with the International Monetary Fund (IMF) and the European Commission, when formulating the budget for 2014, the Government has undertaken to reduce the general consolidated budget deficit to 2.2% of GDP (from 2.5% in 2013), according to the cash methodology and to 2.4% of GDP according to ESA95 (from 2.3% in 2013). The structural adjustment pace proposed for 2014 is only 0.1 pp of GDP, while in 2013 it was 0.7 pp. The Convergence Programme for 2014-2017 reaffirms the Government's commitment to achieve the medium-term objective (MTO), respectively a structural deficit of 1% of GDP in 2015, given that the significant slowdown in the fiscal consolidation pace in 2014 would be fully recovered in 2015. The budget deficit target for 2015 was set at 1.4% of GDP, according to both methodologies: cash and ESA95.

In the Fiscal Council's opinion, the risks related to the conduct of the fiscal policy are relatively balanced for the current year and tilted to the negative side for 2015 (a budget deficit higher than the projected one). For 2014, additional concerns come from the budget execution during the first six months, but the underachievement of revenues has the potential to be accommodated by reducing certain categories of expenditure, most likely those for investment, while other recently adopted fiscal measures (the tax exemption for reinvested profit and the reduction of social security contributions) will take effect mostly in the next years.

The budget deficit target for 2014 is an achievable goal, and as a result of small fiscal consolidation proposed for this year, but the fulfillment of targets for 2015 (a structural deficit of 1% of GDP assumed in the Convergence Programme for 2014-2017) appears as a major challenge given the proposed pace of fiscal consolidation as well as considering the undervalued negative impact on the tax revenue as a result of the exemption on reinvested profits and the recent reduction in social security contributions. In this context, the decision to reduce the employer's social security contribution by 5 pp would make more difficult the compliance with the assumed targets in the absence of extensive compensatory measures.

The fiscal policy appears as an unpredictable one, lacking a medium-term vision, and this has consequences from both a microeconomic perspective, the economic agents' decisions being sensible influenced by the frequent changes in the tax system, but also from a macroeconomic perspective, considering the their impact on the overall economy and on the assumed fiscal targets.

The biggest risk associated to the conduct of the fiscal policy in the coming years seems to be represented by a lower political commitment to the fiscal consolidation, especially given the fact that the exit from the excessive deficit procedure, based on Romania's good performance in adjusting the accumulated fiscal imbalances, is likely to reduce the constraints of the fiscal policy.

The fiscal rules exert a weak constraint on the fiscal policy.

The way in which the budget process was conducted in 2013 - both revisions increased the deficit target given the existence of an explicit legal prohibition and of sufficient indications, based on the budget execution at the end of the first 6 months regarding a high probability of achieving lower than estimated budgetary revenues, questions the relevance of the budgetary rules and the commitment to meeting fiscal discipline.

The effectiveness of a fiscal rule is determined by the level of constraint that it exercises over the settlement of the fiscal policy. The ease with which the fiscal rules could have been circumvented repeatedly this year, along with the recorded violations in the years that have passed since the adoption of the FRL in 2010, highlights the weakness of the constraints exercised by the fiscal rules and raises serious questions on the commitment to meet the future fiscal rules established by taking into the national law the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary

Union (the Fiscal Compact).

The efficiency of tax collection remains low, despite the initiation of a process to reform the tax collection.

Romania has one of the lowest shares of overall government revenues to GDP in the EU (tax and non-tax revenue), of only 32.7% of GDP in 2013, while the ratio of fiscal revenue in GDP was 27.5%, significantly lower than in Hungary (38.6%), Slovenia (37.6%), the Czech Republic (35.3%) and Poland (31.8%).

In 2013, the efficiency of tax collection for VAT was 56%, significantly lower than the one registered in Estonia (83%), Slovenia (71%) and in the Czech Republic (71%), while the standard VAT rate in these countries is 20% (compared to the level of 24% from Romania).

Regarding the corporate income tax in the countries from Central and Eastern Europe (CEE), in 2013, Romania is ranked seventh out of ten (similar to the previous year), registering a slight increase in the collection efficiency compared to the previous year.

Also, in the case of social security contributions, the taxation efficiency index is 72%, Romania being ranked among last places, considering the countries from Central and Eastern Europe.

The Fiscal Council welcomes the start of a tax collection reform process which is considered essential in the current context, characterized by a low efficiency of the tax system and believes that this process, if successful, has the potential to generate fiscal space in the medium term. However, making decisions about the possible tax cuts or increasing expenses based on the potential efficiency gains must occur *ex post*, after the reform proves to be irreversible and capable of generating long-term results.

The financial situation of the state pension system remains very poor; however, a slight improvement over the last year was recorded.

The weight of the social assistance expenditure in Romania is still significant, and the issue of the structural deficit of the public pension system is not solved. Thus, the 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 (the Law No. 263/2012 regarding the public pension system).

Compared to 2012, the pension expenses increased by 4.06% in 2013, but their share in GDP decreased by 0.3 pp, up to a level of 9.3%, given that nominal GDP advanced by 7.12%.

Despite the progress registered in 2013, there are significant risks on the medium and long term regarding the sustainability of the social security budget, and the opportunity of any additional increases of expenditures or reductions of contributions should be considered only in the context of identifying alternative solutions to reduce the deficit, particularly by broadening the tax base.

The efficiency of public investments in Romania is very low. In this context, in 2013 a public investment management reform process was initiated.

During the last ten years, Romania had the largest public investment expenditure as a share of GDP among the European countries, and also expressed as share of total budgetary revenues, but the infrastructure quality ranks us last considering the same group of countries, which indicates the low efficiency of this expenditure item in Romania.

Compared to 2012, it can be said that there has been made some progress towards creating the legal framework associated with the public investment management reform by approving the Government Emergency Ordinance (EO) 88/2013 and the related rules that are based on a better prioritization of the investment projects, but achieving the intended benefits still remains a desideratum. The evaluation results must necessarily consider a longer period, or until now, the effects of the new legal framework have not materialized, Romania being at the beginning in terms of implementing the reforms in the management of public investments and adopting the best practices from Europe.

The poor performance in absorbing the European funds, together with the risk of automatic decommitment, requires urgent improvement of the

Romania’s performance in terms of EU funds absorption remains low, it being ranked last among the UE state members, with a degree of absorption of only 36.9%, but this value is by 15.05 pp higher than that registered at the end of 2012.

The poor performance in attracting the European funds, *absorption of EU funds.*

simultaneously with the risk of automatic decommitment (the funds related to the allocations for 2007-2013 can be attracted only by the end of 2015) require resolute actions in the sense of starting the fundraising procedures corresponding to the new financial year together with the measures taken to reduce the risks of losing the allocations for 2007-2013. The current situation raises doubts about the fulfilment of the absorption targets in 2014.

Given the fact that during 2014-2015 two financial periods overlap (2007-2013 and 2014-2015), Romania has a further opportunity to accomplish more EU-funded projects. In the initial budget for 2014, it was intended an increase of the share of EU funds in total investment expenses, a correct and welcomed approach in the Fiscal Council's opinion, but the budgetary execution after 6 months has shown a failure from this perspective.

Tax evasion continues to be very high in Romania.

According to the calculations of the Fiscal Council, based on NIS data, the tax evasion has a very high dimension in Romania, representing 16.2% of GDP in 2013, despite the intention and reduction measures contained in the latest iterations of the fiscal strategy. If Romania collected the taxes at its maximum, it would have budgetary revenues as a percentage of GDP higher than the European average. Approximately 75% of the tax evasion is generated by VAT (12.21%), while the social contributions contribute with about 15% to the total tax evasion, mainly through the phenomenon of "unrecorded work" (employees in the informal economy). In the year 2012, in Romania there were about 1.57 million employees, employers and individual entrepreneurs unregistered, "black market", representing approximately 27.7% of all employees, employers and entrepreneurs in the economy.

An in-depth reform of the administration of taxes in Romania targeted towards increasing tax collection is absolutely necessary in the current context, characterized by low efficiency of the fiscal system, and the Fiscal Council appreciates that this process has the potential to generate fiscal space on the medium term.

However, a cautious approach must consider the additional budget revenues from reducing tax evasion only *ex post*, after they have materialized, especially given that in the recent years there was not witnessed a significant decrease of this phenomenon, on the contrary, on certain segments there were increases.

The risks to meet the fiscal targets are evaluated partial and disparate in the MPF's programming documents.

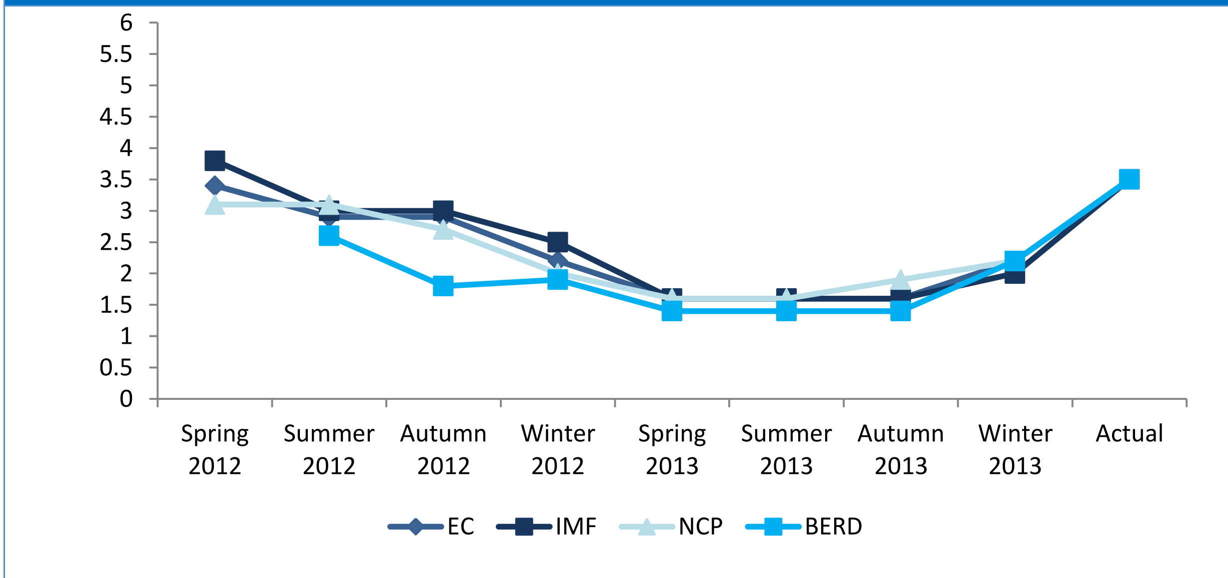
The risks to meet the fiscal targets (the risk associated with the macroeconomic framework change, the fiscal sustainability risks, the risks associated with the MPF payments as guarantor for guarantees issued by the state and the risks arising from the public-private partnership - PPP) are evaluated partial and disparate in the MPF's programmatic documents ("The Convergence Program for 2013-2016", "The Macroeconomic Situation Report for 2014 and the Projection for 2015 - 2017" and "The revised Fiscal Strategy for 2014-2016 ").

In this context, a comprehensive and integrated analysis of the fiscal risks appears to be necessary for their proper management and to improve the budgetary programming. The Fiscal Council recommends including the risks associated to the changes of the macroeconomic framework in the fiscal strategy, possibly with the determination of the alternative trajectories for the budgetary aggregates assuming different scenarios of macroeconomic development, but also those generated by the PPP development and the analysis of all fiscal risks mentioned should be supplemented by a set of measures aimed to reduce them.

II. Macroeconomic framework in 2013

In 2013, Romania recorded the third consecutive year of economic growth as the GDP advanced by 3.5% in real terms, a significantly superior dynamic compared to 0.6% reached in 2012. However, real GDP has still to recover 1.68% of the peak reached in 2008, the cumulative increase in the last three years by about 6.5% being lower than the steep decline in 2009-2010. Compared with the initial forecasts considered in preparing the draft budget for 2013, but also the autumn forecasts of the European Commission and the National Commission for Prognosis made in 2013, the economic growth was higher by approximately 1.9 pp, mainly due to favorable developments in the industry sector, which has contributed to GDP by 2.2%, and the agriculture sector (contribution to GDP of 1.1%).

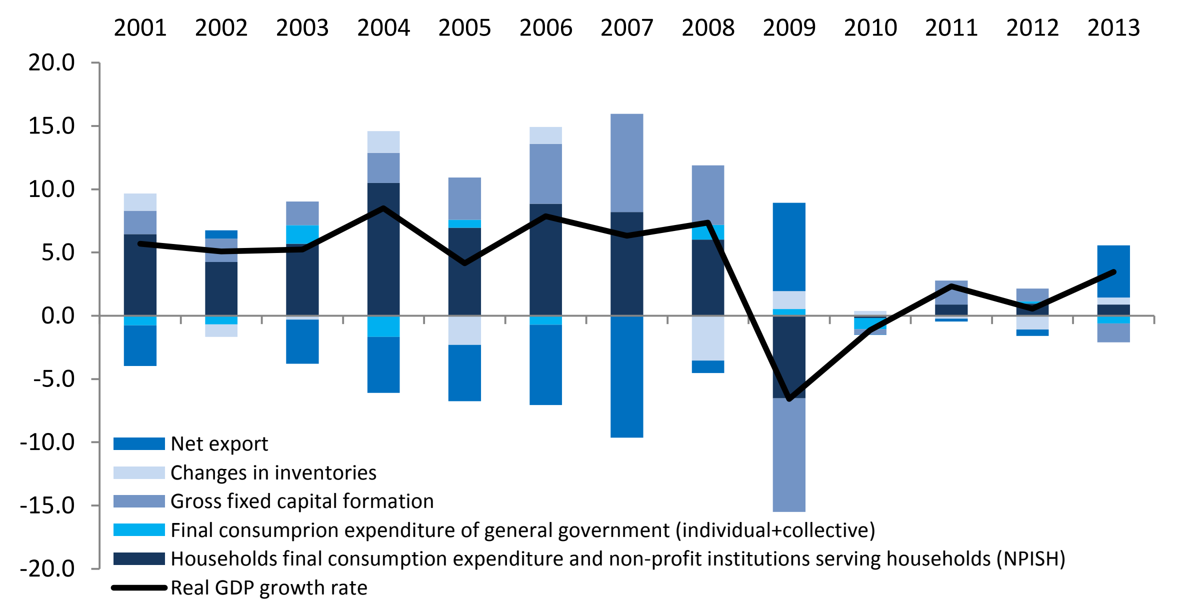
Figure 1: The evolution of economic growth forecasts for 2013



Source: EC, IMF, NCP, BERD

The main contribution to economic growth registered in 2013 came from net exports (+4.4 pp), although the initial forecasts were considering a higher increase in imports compared with exports, expecting an anticipated recovery of the domestic demand. In reality, the external demand was the main factor that supported the growth of production in 2013, exports advancing with a remarkable rate of 13.5%, while imports rose only with 2.4%, due to a still weak domestic demand. The increase in real terms of the households final consumption expenditure (+1.3%) contributed with 0.9 pp to GDP growth, while inventories had a negative contribution of 0.6 pp, negative contributions being also attributed to general government final consumption expenditure (-0.3 pp, corresponding to a real decrease of 1.78%), and gross fixed capital formation (-0.9 pp), whose volume was reduced by 3.3%. It should be noted that, for decline in this component, a significant contribution had a consistent reduction in public investment spending, respectively by about 17% in real terms. On the supply side, increases in activity's volume were recorded in agriculture, forestry and fishing (23.4%) in terms of a positive base effect caused by adverse weather conditions in 2012, industry (8%) supported by the external demand and by the commissioning of new capacities, but also in real estate (2%), information and communication (1.8%), professional, scientific and technical activities (1.1%), while negative developments were recorded in financial intermediation and insurance sectors (-5.6%), public administration and defense, education, health and social assistance (-1.1%), wholesale and retail trade, repair of motor vehicles and motorcycles, transport and storage, hotels and restaurants (-0.2%), shows, culture and recreation activities; repair of household goods and other services (-0.1%).

Figure 2: Contributions to economic growth



Source: Eurostat, Fiscal Council's calculations

The average inflation rate remained in line with the forecasts considered in the revised Fiscal Strategy (rFS) for 2013-2015 (annual average of 4.0%, compared with a projection of 4.3%). The general price increase in December 2013 compared with December 2012 was 1.55%, significantly below the level projected in the revised Fiscal Strategy (3.5%). The difference between the average rate of inflation and inflation at the end of the period was primarily due to some favorable supply shocks occurrence in the second half of 2013. In the first half of the analyzed period, inflation was at a high level (monthly inflation calculated against the corresponding period of 2012 exceeded 5%) due to the increase in administered prices at the beginning of the year and to the increase of some excise duties in April. The slowdown in price growth in the second half of 2013 was driven by a very good agricultural production and by VAT reduction on bakery products. In a falling inflation framework, the central bank gradually reduced the monetary policy rate since the third quarter of 2013 (from 5.25% to 3.75%) thus creating the prerequisites for sustainable recovery of the lending process, given that the nongovernment credit growth remained in negative territory during the analyzed period.

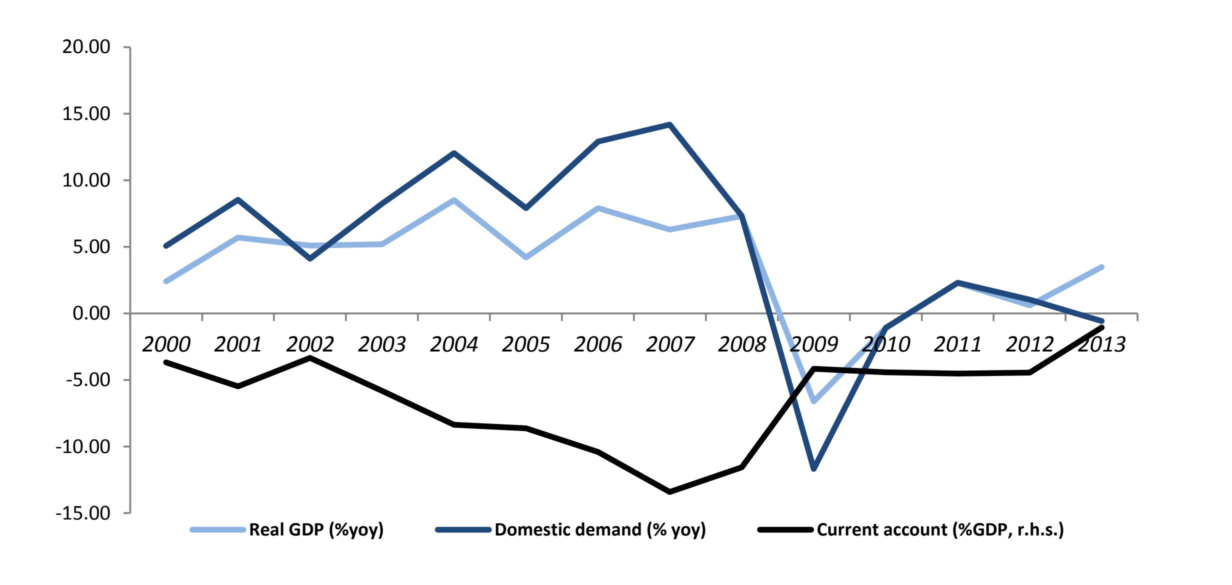
The prices increase at the level of whole economy, as measured by the GDP deflator, was 3.5% in 2013, inferior to that considered in the revised Fiscal Strategy for 2013-2015, respectively 4.1%. At the same time, the deflator varied significantly at the level of GDP components. Therefore, the increase in prices of households final consumption expenditure was 4.6%, superior to the average level of inflation measured by the CPI deflator, the government spending recorded a value of 106.4% due to salaries recovery in the budgetary sector, while prices remained stable for investments (investment deflator was 100%), and the changes in prices for exported products generated a negative contribution, reaching a level of -2.1%.

Romania's external position registered a significant improvement. Therefore, the current account deficit declined from 4.44% of GDP in 2012 to 1.06% in 2013, in the context of a 74% nominal decrease of the current account and an increase of GDP with 8.1%, taking into account values expressed in euros. The decrease of the current account deficit from 5,843 million euro to 1,506 million euro was mainly determined by a reduction in the balance of trade deficit with 4,000 million euro, comparing with 2012. Also, at the improvement of the external position contributed the increase of services balance surplus (+1,458 million euros) and the current transfers balance (+287 million euros). A negative contribution to the current account deficit change had increased of revenues deficit by 1,363 million euros compared to 2012. It is worthy of note that the evolution of exports of goods which increased in nominal terms by about 10% (4,493 million), their increase being supported both a very good agricultural year and the expansion of production capacity in industry sector, given the gradual recovery of the EU economy, the main trading partner of Romania. However, imports grew by only 1%, considering values expressed in euro, amid weak domestic demand and an average decrease in their prices by about 1.4% over the previous year.

Analyzing the changes in the current account of balance of payments in terms of difference between the rate of saving and the rate of investment, it can be seen that last year decrease by 3.4 pp of GDP came mainly from 3.1 pp reduction in the rate of investment - to a level of 22.9% of GDP in 2013, while the increasing level of savings has had a positive contribution by only 0.3 pp. In addition, the adjustment of the current account deficit with 10.5 pp of GDP in 2008-2013 was achieved by reducing investment by 8.3 pp of GDP, while the national savings rose in the same period by only 2.2 pp of GDP.

The foreign direct investment reported also a positive trend; they increased with 26.8% since 2012, while their value amounted 2,713 million euros. Thus, it can be seen that in 2013 foreign direct investments financed entirely the current account deficit. Although the peak level of the last four years was reached in 2013, it is much lower than in the period preceding the financial crisis (in the period 2007-2008, the annual average of FDI was 8,000 million euros).

Figure 3: The evolution of the real GDP, domestic demand and current account, 2000-2013



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

The external debt of Romania decreased by 3.25% in 2013 to a level of 96.44 billion euros. The medium and long-term external debt amounted 79.78% of total external debt at the end of the year, respectively 76.95 billion euros, decreasing by 2.3% compared to December 31th 2012. The short-term external debt recorded a reduction of 6.83% to a level of 19.49 billion euros (20.22% of total external debt).

Because of the repayments made, the debt to IMF lowered at the end of 2013 compared to the same period of the precedent year by 4.97 billion euros, respectively at a level of 5.82 billion euros. Therefore, there was decreases both in the level of the debt component for financing the budget deficit (-1.02 billion euros) and in that allocated to strengthen the international reserves (-3.94 billion euros).

The downward trend of the external debt was as well due to the decrease of private external debt (especially in the context of deleveraging in the banking sector). One factor that acted to increase external debt is an increase in state’s foreign currency loans by issuing bonds on the international markets.

In 2013, non-government loans declined in real terms, decreasing with 4.7% in December 2013 compared to the same period of 2012. The downfall was more pronounced in the case of foreign currency denominated-loans, which decreased by 6.8 % in euro equivalent, while the dynamics of domestic currency denominated-loans recorded a decrease in real terms of 0.8%. A declining loan demand amid relatively low economic growth, high levels of household indebtedness and preservation of risk aversion both at the level of creditors and debtors were the main factors that led to the contraction of lending. Another factor impacting negatively on lending was the increase in capital requirements for financial institutions in the EU (imposed by Basel III regulations), which involved an accelerated pace of deleveraging in the banks and their subsidiaries in Central and Eastern Europe. Also, the financial institutions were forced to resort to maintaining a prudent conduct in terms of credit, in the context of continuous portfolio quality deterioration, and increased provisions requirements.

The evolution of foreign currency denominated financing has been negatively affected by the limitation of foreign currency denominated-loans to borrowers exposed to currency risk as a result of NBR implementation of the European Systemic Risk Board recommendations, but a factor that acted to the contrary was the continuation of the program "First Home" in foreign currency until August of 2013. Lending in domestic currency was fueled by lower interest rates and by the continuation of the program "First Home" in local currency starting with the second half of the year.

Regarding the developments in the labor market, in 2013 the average number of employees continued to increase to a level of 4,520 thousand people[1], advancing by 1.7% compare to 2012, in the context of an increasing number of jobs created by the private sector, while the number of public employees has remained relatively constant. On the other hand, at the end of 2013, the unemployment rate calculated according to the criteria of the International Labor Office (ILO) increased by 0.2 pp respectively from 7.1% to 7.3%[2]. The total number of unemployed registered at the National Agency for Employment (NAE) increased from 493 thousand to 512 thousand people, the registered unemployment rate increasing from 5.59% to 5.65%. The unemployment rate (computed according to the criteria of ILO and the NEA) has evolved in the same direction as the average number of employees in the economy, and this phenomenon can be explained by the increase in the active population with 33 thousand people, of which 26 800 are included in the unemployed category.

[1] According with Workforce Balance, NCP estimates.

[2] According with NIS, TEMPO online.

In 2013, the average gross wage[3] per total economy was 2,240 lei, up with 5% from 2012, while net average wage was 1622 lei, increasing by 4.8%. Considering an average inflation of 4%, the real wage increased by approximately 0.8%. The positive trend of the average salary was mainly driven by the growth of wages in the public sector (12.1%), due to the full recovery of wage reductions implemented in 2010. During the same period, average wages in the private sector[4] advanced in nominal terms by 3.27%, below the inflation rate, their dynamics being affected by the constraints on the labor market and productivity gains.

The evolution of main macroeconomic indicators in 2013 compared with forecasts considered in the revised Fiscal Strategy for 2013-2015 (adopted in January 2013) are summarized in the following table:

Table 1: Macroeconomic indicators (differences from prognosis)

	Revised Fiscal Strategy 2013-2015	Effective 2013
	- % yoy -	
GDP		
GDP (million lei)	623,314.0	628,581.3
Real GDP	1.6	3.5
GDP deflator	4.1	3.5
GDP components		
Final consumption	2.2	0.73
Private consumption expenditure	2.3	1.32
Government consumption expenditure	1.6	-1.78
Gross fixed capital formation	3.5	-3.3
Exports (volume)	1.0	13.5
Imports (volume)	2.8	2.4
Inflation rate		
End of period (December 2013)	3.5	1.6
Annual average	4.3	4.0
Labor market		
Unemployment rate at the end of period	5.2	5.65

[3] According to INS, TEMPO online, average wage by the national economic activities NACE Rev. 2

[4] The private sector is approximated by removing government and defense sectors, education and health and social assistance.

Average number of employees[5]	1.3	1.7
Gross average wage	5.68	4.84

Source: National Institute of Statistics, National Commission of Prognosis

[5] Differences between NCP forecast and the reported effective level is due to the different methodology: while NCP uses as a reference forecast the workforce balance, the effective figures are from NIS monthly buletine which includes only economic agents with more than 5 employees.

III. Fiscal policy in 2013

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 set forth in the Fiscal Strategy and Annual Budget approved in the previous budget year*" and will include:

a) An ex post evaluation of the macroeconomic and budgetary forecasts set out in the Fiscal Strategy and the annual budget to which the annual report corresponds;

b) 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) An assessment of the Government's compliance with the principles and rules of this law during the preceding budget year;

d) 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.

According to art. 23 - letters b) and c) of the Fiscal Responsibility Law no. 69/2010, the fiscal framework section of the fiscal strategy may be revised when there is a significant worsening of the forecast of macroeconomic indicators and other assumptions that underpinned the previous fiscal strategy, respectively when a Government change occurs, in which case, at the beginning of a new mandate, the Government will make public, whether its program complies with the latest fiscal strategy and the other budget documents approved by Parliament. Both situations stated in the articles of law above mentioned were valid in the process of the budget elaboration for 2013, and the Government endeavor to update the previous version of the fiscal strategy corresponding for the period 2013-2015 was a justified one. The draft budget for 2013, adopted at the beginning of February of the same year was accompanied by a revised version of the fiscal strategy, which involves an identical fiscal framework for 2013 in both documents. In these circumstances, the Fiscal Council's obligation to assess in the annual report the objectives, targets and indicators set by fiscal strategy and the budget is reduced to an analysis of the projections contained in the draft budget. However, to show the changes that occurred in the fiscal framework for the period 2013-2015, punctually will be considered also the targets set in the 2013-2015 Fiscal Strategy, even if they did not exert any constraints on the fiscal policy.

The general consolidated budget for 2013 was based on a significantly more unfavorable macroeconomic forecast scenario than the one taken into account in developing the Fiscal Strategy for 2013-2015 (adopted by the Government in June 2012), the economic growth being estimated to be only 1.6% in real terms, compared with 3.1% economic growth forecast used in developing the strategy. With the worsening growth prospects, the draft budget for 2013 envisaged a budget deficit target of 2.15% of GDP (cash standards) or 13.394 billion lei, higher than the 1.8% level assumed in the Fiscal Strategy for 2013-2015. Regarding the budget deficit target determined according to ESA 95 methodology, this was increased by 0.2 pp compared to the previous version of the strategy, respectively 2.4% of GDP. The Fiscal Council noted in its opinion on the draft budget, that the proposed target is consistent with the structural adjustment path (according to the ESA95 deficit) needed to achieve in 2014 the medium term objective of 1% structural deficit (which would ensure the conformation to the provisions of the Treaty on Stability, Coordination and Governance (TSCG) in the Economic and Monetary Union (EMU) ratified in June 2012). It should be noted that, at that time, the structural deficit for the year 2012 was estimated by the EC at a level of 1.8% and the proposed structural adjustment pace for 2013 was 0.4 pp of GDP.

The final budget execution recorded the achievement of the ESA95 deficit target (actual deficit of 2.3% of GDP), Romania confirming the positive developments in terms of fiscal consolidation that led, in 2013, to the exit from Excessive Deficit Procedure initiated in 2009. This EC decision envisaged the deficit below 3% of GDP registered in 2012, and prospects for continued observance of this ceiling. According to the cash standard execution, the budget deficit stood at a level of 2.51% of GDP, the exceeding of the initial target mainly occurred due to underperformance of non-tax revenues and revenues from European funds, but also as a result of expenditures on goods and services significantly higher than the initial projection. Adjusting the budget deficit by about 0.7 pp of GDP according to ESA95 methodology, while maintaining cash deficit as a percentage of GDP for the year 2012 is explained mainly by the implementation of EU Directive no. 7/2011 on combating late payment in commercial transactions (which required additional payments of about 2.5 billion lei in the year 2013) and the payment of an tranche of 10% of enforceable titles related to wages obligations of certain categories of public sector employees (totaling about 900 million). Both the above mentioned expenses were previously covered in the budget execution in accrual system, corresponding to ESA95.

In terms of fiscal policy rules, the nominal ceilings for the general government balance in 2013, its total expenses (excluding income from post-accession EU funds, pre-accession funds, and financial assistance from other donors) and personnel expenditure were established by Law no.

4/2013[6] (see *Table 2* below). The budget execution does not confirm compliance for all the indicators mentioned above. The budget deficit target for 2013 has exceeded the nominal target assumed, even if the total expenditure was below the ceiling established by Law no. 4/2013, given that the significant failure of the expected revenue was partially accommodated by costs reduction. The level of personnel expenses at the end of the year exceeded with 144.6 million the nominal ceiling, but due to a higher nominal GDP than envisaged in the budget's construction, their level expressed as a percentage of GDP stood at a level of 7, 37%, thereby falling within the established limits.

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

	Law no. 4/2013			Budget execution 2013		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
million lei	**-13394**	**210828.9**	**46154**	**-15771.3**	**206704.8**	**46298.6**
% of GDP	*-2.1%*	*33.82%*	7.40%	*-2.51%*	32.88%	7.37%

** Excluding financial assistance from the EU and other donors*

The first budget revision approved in July 2013, increased the general consolidated budget revenues with 0.12 billion lei and spending with 1.43 billion lei compared to the original program, while changing the budget deficit according to cash methodology at a level of 14.7 billion lei, higher with 1.3 billion lei than the ceiling of 13,394 billion lei (from 2.1 percent to 2.3 percent of GDP), the new targets violating the Law no. 4/2013 on the approval of ceilings for certain indicators specified in the Fiscal Strategy.

The increase of the projected budget revenues was due solely to supplementing the original "in chain" compensation swap scheme for clearing outstanding payments to the budget (initially estimated at 1 billion lei) in the amount of 1.12 billion lei. Thus, this amount would be transferred from the state budget to local budgets and to certain state companies to settle outstanding obligations to the budget, the effect of the scheme being neutral for the budget deficit. Excluding the impact of compensation schemes, budget revenues are projected to decrease by about 1 billion USD due to the unfavorable impact of the downward revision of VAT revenue (-0.89 billion lei), tax on profit revenues (-0.85 billion lei), excise (-0.52 billion lei) and non-tax revenues (-0.39 billion lei). Some of these decreases were partially offset by the plus in projected revenue for the amounts received from the EU in the account of payments made (0.93 billion lei) and for the other general taxes on goods and services (+0, 83 billion lei),

[6] Law approving ceilings for indicators specified in the Fiscal Strategy.

at this chapter being found clawback tax receipts, which were not included in the original estimates. The Fiscal Council warned in his opinion on the budget revision that the significant failure of budget revenues in the first half of 2013 has not been fully considered in developing the revenue projection for the full year, which is very optimistic. Thus, despite the upward revision of the economic advance at 2%, its structure was not rich tax and the collected revenues would most likely be lower than the originally estimated.

The total expenditure was increased by 1.43 billion compare to the original program, from which the amount of 1.12 billion lei represented the supplementation for the clearing swap scheme (618 million capital expenditure, 500 million goods and services). The largest increase was localized at the level of goods and services (2 billion lei, fueled partly on the budget revenue side by the clawback tax), which is mainly motivated by the accelerated payment of arrears in the health sector. Spending reductions occurred primarily in the categories: "social assistance" (-604 million lei), "capital expenditure" (-439 million lei), „projects funded by external post-accession grants" (-466 million lei), "other transfers" (-494.4 million lei). Moreover, the Fiscal Council warned at the beginning of the year about underestimating spending on goods and services, given the costs associated with implementing the EU Directive on combating late payments in commercial transactions.

Compared with the parameters approved in the context of the first budget revision, the second revision envisaged a decline of the estimated general government revenues by 3.4 billion lei and spending by 2.2 billion lei, the deficit target being revised upward to 15.90 billion lei (higher with 1.2 billion lei, respectively by 0.2 pp of GDP), representing 2.54% of GDP (estimated at 625.6 billion lei). Moreover, this trend has confirmed the opinion of the Fiscal Council on the budgetary revenue expressed with the occasion of the first revision, the underachievement of revenues being partially accommodated through the use of the existing reserves in the expenditure aggregates.

Considering individual revenue items of the consolidated general government, the largest downward revision was recovered in the non-tax revenues (1.65 billion lei). The cumulated revision at the level of tax revenues (1.9 billion lei) had as main sources of revenue the estimation of lower excise duties (-901 million lei), followed by VAT (-365 million lei) and personal income tax (-308 million lei). The Fiscal Council expressed in its opinion on the second budget revision serious reservations about the ability to achieve the target at the end of the year for revenues from post-accession EU funds, given that, three months before its end, the level of inputs (5.03 billion lei) was less than a half of the estimated amount for the entire year (12.15 billion lei).

Adjusting for the influence of swap compensation schemes for clearing outstanding obligations to the budget (amounting to 2.12 billion lei, whose distribution by category of expenditure has undergone some changes compared to that envisaged in the first budget revision), the reduction of total expenses was due mainly to cuts in the procurement of goods and services (-744 million lei), social assistance (-556 million lei), use of existing reserves in the budgeted amount for interest expense (-477 million lei), reduction of the component other transfers (-446 million lei) and expenditure reduction associated with programs funded by external grants (-287 million lei). The investment spending, which include capital expenditures, expenses associated with programs funded by reimbursable funds, projects funded by external grants and other transfers of the nature of post-accession investments were reduced at the second budget revision with 1.2 billion lei to the level of the previous budget revision.

The Fiscal Council's opinion on the first budget revision reported the violation (by derogation) of the rules regarding the budget revisions as stated by article 6 letter b) and c) and article 16 of the Fiscal Responsibility Law no. 69/2010. The Fiscal Council considers that the breach by the draft budget revision of the fiscal policy rules seriously undermines their credibility, especially regarding non-compliance with the deficit target, for which the derogation was a first (revision of the 2012 deficit target was covered by the escape clauses of the Law 69/2010). By the second budget revision in October 2013, the total expenditure was reduced to partially offset the decrease of the budget receipts estimates; thus, the total expenditure (excluding financial assistance from the EU and other donors) has been brought within the ceiling prescribed by Law 4/2013 and was restored the observance of the rule stated by article 6 letter c). However, the rule stipulated in article 6 letter b) of Law 69/2010, was broken again as the project of the second revision stipulated a budget deficit of 15.9 billion lei, up with 2.5 billion lei than the ceiling of 13,394 billion lei established by the Law 4/2013, the deviation from the legal ceiling increasing by another 1.2 billion lei compare to that already recorded during the first budget revision.

The way the budget process was conducted in 2013 - both budget revisions increasing the deficit target while existing an explicit legal prohibition and sufficient indications, based on the budget execution at the end of the first 6 months, regarding a high probability for much lower budgetary revenues performance than the revised estimates, questions the relevance of the fiscal rules and the commitment to meeting fiscal discipline. The effectiveness of a fiscal rule is determined by the constraint that it exerts on the fiscal policy formulation. The ease with which the fiscal rules have been repeatedly circumvented this year, with the recorded violations in the years that have elapsed since the adoption of the Fiscal Responsibility law in 2010 (the rules stated by article 6 letter c) and article 21, highlights the weakness of the constraints exerted by the fiscal rules from the FRL and raises serious doubts on the commitment to meet the future fiscal rules established by taking into national law the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact).

Evolution of the key budget aggregates during 2013 is presented in *Table 3*.

Table 3: The evolution of the main budgetary aggregates during 2013 (billion lei)					
	2013-2015 Fiscal Strategy	Initial budget	First revision	Second revision	Budget execution 2013
Total revenues	**212,1**	**208,3**	**207,3**	**203,8**	**199,0**
Fiscal revenue	122,2	122,0	120,4	118,5	118,2
Social contributions	56,3	54,4	54,4	54,3	54,3
EU funds	14,3	11,9	12,8	13,1	9,1
Total expenditure	**223,7**	**221,7**	**222,0**	**219,7**	**214,8**
Current expenditure	200,5	204,0	204,8	202,5	198,4
Capital expenditure	23,2	17,7	17,2	17,2	17,5
Budget deficit	**-11,7**	**-13,4**	**-14,7**	**-15,9**	**-15,8**

Source: Ministry of Public Finances

Note: Amounts without the compensation schemes

The results of the budget execution in the fiscal year 2013 were lower than the forecasts of the second revision; both revenue and expenditure have registered developments below expectations. On the revenue side, the gap from the estimated amount to be collected was about -4.8 billion lei, mainly due to a very poor performance of the UE funds absorption (-4.0 billion lei - confirming the reservations expressed by the Fiscal Council on the occasion of the second budget revision regarding the projection of this budgetary aggregate) and lower than the projected receipts corresponding to the tax on the use of goods, authorizing the use of property or the conduct of activities (0.5 billion lei) and fiscal revenues (-0.24 billion lei). Regarding expenses, they fell by 4.9 billion lei, the main categories that registered reduction are the expenditures on projects financed through post-accession EU funds (-2.6 billion lei, the reduction was operated in order to accommodate the failure to collect the UE funds), other transfers (-0.5 billion lei), social security (-0.44 billion lei), transfers between government units (-0.27 billion lei), goods and services (0.22 billion lei). Thus, the budget deficit in cash terms at the end of the year has not exceeded the level estimated in the second budgetary revision, but it has significantly exceeded the target set by the draft budget, i.e. 2.37 billion lei.

The fiscal consolidation started in 2010 in order to correct the existing major imbalances regarding the public finance position, was characterized by an alert pace, Romania succeeding in a relatively short period of time a budget deficit reduction, expressed according to ESA95 standards, from 9% of GDP in 2009 to 2.3% of GDP in 2013. The fiscal adjustment in the period 2009-2013 considering ESA95 standards was performed by cutting spending by 6.2 pp. of GDP and increasing revenues by 0.6 pp. of GDP. The expenditure reduction were made primarily in the personnel expenses (-2.8 pp of GDP), gross fixed capital formation (-1.5 pp of GDP) and social security (-1.4 pp of GDP). On the budgetary revenue side, the growth by 0.6 pp of GDP in 2009-2013 was mainly due to the increase of the legal VAT rate from 19% to 24% in 2010, so the VAT revenues rose during 2009 - 2013 by 1.7 pp of GDP (2009 marked a decline in the VAT revenues by 1.3 pp of GDP compared to 2008), offsetting the decline in receipts from the social security contributions (-1.4 pp of GDP) and those from the income tax (-0.8 pp of GDP). In 2013 the budget deficit reduction from 3% to 2.3% of GDP – according to ESA95 standards - was achieved by reducing spending by 1.7% of GDP while the targets for revenue collection were not realized by a considerable margin. Thus, revenues were lower by 1% of GDP, mainly as a result of lower fiscal revenues by 0.7 pp of GDP while adjustments to the budget expenditure occurred mainly in the intermediate consumption (-0.7 pp of GDP), other expenses (-0.5 pp of GDP), social security (-0.3 pp of GDP) and gross fixed capital formation (-0.3 pp of GDP).

Table 4: The development of budgetary expenditure and revenue according to ESA95

	2009	2010	2011	2012	2013	Changes 2013 to 2012	Changes 2013 to 2009
Total revenue (% of GDP)	**32,1**	**33,3**	**33,9**	**33,7**	**32,7**	**-1,0**	**0,6**
Fiscal revenue	17,3	18,0	19,2	19,3	18,6	-0,7	1,4
Indirect taxes, out of which:	10,7	11,9	13,0	13,2	12,7	-0,4	2,0
VAT	6,6	7,7	8,7	8,5	8,4	-0,2	1,7
Excises*	3,1	3,0	3,1	3,1	:	:	0
Direct taxes, out of which:	6,5	6,1	6,2	6,1	5,9	-0,2	-0,7
PIT	3,7	3,4	3,5	3,6	3,6	-0,1	-0,1
CIT	2,4	1,8	1,9	1,7	1,7	0,0	-0,7
SSC	10,2	9,5	9,1	9,0	8,8	-0,2	-1,4
Other current revenue	1,7	2,7	2,2	2,5	2,7	0,2	1,0
Total expenditure (% of GDP)	**41,1**	**40,1**	**39,4**	**36,7**	**35,0**	**-1,7**	**-6,2**
Intermediate consumption	6,5	5,8	6,1	5,9	5,3	-0,7	-1,2
Compensation of employees	10,9	9,7	7,9	7,8	8,1	0,3	-2,8
Interest payments	1,5	1,5	1,6	1,8	1,8	0,0	0,2
Social assistance	13,8	14,1	13,4	12,7	12,3	-0,3	-1,4
Subsidies	0,7	0,6	0,4	0,4	0,3	0,0	-0,4
Other current expenditure	1,4	1,9	2,0	2,3	1,8	-0,5	0,4
Gross fixed capital formation	5,9	5,7	5,5	4,7	4,5	-0,3	-1,5
Budget deficit (% of GDP)	**-9,0**	**-6,8**	**-5,5**	**-3,0**	**-2,3**	**0,7**	**6,8**

Source: Eurostat

*Note: * for 2013 data are not available yet, the difference 2009-2013 refers to 2009-2012*

Regarding the budget execution according to cash standards, the year 2013 recorded the maintenance of the budget deficit expressed as a percentage of GDP at the same level as previous year, i.e. 2.5%, as both revenues and expenses recorded a decrease of 0.9 pp of GDP. Compared to 2012, the main budgetary revenues registered a downward trend while on the expenditure side, the reduction of social spending by 0.5 pp of GDP and the investment spending by 0.4 pp of GDP partly offset the increase in personnel expenses (+0.4 pp of GDP) and in expenses with goods and services (+0.3 pp of GDP). Considering the period 2009-2013, the fiscal adjustment according to cash standards was performed by reducing spending by 4.4 pp of GDP and increasing budgetary revenues by 0.3 pp of GDP.

Table 5: The development of budgetary revenue and expenditure according to cash methodology

	2009	2010	2011	2012	Initial budget 2013	Execution 2013	Changes execution to initial budget	Changes 2013 to 2012	Changes 2013 to 2009
Total revenue (% of GDP)	**31.4**	**32.2**	**32.2**	**32.5**	**33.4**	**31.7**	**0.9**	**-0.9**	**0.3**
Fiscal revenue	17.6	17.8	18.5	31.0	31.4	30.2	0.4	-0.8	12.6
PIT	3.7	3.4	3.4	2.0	2.1	1.9	0.1	-0.1	-1.8
CIT	2.4	1.9	1.8	1.8	1.9	1.7	0.0	-0.1	-0.7
Property tax	0.7	0.7	0.7	0.7	0.7	0.7	0.0	0.0	0.0
VAT	6.8	7.5	8.3	8.3	8.3	8.1	0.0	-0.2	1.3
Excises	3.1	3.3	3.4	3.5	3.6	3.4	0.1	-0.1	0.3
SSC	9.6	8.7	9.0	8.7	8.7	8.6	0.0	-0.1	-1.0
Non fiscal revenue	3.1	3.8	3.3	3.1	3.1	2.7	0.0	-0.4	-0.4
Donations	0.7	0.8	0.1	0.1	0.1	0.0	0.0	0.0	-0.7
Amounts received from the EU for payments made	0.4	1	1.1	1.4	1.8	1.4	0.4	0.1	1.0
Total expenditure (% of GDP)	**38.6**	**38.6**	**36.5**	**35.1**	**35.6**	**34.2**	**0.5**	**-0.9**	**-4.4**
Personal expenditure	9.3	8.2	6.9	7.0	7.4	7.4	0.5	0.4	-1.9
Goods and services	5.7	5.6	5.7	5.8	6.0	6.1	0.2	0.3	0.4
Interest	1.2	1.4	1.6	1.8	1.8	1.7	0.0	-0.1	0.5

payments									
Subsidies	1.4	1.3	1.0	1.0	0.8	0.8	-0.2	-0.2	-0.6
Projects financed from post-accession grants	0.5	1.4	1.9	2.3	2.8	2.2	0.5	0.0	1.7
Social protection	12.8	13.1	12.2	11.4	11.2	10.9	-0.2	-0.5	-1.9
Capital expenditure	4.4	3.7	4.0	3.2	2.8	2.8	-0.4	-0.4	-1.6
Budget deficit (% of GDP)	**-7.3**	**-6.4**	**-4.3**	**-2.5**	**-2.1**	**-2.5**	**0.4**	**0.0**	**4.8**

Source: Ministry of Public Finances

Further, this chapter will include a detailed analysis of the developments of the main budgetary revenue and expenditure aggregates, followed by an assessment of the public debt dynamics and its determinants based on a medium term projection.

III.2. Budgetary revenues

The revenues of the general consolidated budget, without the impact of the compensation schemes, increased by 4.25% in 2013 compared to the previous year, to 199.04 billion lei (31.67% of GDP). Compared to 2012 the share of budgetary revenues in GDP fell by 0.88 pp within the context of a superior dynamic of the nominal GDP (+7.12%), the reduction being localized at the following categories of revenues: VAT (-0.23 pp), excise duties (-0.09 pp), corporate income tax (-0.1 pp), social insurance contributions (-0.09 pp) as a result of the decision to return to the pensioners the health insurance contributions collected illegally and to increase the scheduled amounts transferred to the Second Pension Pillar[7]. On the other hand, positive developments in terms of share of GDP were recorded by personal income tax revenues (+0.6 pp), the amounts received from the EU payments (+0.6 pp), and, also, by the budgetary aggregate tax on use of goods, authorizing the use of property or the conduct of activities on the basis of revenues obtained from renting the frequency bands (0.13 pp), but these are extraordinary revenues.

Also, the budgetary revenues were by 1.47 pp of GDP lower than the level considered in the draft budget, mainly due to lower than expected fiscal revenues, the difference between the final value and the initial projection being 0.67 pp of GDP. This significant underperformance in fiscal revenues can be justified by the fact that the economic growth recorded in 2013 was not tax rich (respectively an economic growth favorable to an increase in budgetary revenues), driven primarily by the positive evolution of the exports and a very good agricultural

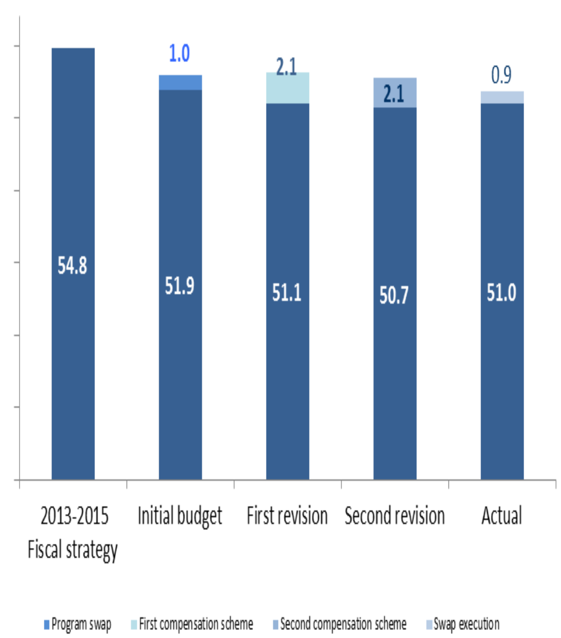
[7] These are recorded as negative revenues in the budget execution.

production. Thus, the major differences compared to the original projection were located in the excise revenues (-0.2 pp of GDP), the VAT revenues (-0.16 pp of GDP), as well as those related to corporate income tax (-0.13 pp of GDP). Also, a development below expectations was registered at the level of EU funds absorption, the difference between the actual value and that planned is approximately -0.37 pp of GDP. The budgetary execution for social contributions, grants, capital income and property taxes was in line with the expectations envisaged in the draft budget. The dynamics of the budgetary revenues was positively influenced by the clawback tax receipts not included in the draft budget, so that the category other general taxes on goods and services recorded an increase of 0.09 pp of GDP compared to the initial estimates.

III.2.1 VAT and excises

The VAT receipts, without the impact of the compensation schemes, recorded in 2013 a level of 50.97 billion lei, respectively 8.11% of GDP, with about 0.97 billion lei lower than the amount envisaged in the draft budget. Compared to the initial budget, VAT revenue were revised downward during the budgetary revisions on the background of an unfavorable dynamics of private consumption in the first semester and also due to the effect of reducing the VAT rate on bread, flour and wheat (the impact was estimated by the MPF at 90 million lei). It should be noted that through the two budgetary revisions the compensation scheme was increased (an additional impact at the level of VAT revenues of 1.1 billion lei), but this increase was not reflected in the level of the final execution.

Figure 4: VAT revenues, 2013 (billion lei)



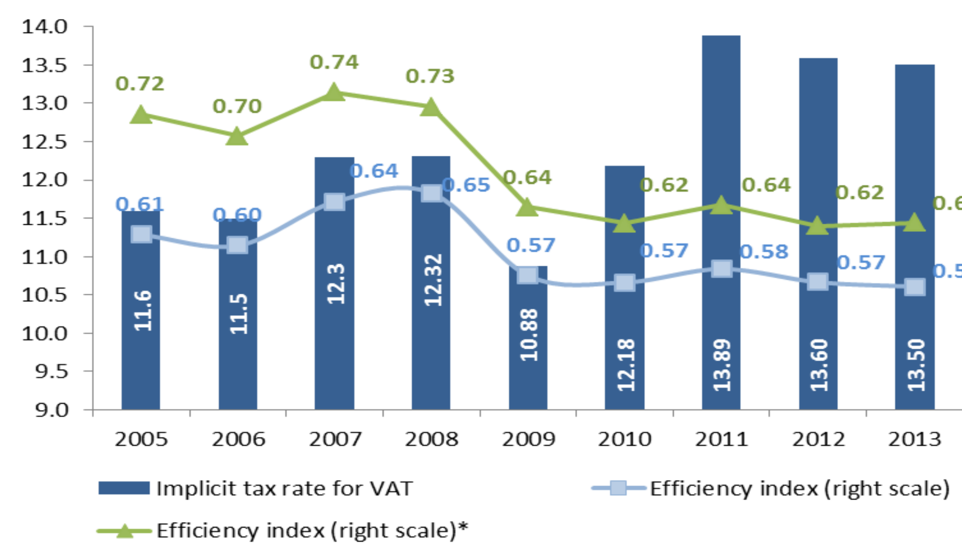
Source: Ministry of Public Finances

Compared with 2012, the VAT revenues, without the impact of the compensation schemes, have increased with 2.03 billion lei (4.14%).

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 2010-2013.

The budget execution at the end of 2013 expressed according to ESA95 standards indicates a slight reduction in the level of taxation efficiency compared to the previous year (a decrease of the efficiency index from 57% in 2012 to 56% in 2013), the dynamics of VAT revenue was slightly lower than that of the corresponding relevant macroeconomic tax base (household final consumption and NPISH[8]). Considering the macroeconomic structure, the favorable agricultural year had a positive impact on the component "self-consumption", which is not likely to generate fiscal revenue. Thus, isolating the effect of this component, the collection efficiency remained at the same level as in 2012. On the other hand, the dynamics of VAT revenue was adversely affected by the reduction of the VAT rate on bread from September, but the effect of this measure at the level of the efficiency index is insignificant in 2013, taking into account the marginal impact on the budgetary revenues, determined by the short interval of time remaining from the moment of implementation until the end of the year.

Figure 5: The evolution of the implicit tax rate and of VAT taxation efficiency in Romania



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

The effectiveness of taxation for VAT of 56% in 2013 is significantly lower than in Estonia (83%), Slovenia (71%) and the Czech Republic (71%). Romania collected in 2013 8.47% of GDP in VAT revenue (ESA95 execution), compared to 8.45% of GDP in Estonia, 8.64% in Slovenia and 9.22%

[8] Non-profit institutions serving households.

in Bulgaria, while the standard rate of VAT in these countries was 20% (compared with 24% in Romania). In 2013, a lower efficiency of taxation as defined above was observed only in Slovakia, Latvia and Poland.

Although, it must be noted that the differences in the efficiency index of taxation also reflect the 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) [9], 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 trade openness of the economy – the corresponding indicators for the three variables in Romania being unfavorable. In addition, it should be noted that this method of calculating the VAT efficiency indicator does not take into consideration the impact of the reduced VAT rates and does not take into account other components of GDP that are subject to VAT (part of intermediate consumption and part of gross capital formation fix - see the chapter of tax evasion).

Table 6: Taxation efficiency - VAT

Country	Standard VAT* (%)			Implicit tax rate**			Taxation efficiency index***			Rank		
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
BG	20.0	20.0	20.0	14.0	14.3	14.6	0.70	0.71	0.73	3	4	4
CZ	20.0	20.0	21.0	14.0	14.7	15.4	0.70	0.74	0.73	4	2	3
EE	20.0	20.0	20.0	16.6	16.9	16.2	0.83	0.85	0.81	1	1	1
LV	22.0	21.5	21.0	10.9	11.4	11.6	0.49	0.53	0.55	10	8	9
LT	21.0	21.0	21.0	12.6	12.1	11.8	0.60	0.58	0.56	6	6	6
HU	25.0	27.0	27.0	16.2	17.1	17.2	0.65	0.63	0.64	5	5	5
PL	23.0	23.0	23.0	13.2	11.9	12.0	0.57	0.52	0.52	9	10	10
RO	24.0	24.0	24.0	13.9	13.6	13.5	0.58	0.57	0.56	8	7	7
SI	20.0	20.0	20.0	14.4	14.4	15.4	0.72	0.72	0.77	2	3	2
SK	20.0	20.0	20.0	11.9	10.5	11.2	0.59	0.53	0.56	7	9	8

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

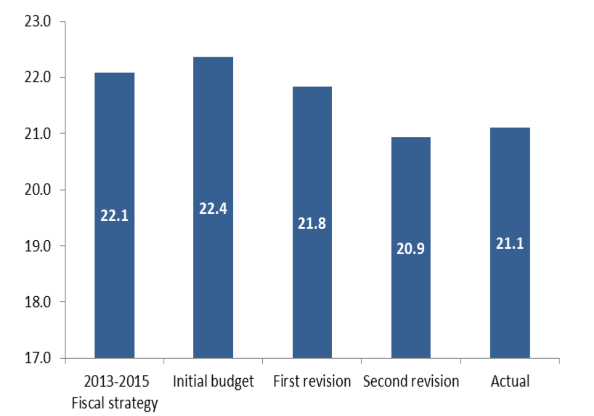
** If standard rates have been modified during the year, a weighted average of standard rates has been reported.*

[9] 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.

*** 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, 2012 and 2013 include additional receipts due to implementation of compensation scheme for clearing arrears (+1709 mil. lei in 2011, +1571 mil. lei in 2012, +854.7 mil. lei in 2013).*

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

Figure 6: Excises, 2013 (billion lei)



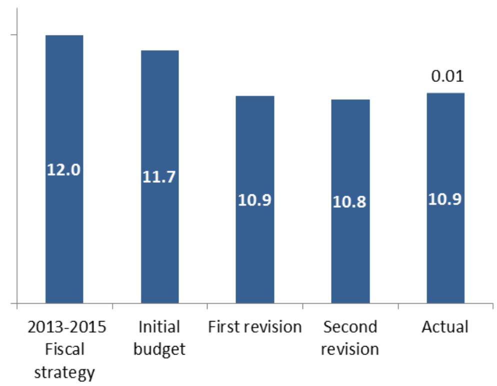
Source: Ministry of Public Finances

The revenue collected from the excise duties in 2013 amounted to 21.1 billion lei (3.36% of GDP), which indicates an achievement of these receipts below expectations, the original budgeted level being 22.4 billion lei. Similar to the developments of the VAT receipts, the revenues from the excise duties were revised downward during the two budget revisions (-1.5 billion lei compared to the initial projections), due to a negative dynamics of the consumption, but the size of the revisions may suggest a decreased collection efficiency. Compared to the previous year, the extra income from the collection of excises recorded a level of 0.88 billion lei (+3.36%), reflecting the increases in the rates of excise on certain products (petrol, diesel, cigarettes, alcohol and luxury goods), but also the positive effect generated by the increase of the exchange rate (+5.2% considering the reference rate used in calculating the excises). It should be noted that the increase of excise duties on luxury goods and alcohol was a measure introduced in order to offset the effect of reducing the VAT rate on bread, flour and wheat on budgetary revenues.

III.2.2 Direct taxes

The revenues from the corporate income tax according to cash standards, in amount of 10.92 billion lei, without the compensation schemes (8.8 billion lei), have registered a modest increase of 1.46% in 2013, compared to the previous year (+157 million lei), being much lower than the original budget estimates (by approximately 805 million lei), the reduced dynamics of these revenue being influenced by the regularizations made for the corporate income tax owed by the commercial banks[10], but also by the poor evolution of the revenues from the non-financial economic agents, the latter being adversely affected by the weak financial performance of the companies[11].

Figure 7: Corporate income tax, 2013 (billion lei)



Source: Ministry of Public Finances

The nominal revenues from the corporate income tax, without the compensation schemes, remained significantly below the pre-crisis levels. This trend can be observed also by considering the efficiency index, expressed according to ESA95 standards, which showed a significant reduction in the period 2008-2012 (in line with developments in NMS 10); Figure 8 suggests a direct link between the effectiveness of collection and the cyclical position of

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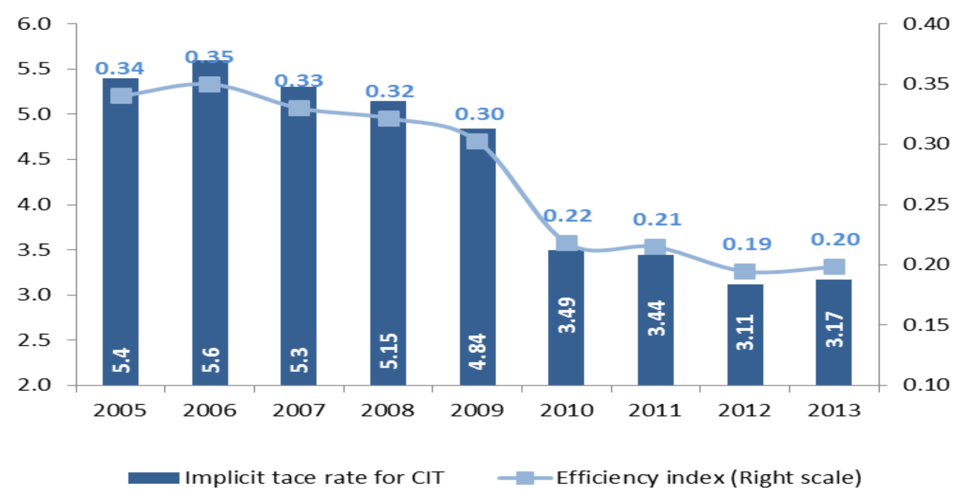
[10] The taxpayers commercial banks - Romanian legal entities and branches of banks in Romania - foreign Romanian legal entities have the obligation, under the Tax Code to declare and pay annual corporate income tax (completing the statement until 25 March the following year), with quarterly prepayments updated with the inflation index. Given that 2012 recorded an aggregate loss of the banking system in amount of 2347 billion lei compared to 0.786 billion lei in 2011, the adjustment made in early 2013 to advance payments in 2012 meant tax refunds for the overpaid corporate income tax in 2012. Also, the payments made in 2013 had as a basis the poor profits registered in 2012.

[11] According to the National Trade Register Office (NTRO), the number of companies which became insolvent in 2013 was by 10.37% higher than in 2012. Moreover, according to a study of Coface the rate of insolvencies - defined as the number of newly opened insolvency reported to the number of active companies - during 2013 in the countries from Central and Eastern Europe, Romania stands with the second highest rate of insolvencies, i.e. 6.44%, the only country with a higher percentage being Serbia, with 7.61%.

economy. After the recommencement of economic growth in 2011, the efficiency index seems to have stabilized, so that, if in cash terms, the dynamics of the corporate income tax, was only 0.58%, according to ESA95 standards, increased by 10.16% in 2013, compared to 2012; a slight growth of the efficiency index can be seen in 2013, as the corporate income tax revenues have advanced at a rate superior to the relevant macroeconomic base (gross operating surplus).

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



Source: Fiscal Council's calculations

Compared to other countries from Central and Eastern Europe[12] in 2013, Romania is ranked on the seventh position (as in 2012), with an efficiency index of 20% and an implicit tax rate of 3.2% (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 may be noted that Romania, like most countries in the region experienced a slight increase in the efficiency collection compared to the previous year, except for Slovakia, which recorded a decrease in the efficiency collection, given the increase of the corporate income tax rate from 19% in 2012 to 23% in 2013. On the other hand, Bulgaria is the only country that recorded a considerable improvement in the efficiency of collecting corporate income tax from 37% in 2012 to 45% in 2013. It is likely that the improvement of this indicator depends on the position of the economy in the business cycle, but also on the measures taken by the Ministry of Public Finances to combat tax evasion or towards improving the tax legislation.

[12]Poland is not included in the ranking for the 2013 due to the unavailability of data on the gross operating surplus in national accounts.

Country	Legal corporate income tax (%)			Implicit tax rate*			Taxation efficiency index**			Rank		
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
BG	10.0	10.0	10.0	3.8	3.7	4.5	0.38	0.37	0.45	1	1	1
CZ	19.0	19.0	19.0	7.0	7.0	7.0	0.37	0.37	0.37	2	2	2
EE	21.0	21.0	21.0	3.0	3.5	4.4	0.14	0.17	0.21	8	9	6
LV	15.0	15.0	15.0	2.8	3.2	3.3	0.19	0.21	0.22	7	5	3
LT	15.0	15.0	15.0	1.6	2.6	2.7	0.11	0.17	0.18	10	8	8
HU	20.6	20.6	20.6	2.9	3.3	3.6	0.14	0.16	0.17	9	10	9
PL	19.0	19.0	19.0	4.1	4.1	0.0	0.22	0.22	NA	5	4	NA
RO	16.0	16.0	16.0	3.4	3.1	3.2	0.21	0.19	0.20	6	7	7
SI	20.0	20.0	17.0	4.8	3.6	3.6	0.24	0.20	0.21	4	6	5
SK	19.0	19.0	23.0	4.8	4.6	4.9	0.25	0.24	0.21	3	3	4

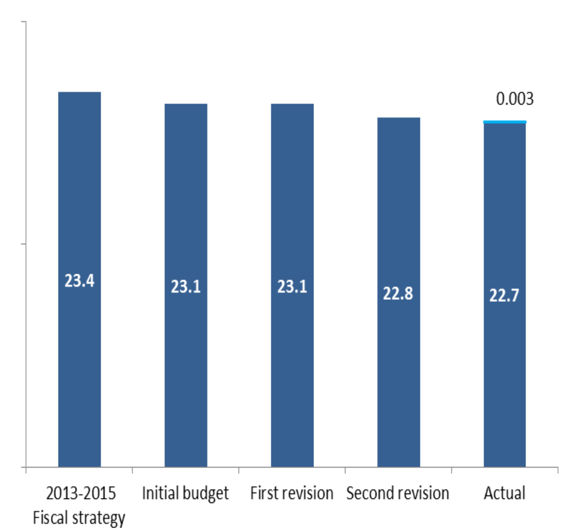
Table 7: Taxation efficiency – corporate tax income

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.*

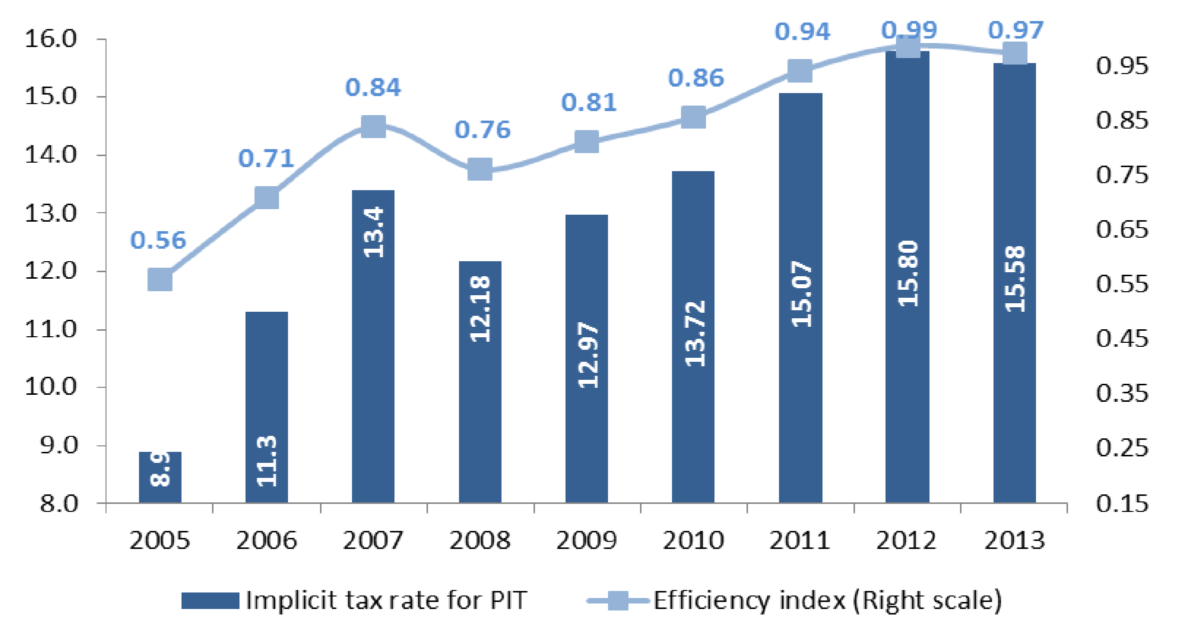
The receipts from the personal income tax expressed in cash standards, in amount of 22.73 billion lei, performed below expectations, being under the original budget estimates by about 414 million lei (-1.8%), but exceeding the revenues collected in 2012 by about 1.84 billion lei (+8.8%). The dynamics of this budgetary aggregate reflects an increase of 5% of the average gross wage in the economy, but also the increase of the average number of employees (1.7% compared to 2012), solely due to an increase in the number of jobs created by the private sector, while the number of public employees has remained relatively constant.

Figure 9: Personal income tax, 2013 (billion lei)



Source: Ministry of Public Finances

Figure 10: Implicit tax rate and taxation efficiency index for personal income tax in Romania



Source: Fiscal Council's calculations

The dynamics of personal income tax revenue expressed in ESA95 standards (+5.5%) is lower than that in cash terms (+8.8%), also being inferior to that of the macroeconomic base, which is equivalent to a slight reduction in the collection efficiency. However, the level of this indicator remains quite high (0.97)[13], the period 2008-2012 being characterized by a consistent improvement of the collection efficiency, the corporate income tax receipts and the wages have constantly advanced at a rate higher than that recorded by appropriate macroeconomic basis. 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.

[13] Compared to 2012 Fiscal Council`s Report it can be noticed for Romania a major change for the efficiency index value, by approximately 10 pp due to the downward revision of the data regarding the tax base - "compensation of employees".

Table 8: Taxation efficiency – personal income												
Country	Legal corporate income tax (%)			Implicit tax rate**			Taxation efficiency index ***			Rank		
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
BG	10.0	10.0	10.0	10.3	10.4	9.9	1.03	1.04	0.99	1	1	1
CZ	15.0	15.0	15.0	8.8	8.8	9.1	0.59	0.58	0.61	10	10	7
EE	21.0	21.0	21.0	15.6	15.9	16.0	0.74	0.76	0.76	5	7	5
LV	25.0	25.0	24.0	19.6	19.9	19.4	0.78	0.80	0.81	4	4	4
LT	15.0	15.0	15.0	12.6	12.7	12.8	0.84	0.85	0.86	3	3	3
HU	16.0	16.0	16.0	11.7	12.7	12.0	0.73	0.79	0.75	6	5	6
PL	25.0	25.0	25.0	18.3	19.0	NA	0.73	0.76	NA	7	6	NA
RO	16.0	16.0	16.0	15.1	15.8	15.6	0.94	0.99	0.97	2	2	2
SI	27.0	27.0	27.0	16.2	16.5	15.6	0.60	0.61	0.58	9	9	9
SK	19.0	19.0	22.0	11.4	12.0	12.8	0.60	0.63	0.58	8	8	8

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

** For countries with progressive taxation system (Slovakia - since 2013, Poland, Slovenia), the figure reported is the average tax rate (Slovakia, Poland - with two tax rates system) or central rate (in Slovenia - with three tax rates system).*

*** 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 the 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.*

Compared with other countries in the region, Romania kept its second position in the sample[14], with an efficiency index of 97% and an implicit tax rate of 15.6% (calculated as the ratio of direct taxes paid by households[15] and gross wages from national accounts - including shadow

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

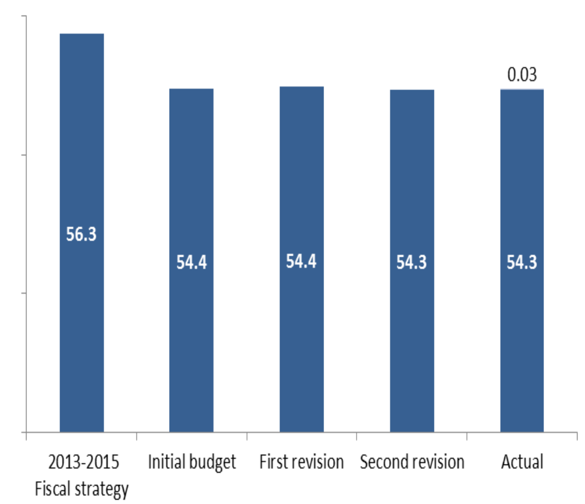
[15] It includes other forms of taxes paid by the population (as. tax on capital gains, interest income and pensions), not just wages. Unfortunately, there is no detailed data available on the types of taxes paid by the population in order to take into account only taxes on wages. This is the explanation for which the value of efficiency index may be higher than one (see for example Bulgaria in the period 2011-2012).

economy, for which social security contributions paid by employees were deducted from salaries).

III.2.3 Social contributions

The revenues from social contributions, amounting to 54.38 billion lei at the end of 2013 in cash standards, were approximately equal to the initial estimates (54.36 billion lei), while the impact of the compensation schemes implemented during the year was 31.1 million lei, which was not included in the original budget. The receipts from social contributions recorded about the same level as the estimated projections for the second budget revision, noting an increase of 6.04% (without the impact of the compensation schemes) compared to the level registered at the end of 2012.

Figure 11: Social security contributions, 2013 (billion lei)



Source: Ministry of Public Finances

The dynamics of the social contribution receipts in 2013 was negatively affected by the increase in the scheduled amounts transferred[16] to the Second Pension Pillar, but also by the repayment of the amounts illegally collected from the retirees representing the health insurance contributions, as a result of the Constitutional Court's decision from April 2012[17].

[16] The contribution rate to the private pension fund increases by 0.5 pp per year, starting on 1st January of each year so that in 2013 the share was 4%, compared to 3.5% in 2012 and 3% in 2011.

[17] The decision states that the health insurance contribution applies only to pension income exceeding 740 lei, deducting this amount from the tax base. The Government decided to refund these amounts, withheld illegally as follows: for those detained during the period January-March 2011, the refund is made in equal monthly installments during the period June - August 2012; for amounts withheld in April 2011 - April 2012, the return shall be made by 30 September 2013.

Table 9: Social security contributions (mil. lei)				
		Execution 2011	**Execution 2012**	**Execution 2013**
Adjusted series[18]	**1**	**50.637,3**	**51.658,3**	**54.378,9**
Swap	2	726,0	407,6	31,1
Second Pension Pillar	3	1.976,2	2.501,3	3.125,2
Amounts illegally withheld / refunded to retirees	4	-1.051,3	262,8	788,5
Gross series	**5=1-2+3+4**	**50.836,1**	**54.014,8**	**58.261,5**

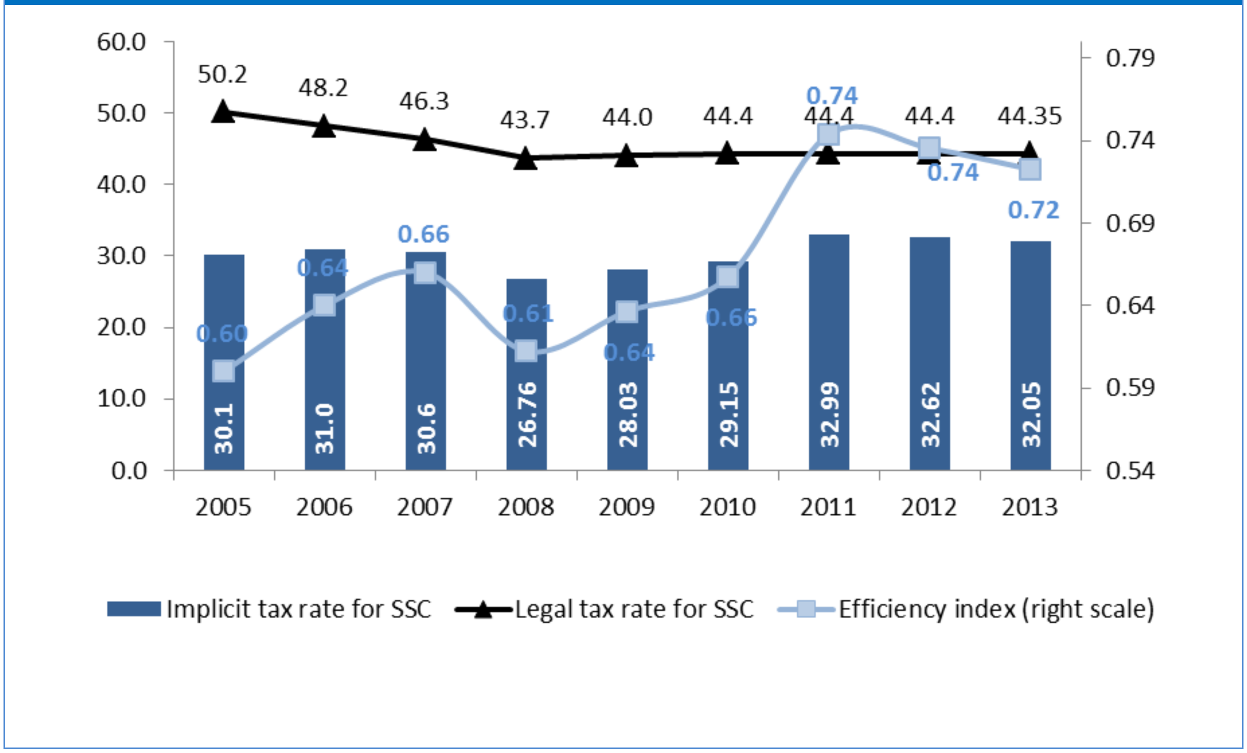
Source: Fiscal Council's calculations

Thus, if it is considered the unadjusted series, it appears that in 2013 the social contributions revenues, amounting to 58.26 billion lei, registered a favorable trend, exceeding revenues from 2012 with about 4.25 billion lei (+ 7.86%).

The revenue dynamics, expressed according to ESA95 standards (+5.12%), was lower than that of the relevant macroeconomic base (+6.98%), respectively the 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 0.74 to 0.72). However, it may be noted that the implicit rate of taxation corresponding to social contributions is at a higher level than in 2010, before broadening the tax base (extended health insurance contributions base for pensions over 740 lei monthly, redefining the dependent activities and the introduction of social security contributions for the military personnel).

[18] It is that contained in the budget execution.

Figure 12: The development of the implicit tax rate and taxation efficiency index for social security contributions in Romania



Source: Fiscal Council's calculations

In comparison to other countries in the region[19], Romania continues to be ranked on the eight position regarding the social contributions collection efficiency, the implicit tax rate being below the level registered in several countries that perceive a lower level of social security contributions. Thus, even if the aggregate statutory contribution rate ranks fourth in the region (after Slovakia, the Czech Republic and Hungary), Romania's implicit tax rate is close to the one of Estonia, 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 Estonia (the country ranked on the fourth position in relation to the taxation efficiency index) would have generated additional budget revenues of 13 billion lei (approximately 2.7% of GDP) in 2013.

[19] There is no data available regarding the gross wages in the national accounts for Poland in 2013.

Table 10: Taxation efficiency – social security contributions												
Country	Legal tax rate for SSC* (%)			Implicit tax rate**			Taxation efficiency index***			Rank		
	2011	2012	2013	2011	2012	2013	2011	2012	2013	2011	2012	2013
BG	31.0	31.0	31.0	22.6	21.6	22.4	0.73	0.70	0.72	9	10	7
CZ	45.3	45.3	45.3	47.8	47.6	48.5	1.06	1.05	1.07	1	1	1
EE	37.2	37.2	36.0	34.6	33.1	31.7	0.93	0.89	0.88	3	3	4
LV	35.1	35.1	35.1	24.9	24.6	22.9	0.71	0.70	0.65	10	9	9
LT	40.1	40.1	40.1	35.9	35.5	35.0	0.89	0.89	0.87	4	5	5
HU	44.5	47.0	47.0	36.4	36.2	35.9	0.82	0.77	0.76	7	7	6
PL	37.6	39.6	39.6	36.3	39.4	NA	0.97	0.99	NA	2	2	NA
RO	44.4	44.4	44.4	33.0	32.6	32.0	0.74	0.74	0.72	8	8	8
SI	38.2	38.2	38.2	33.4	33.9	34.0	0.87	0.89	0.89	5	4	3
SK	48.6	48.6	48.6	42.0	42.7	46.7	0.86	0.88	0.96	6	6	2

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

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

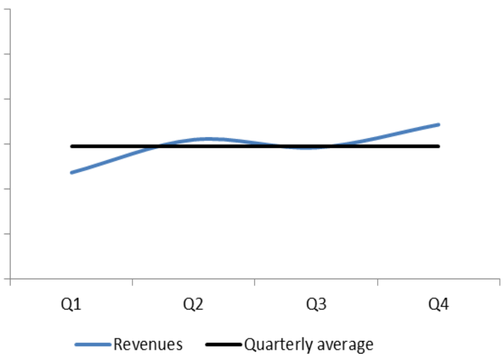
*** Computed as the ratio between "actual social contributions" (cod ESA D.611) and "gross wages and salaries" (cod ESA D11). For Romania, 2011 and 2012 the budget revenues include additional receipts due to implementation of compensation scheme for clearing arrears (+726 million lei in 2011, +476 million lei in 2012 and +31.3 million lei in 2013).*

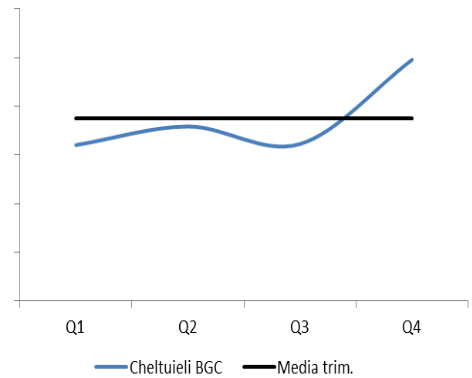
**** Computed as the ratio between implicit and legal tax rate.*

III.3. Budgetary expenditures

The budgetary expenditures, without the compensation schemes (in amount of about 997 million lei), have registered a relative slow rate of growth (+4.43% compared to the previous year), reaching 214.8 billion lei, mainly due to the decline of the expenditure funded from reimbursable funds by 46.2% compared to 2012, the reduction of subsidies with 15.9%, but also the decline of capital expenses with 6.65%. Also, the modest dynamics of social assistance expenditure (+2%) has contributed to the deceleration of total expenditure, taking into account the fact that this budgetary aggregate has a share of 32% in total. The expenditure that have registered a significant increase in 2013 compared to 2012 were personnel expenses (+13.5%), the expenses with goods and services (+12.5%), other expenses (+8.47%), but also those regarding the projects financed through post-accession EU funds (+5.87%).

Figure 13: Quarterly revenues of the general consolidated budget (mil. lei)	**Figure 14: Quarterly expenditured of the general consolidated budget (mil. lei)**





Source: Ministry of Public Finances

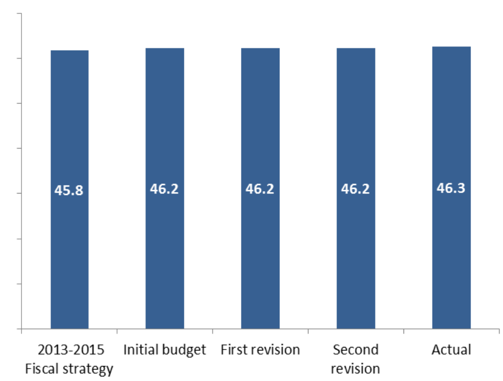
Note: The amounts are without the compensation schemes.

In 2013, 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 2013 reached 59.78 billion lei, by 17% higher than in the previous quarter, and approximately equal to Q4 2012. More than 80% of the spending hike in Q4 2012 was caused by the capital spending that increased by 110.4% compared to the previous quarter, the expenses regarding the projects financed through post-accession EU funds grew by 61.2%, but also those with goods and services which have increased with 17.6%; this increase includes the payments made as a result of the European Commission Directive no 7/2011 on combating late payments in commercial transactions, in amount of 1.2 billion in Q4 2013. 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 revenue has a lower degree of uncertainty.

III.3.1 Personnel and social assistance expenditure

The execution of personnel expenses has registered a level close to that considered in the draft budget for 2013. Initially, these have been estimated at a level of 46.2 billion lei, the final amount being 46.3 billion lei, respectively 7.37% of GDP. However, the ceiling considered for this category of expenditure, identical to the amount considered in the draft budget, has been exceeded by about 144 million lei, respectively by 0.3%, despite the fact that the average number of employees was slightly lower than was originally planned.

Figure 15: Personnel expenditure, 2013 (billion lei)

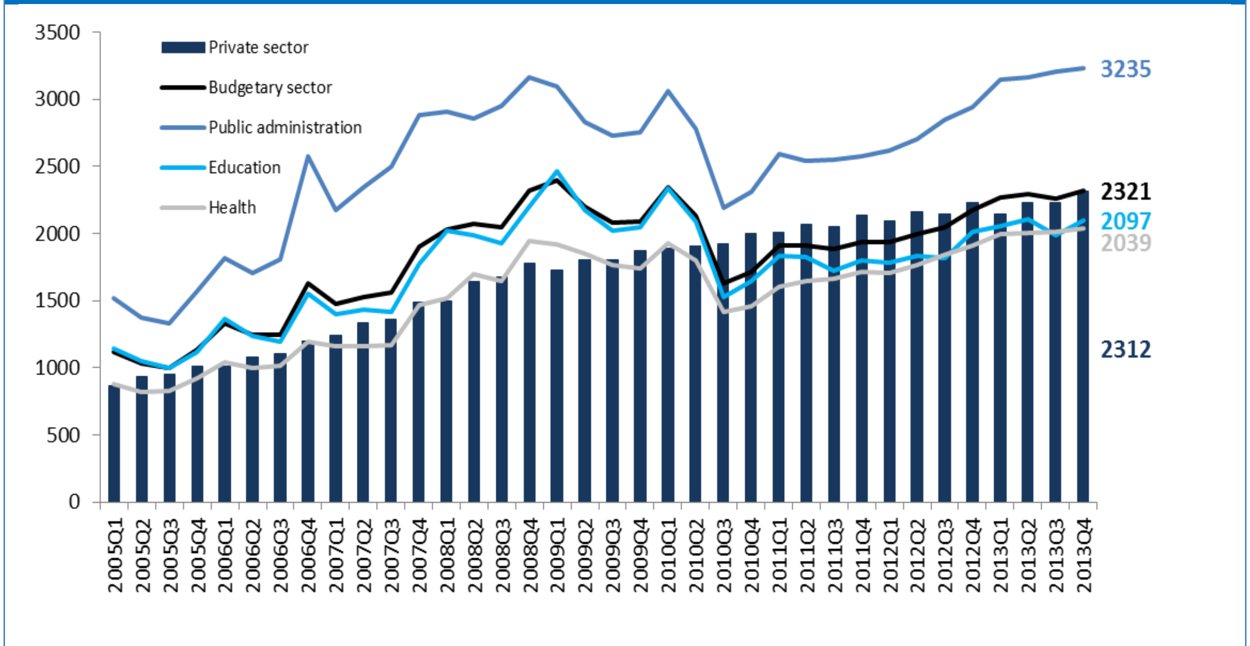


Source: Ministry of Public Finances

Compared to 2012, the personnel expenses increased by 5.5 billion lei, or by 13.5%. Of this increase, 10.5 pp are explained by the restoration of wages in the public sector, while 1.1 pp are due to the doubling of payments related to the obligations regarding the executory titles for certain categories of employees, the latter amounting to 900 million lei 2013.

Following these increases, the average wage in the public sector reached 2,287 lei, 12% higher than in 2012 and approximately equal to that from the first half of 2010.

Figure 16: Average gross earnings in the private and public sector in the period 2005-2013 (lei/month)



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

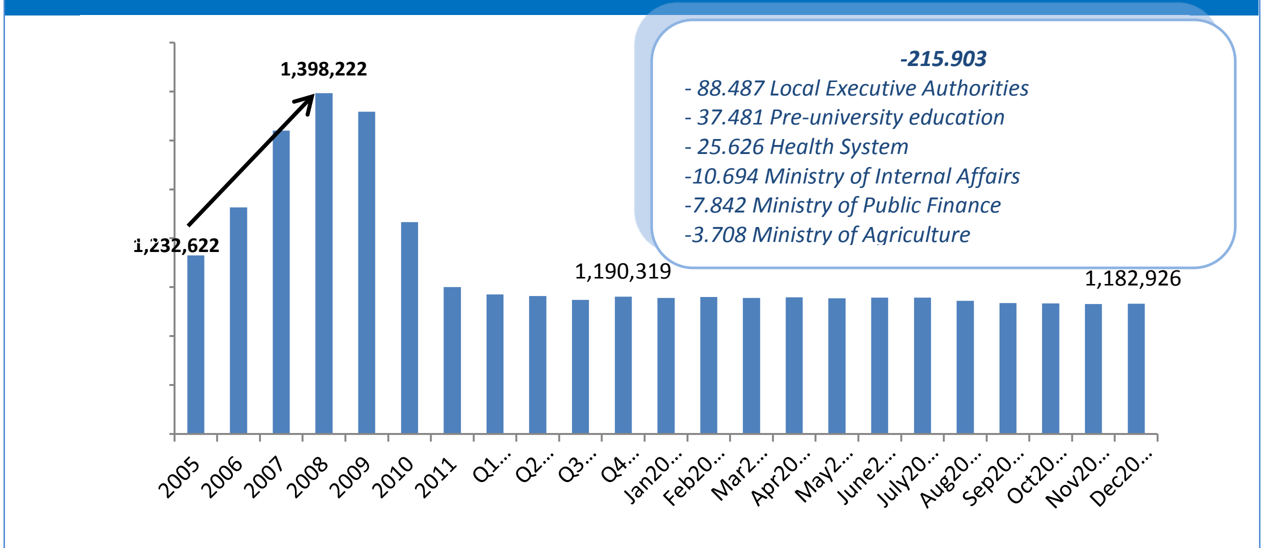
The public employment decreased by 215,903 workers (to 1.18 million employees) between end-2008 and December 2013 (Figure 17), after an increase of 165,600 persons recorded in the period 2005 – 2008. The adjustment recorded in the period 2008 – 2013 was due mainly to the introduction of the rule of "one new employee to 7 departures from the system" and took place at the level of local executive authorities[20] (-88,487 persons), pre-university education (-37,481 persons), health system (-25,626 persons), the Ministry of Internal Affairs (-10,694 persons), the Ministry of Public Finance (-7,842 persons) and the Ministry of Agriculture (-3708 persons). On the other hand, during the same period, increases were recorded in the General Secretariat of the Government (+3,121 persons), the Ministry of Justice (+2,327 persons), the Ministry of Labor (+1,734 persons) and the Ministry of Economy (+1,644 persons).

In the initial budget for 2013, it was considered financing a maximum number of 1,187,000 jobs in the budgetary sector; the monthly average of occupied positions during the year was equal to 1,186,223 jobs, which signifies the framing in the initial limits.

[20] It is possible that some of these reductions are reflected in service outsourcing, explained by the significant increase in spending on goods and services.

The number of employees registered at the end of 2013 decreased compared to the similar period from the previous year with about 7,393 persons, mainly due to the reductions operated at the level of: the Ministry of Public Finances (-2,370 persons) and the local executive authorities (-1,149 persons). Meanwhile, the number of occupied positions increased at the Ministry of Regional Development and Public Administration (+857 persons), the Ministry of Justice (+538 persons) and the Ministry of National Defense (+258 persons). A special situation can be found at the Ministry of Health where the number of employees increased by 10,931 people as a result of the reorganization of the ministry and the subordinated institutions, while at the medical units, the occupied jobs were reduced by 13 236 persons. Thus, the latter change of the number of employees reflects mainly a personnel transfer. It should be noted that since 2013, the rule of “1 new employee to 7 departures” was replaced by the rule 1 for 1, the staff policy regarding the budgetary system becoming more flexible, thus signaling the end of a rapid reduction in the number of employees. Besides, the average number of employees in the public sector in 2013 was only by 0.3% lower than last year. The reduction from the last years was operated only in a small extent based on qualitative criteria such as reducing staff where a surplus of workers is identified, while hiring new employees in the scarce arears based on cost standards rigorously defined. Thus, the adjustment seems to be the result of applying the rule of "1 for 7" given that most of the exits from the system were realized through voluntary departure or retirement. The abandonment of this rule is intended to reduce the adverse selection and to allow some changes in the staff structure. The Fiscal Council welcomes this approach, but notes that the new hiring operated in the deficient areas should consider keeping the total number of employees so that maintaining the wage bill previously approved.

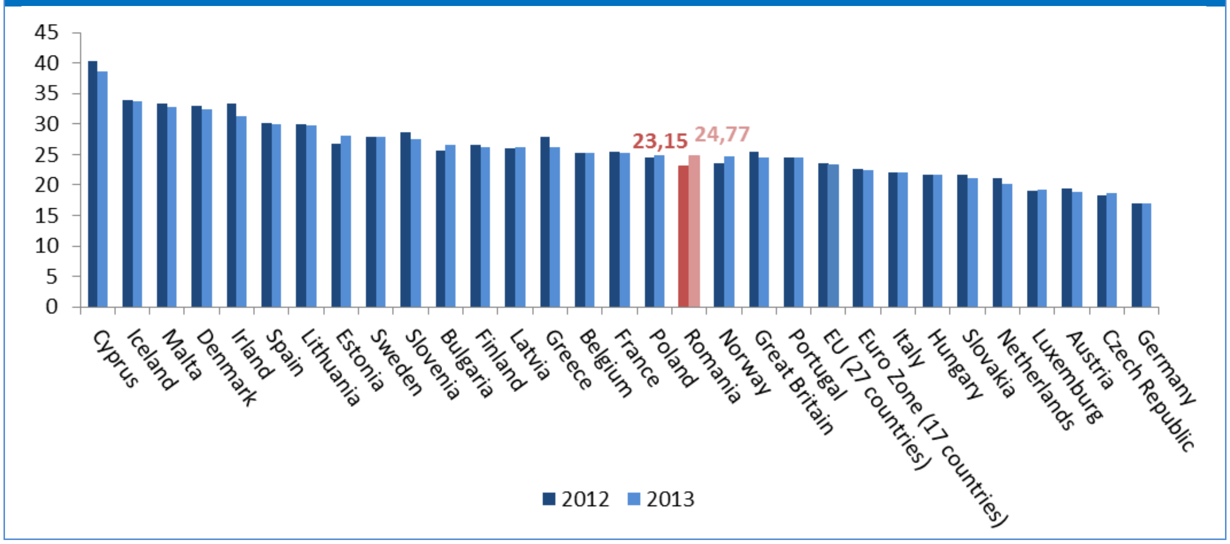
Figure 17: The evolution of the public sector employment



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. If in 2010, the wage bill as a share of total budgetary revenues placed Romania in the first half of the ranking, in 2013 ESA95 data revealed a better ranking for the country, but compared to the year 2012, Romania lost four positions in this ranking, due to the recovery of wages. Moreover, Romania registered a higher expenditure in relative terms compared to similar economies such as Hungary, the Czech Republic or Slovakia.

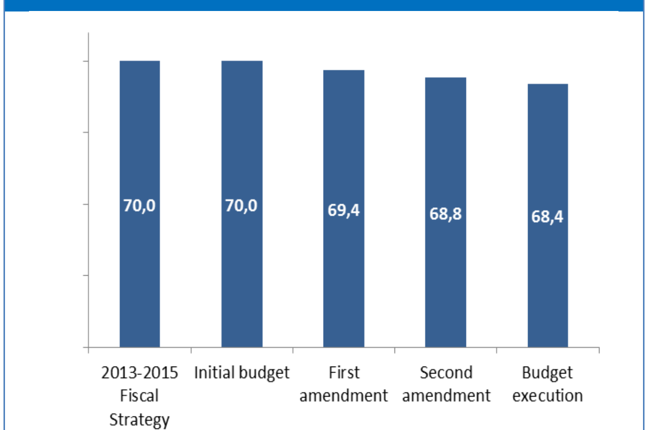
Figure 18: Wage bill as a share of total budget revenues in EU27 countries



Source: Eurostat

The social assistance expenditures registered a lower level in 2013 compared to the projections of the draft budget, being revised downward during both budgetary revisions. Estimated in the initial budget at a value of 70 billion lei, the level of social assistance expenditure, without the compensation schemes, was set at 68.4 billion lei, by 2.3% less than in the initial budget. Compared to 2012, the social assistance expenditure increased by 2%, their share in GDP decreasing by 0.55 pp, up to a level of 11%, in the context of a nominal GDP growth rate of 7.12%.

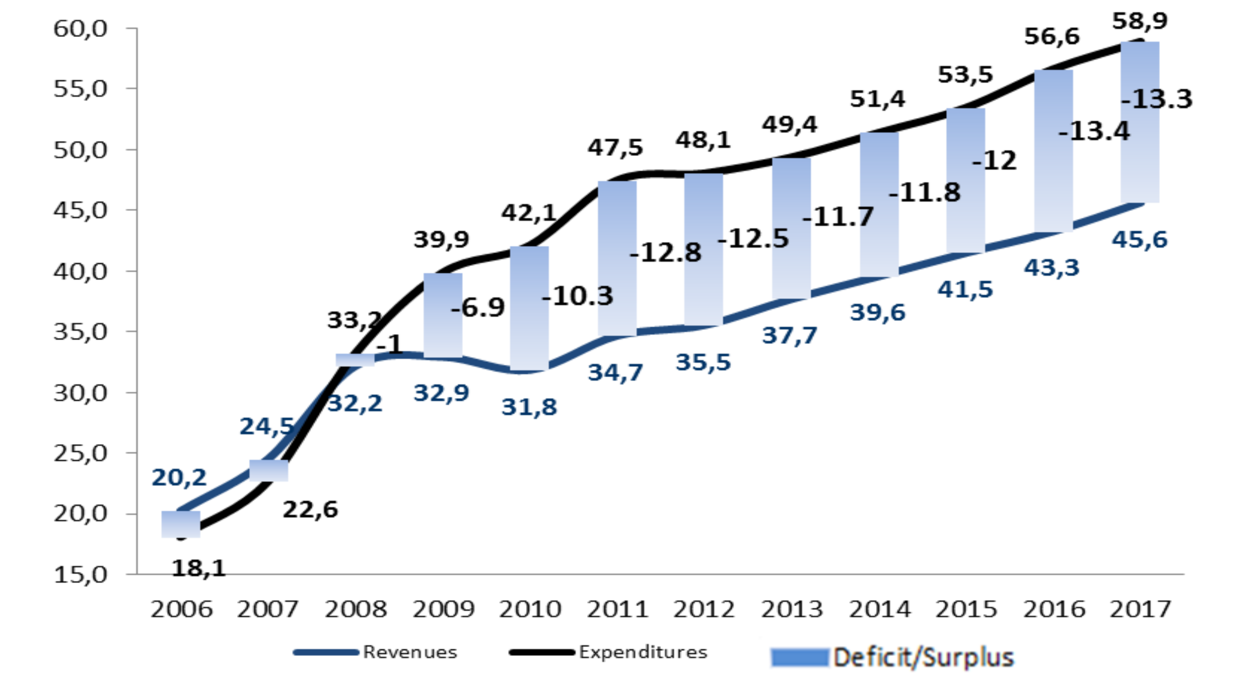
Figure 19: Social assistance expenditure, 2013 (billion lei)



Source: Ministry of Public Finance

The social assistance expenditures 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 expenses are 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[21].

Figure 20: The evolution of revenues and expenditures of the social security budget without considering the reduction of SSC for employer by 5 pp (billion lei)



Source: Ministry of Public Finances, cash standard data

Note: Projections for the period 2014-2017 do not include the impact of SSC reduction for employers by 5 pp.

Since 2009, the social security budget deficit has widened significantly to a peak of 12.8 billion lei in 2011, and the estimated trend for the subsequent years is to maintain it between 11.7 and 13.3 billion lei. It is true that, in terms of expressing the deficit as a percentage of GDP, the projections indicate a decrease from 2.3% in 2011 to 1.7% in 2017, the fiscal effort in real terms being slightly reduced. The excessive increase of social security budget expenditures (+70.5% in 2009 compared to 2007) has occurred in the context of a favorable dynamic receipts from contributions during the period preceding the financial crisis as a result of the economic boom,

[21] The Law No. 263/2010 regarding the unitary system of public pensions modifies the indexation system, increases the standard retirement age and introduces more stringent criteria for early retirement.

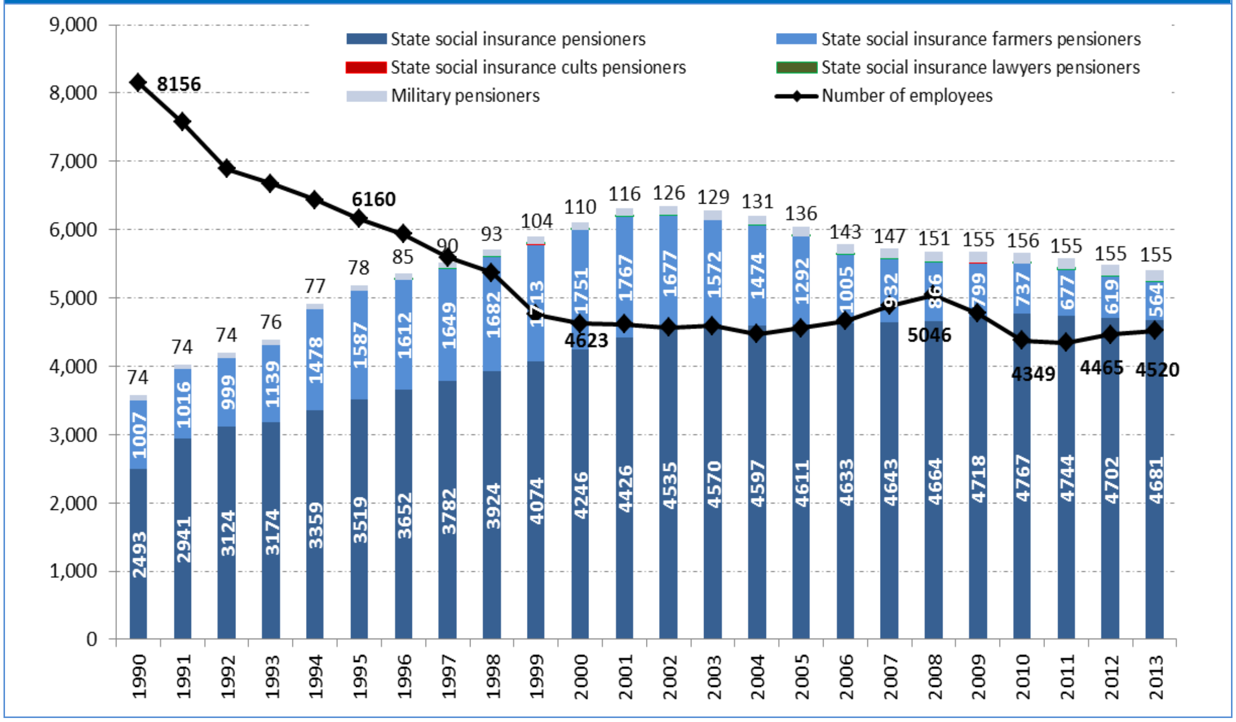
and also anticipating to maintain this trend in the future. Unfortunately, a significant portion of the social contributions revenue rise has proven to be cyclical, further developments invalidating the optimistic forecasts that led to the significant increase of the pension point. Thus, the decision to increase certain permanent expenditures such as those related to pensions should take into account the trend of contributions revenues, as well as the forecasts regarding the employees-pensioners ratio. It also became evident the necessity of finding an indexing rule to ensure long term sustainability of social security budget instead of using the discretionary approach from the past. The new pension law should support in the long term this objective under the conditions of a legislative stability and a strict application of its provisions.

Over the past two years, the social security budget deficit slightly improved, reaching a level of 12.5 billion lei in 2012, respectively 11.7 billion lei in 2013. The reduction of the social security budget deficit by 0.83 billion lei in the last year was due to the security contributions advance by 2.15 billion lei, while the increase of pension expenditure amounted only 1.32 billion lei. Despite the improvements made previous year, on the medium and long term there are significant risks to the sustainability of the social security budget, and the appropriateness of any additional expenditure increases or contributions reductions should be analyzed only in the context of identifying alternative solutions to reduce the deficit, particularly by broadening the tax base.

It is worth mentioning that, in the context of the implementation of the legislative proposal regarding the reduction of the social contribution rate for employer by 5 pp starting October, 1, 2014, approved by the Parliament but not promulgated by the President, the deficit of the social security budget in 2015-2017 will increase by 7 billion lei, being estimated around 19 and 21.1 billion lei, compared to maintaining the actual contribution rates. The estimated impact of this legislative measure in 2014 is equivalent to a loss in social security contributions revenue of 1.11 billion lei.

The financial situation of the pension system has deteriorated since 1990, the ratio between the number of contributors and number of pensioners falling substantially, from 2.3 employees to a pensioner in 1990 to only 0.83 employees to a pensioner in 2013, the number of state social insurance pensioners registering an increasing trend, while the number of employees had a decreasing trend, especially until 1999-2000. However, in recent years, the ratio has improved from 0.77 employees to a pensioner in 2010 to 0.83 employees to a pensioner at the end of the last year, but hovering below 0.88 in 2008.

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



Source: NIS

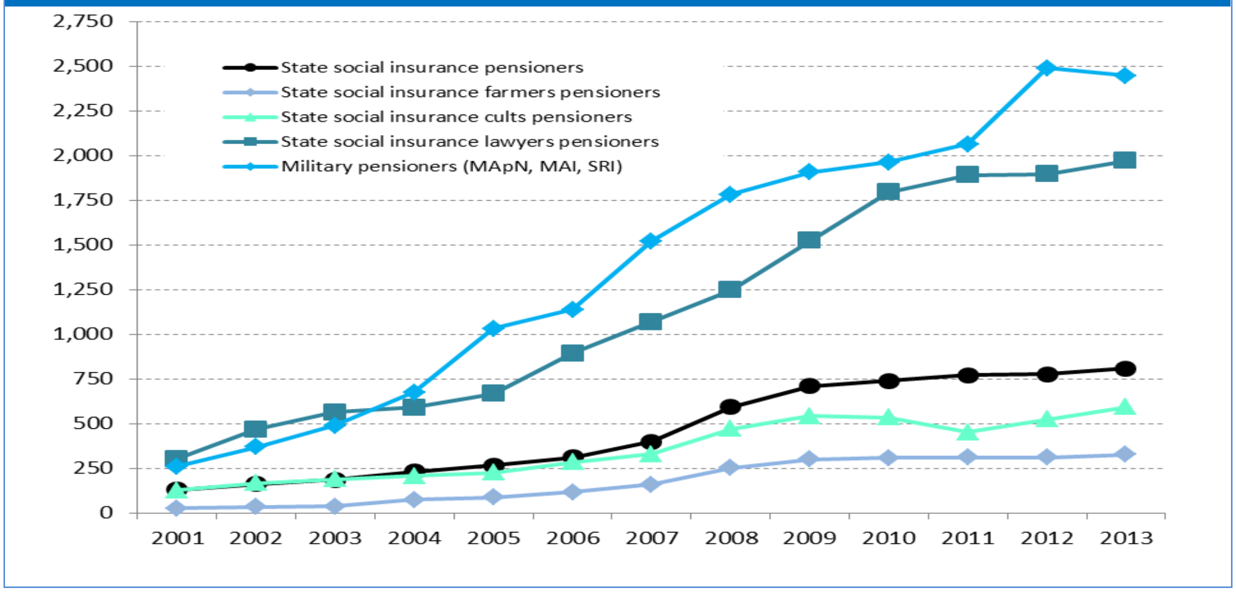
A measure to improve the medium and long term financial situation of the social security budget is the new pension law (Law no. 263/2010 on the unified public pension system) through which it has been pursued a number of objectives aimed at correcting imbalances recorded by pension scheme:

- separating the evolution of the pension point from the evolution of the nominal[22] 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;

[22] 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.

- introduction of more stringent requirements regarding the access to early pension and to disability pension;
- 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.

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



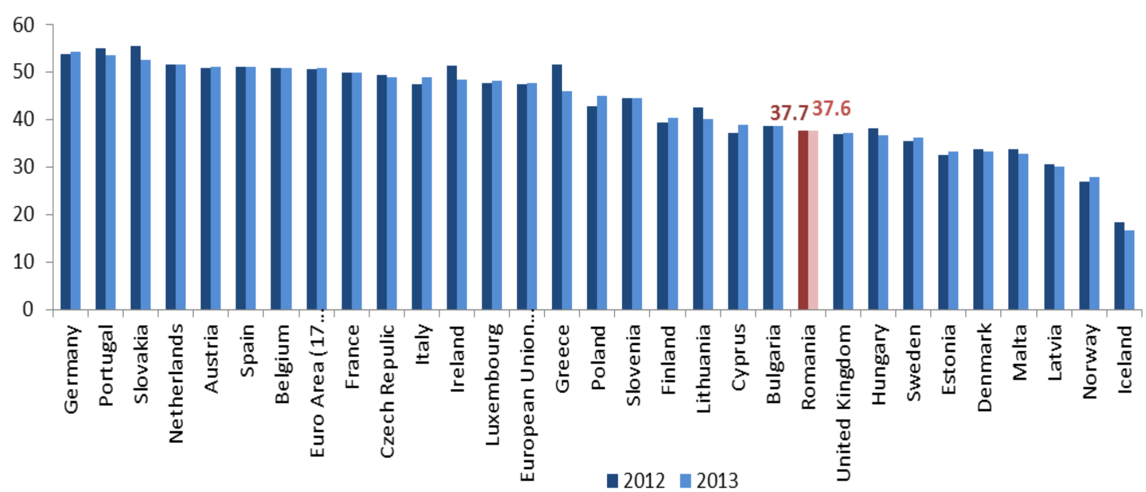
Source: NIS

In 2013, the average monthly pension was 805 lei, higher by 4.1% over the previous year, as a result of the pension point indexation by 3.8%[23], respectively by 29.3 lei. Pensions paid from social insurance budget were situated at an average level of 809 lei, and those for farmers pensioners were on average 327 lei. However, military pensions reached a monthly average equal to 2,446 lei, 2% less than in 2012. Despite this reduction, it is worth noting that the average monthly pension corresponding to beneficiaries from defense system, public order and national security increased by approximately 30% during 2010-2012, after the recalculation according to Law no. 119/2010 and to Government Emergency Ordinance no. 1/2011 and in circumstances that the initial forecasts indicated a decrease of them after applying the principle of contribution.

[23] The 3.76% increase of the pension point was determined based on the average inflation rate in 2011 (3.33%) plus 0.43%, representing 50% of the real growth of the average gross wage from the same year.

In the year 2013, Romania maintained its position from 2012 regarding the share of social security expenditures in total revenues, hovering in the second half of the EU member states ranking. However, this category of expenditure registered a significantly higher level than the social contributions collected.

Figure 23: Social security expenditure as a share of total budgetary revenues in EU27

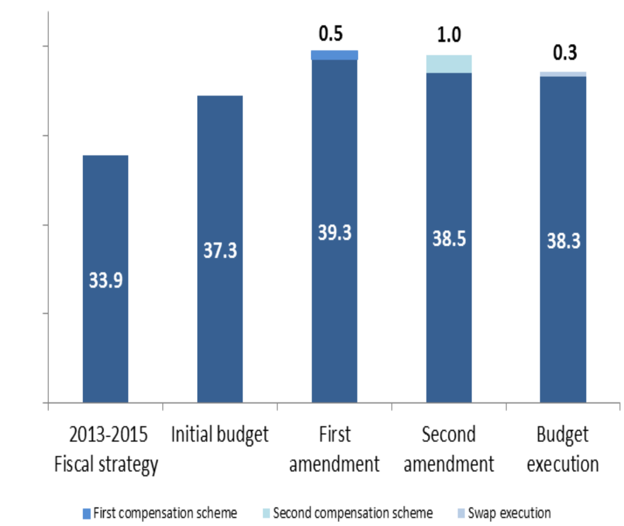


Source: EUROSTAT

III.3.2. Goods and services expenditures

The execution of goods and services expenditures net of the impact of compensation schemes registered a higher level than the one envisaged in the draft budget (+1 billion lei), exceeding by 4.4 billion lei also the level considered for the Fiscal Strategy for the period 2013-2015, respectively 33.9 billion lei, while the corresponding Fiscal Strategy projections did not include the impact of implementing the EU Directive no. 7/2011[24]. Initially estimated at 37.3 billion lei, the final value of this category of expenditure reached a level of 38.3 billion lei, (6.09% of GDP).

Figure 24: Goods and services expenditures 2013 (bln. lei)



Source: Ministry of Public Finances

Expenditures on goods and services were revised upwards during the first budget amendment (+2 billion lei), despite the fact that any increase in this expenditure chapter, after the approval of the budget law and without the reduction of the same amount in other budgetary expenditures, is prohibited by the Fiscal Responsibility Law no. 69/2010. Even if the clawback receipts, not included in the original budget, were used to finance additional expenses on goods and services, the size of the revision cannot be explained only by this factor. Instead, in the second budget amendment, the amount of goods and services expenditures was reassessed to 38.5 billion lei (-0.74 billion lei compared to the first amendment). It is worth mentioning that both rectifications have taken into account the implementation of a swap scheme for clearing outstanding obligations to the budget (each amounting to 0.5 billion lei), but in the final execution were recorded only 0.3 billion lei related to these schemes.

[24] It states that “contracts between firms should provide limited payment terms, as a rule, at 60 calendar days.” In addition, it should be provided specific rules regarding the commercial transactions for the supply of goods and services by enterprises to public authorities, rules to establish, in particular, payment terms that do not normally exceed 30 calendar days, unless the contract expressly provides otherwise, which must be objectively justified by the nature or by the specific features of the contract, but not exceeding, in any case, 60 calendar days.

Moreover, the Fiscal Council drew attention in February 2013, in the opinion on the revised Fiscal Strategy for 2013-2015, to the fact that the amounts allocated to the chapter of goods and services expenditures through the draft budget are undersized, and there are significant risks to overcome them. The amount originally proposed was more difficult to comply with, given the impact of applying EU Directive no. 7/2011 on combating late payments in commercial transactions, the financial effort initially estimated being approximately 3.5 billion lei (0.54% of GDP).

As in previous years, in 2013 the level of goods and services expenditures considered in the draft budget was exceeded during the year. Thus, the final execution of the goods and services expenses increased by 2.8% compared to the original projected level (however, the dynamic was lower than that of 7.2% in 2012, respectively 10.63% in 2011). The spending on goods and services rise on the occasion of the draft budget revisions was justified by accelerating the payments of arrears in the health sector, supported in part, on the revenue side of the budget, by the clawback tax, receipts that were not included in the draft budget. The Fiscal Council notes serious lacks in the budgetary programming, the credibility of initial estimates regarding the trajectory of this expenditure chapter being seriously affected by revisions operated during the year.

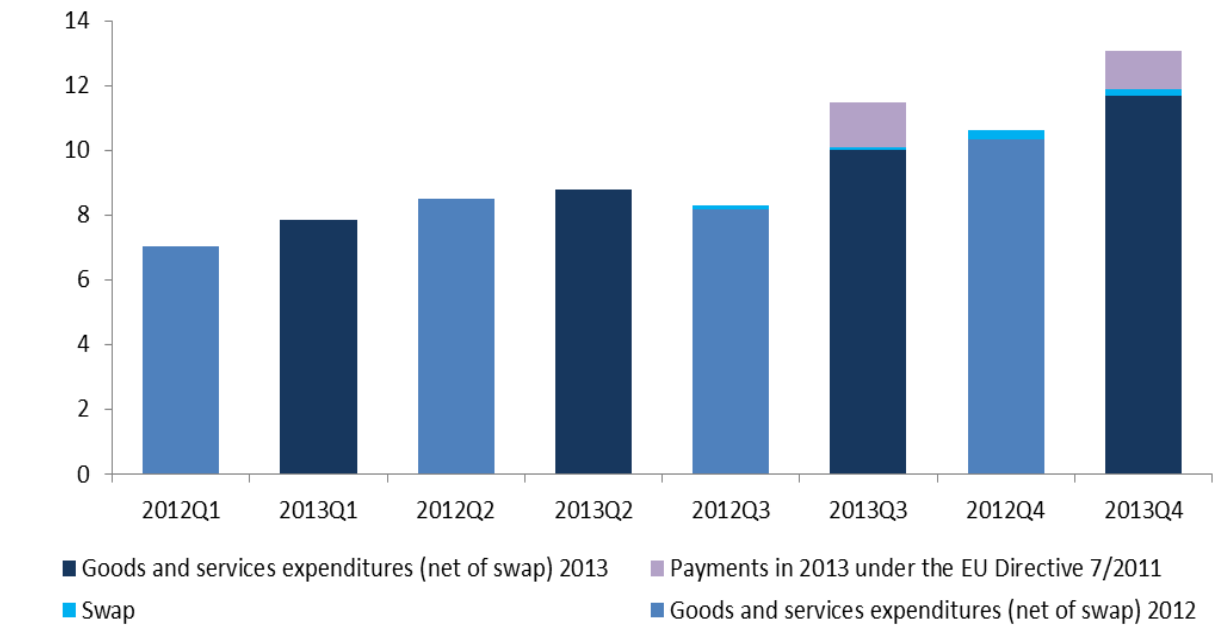
Table 11: Evolution of goods and services expenditures in 2011-2013 (billion lei)

	Fiscal Strategy	Initial budget	First amendment (without *swap*)	First compensation scheme	Second amendment (without *swap*)	Second compensation scheme	Budget execution (without *swap*)	Swap execution
2011	28.54	28.62	29.32	-	29.98	0.13	31.64	0.13
2012	31.26	31.74	32.78	0.25	33.18	0.50	34.04	0.41
2013	33.88	37.25	39.27	0.50	38.52	1.00	38.30	0.28

Source: Ministry of Public Finances

Compared to 2012, goods and services expenditures, net of impact of compensation schemes swaps, increased by 12.52% (+4.26 billion lei), increase that included also the payments made as a result of the application of EU Directive no. 7/2011 on combating late payments in commercial transactions. In the budget substantiation, these payments were estimated at 3.5 billion lei, while the final execution registered a lower level (2.5 billion lei), with payments made in the second half of 2013 (1.37 billion lei in Q3 and 1.2 billion lei in Q4). Excluding the increase of goods and services expenditures caused by the application of EU Directive no 7/2011, this category of spending was higher by about 5%, this advance being lower than nominal GDP. It should be noted that the implementation of this measure had a significant, but temporary (one-off) impact on the general consolidated budget, and the starting point for further analysis on the evolution of this spending category will be net of the impact of the application of EU Directive no 7/2011.

Figure 25: The evolution of spending on goods and services during 2012Q1 – 2013Q4 (billion lei)



Source: Ministry of Public Finances

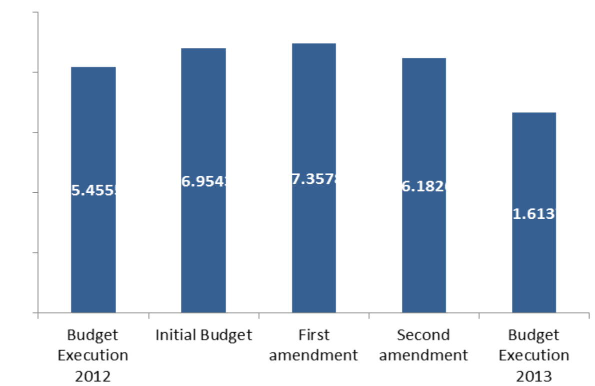
The trajectory recorded by goods and services expenditure reflect significant deficiencies in the budgetary programming, even though the increases operated during the year were partly justified by the acceleration of arrears payments in the health sector and were supported by the clawback tax receipts, not included in the draft budget. Starting with 2014, these revenues are included in the initial budget projection, fact that should contribute to the creation of premises for adequate dimensioning of goods and services expenses. Also, some progress has been made in recent years, considering that the final execution registered achievements increasingly closer to the original forecast. However, in the Fiscal Council's opinion, on medium-term, the effectiveness of goods and services expenditures is not possible without very profound structural reforms, particularly in the health system, and without improving the public procurement system in general.

III.3.3. Public investment expenditures

Investment expenses include, according to the budget classification, capital expenditures (non-financial assets), projects funded by external post-accession grants, expenditure for reimbursable programs, capital transfers and other transfers related to investments.

Compared to the previous year, in 2013, public investment expenses, considering all budget chapters included in this category, decreased from 35.5 billion lei to 31.6 billion lei in cash standards, the contraction in real terms being over 17% (respectively from 6.05% of GDP to 5% of GDP). The reduction of investment spending continued as a manner of achieving short-term targets, but with possible negative effects on medium and long term.

Figure 26: Investment expenditures 2013 (bln.lei)



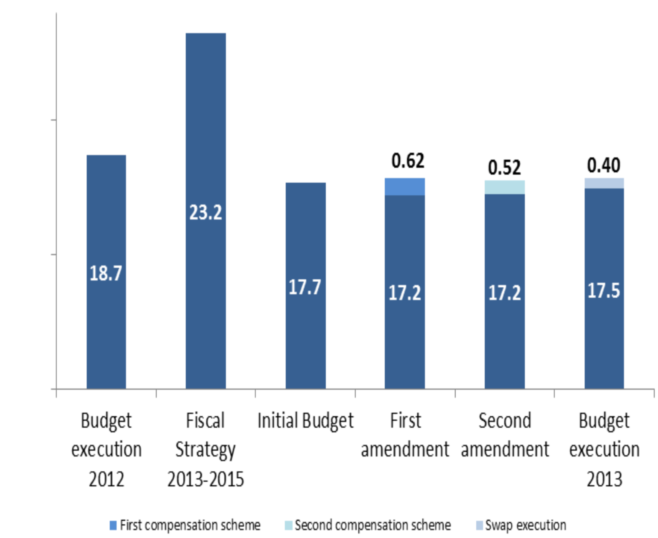
Source: Ministry of Public Finances

In the initial budget for 2013 it was intended to increase the share of EU funds absorption in total investment expenditures, respectively a substitution between capital expenditures (internal sources) and EU funds (external sources), a correct and welcomed approach in the opinion of the Fiscal Council. Adopting such a strategy could contribute to reducing the budget deficit, as investment spending should be supported by revenues from EU funds, and thus releasing own resources that could be used as resources for fiscal consolidation or other purposes.

The initial plan to substitute capital expenditures with non-reimbursable European funds did not worked, investment spending being 5.4 billion lei lower that the amount provided in the proposed budget, mainly as a result of the failure of revenues from external post-accession funds by 3.3 billion lei (about 0.53% of GDP) compared to the original budget plan.

In 2013, capital expenditure, with a share of over 50% of total investment, were projected in the initial budget at a significant lower level (-1 billion lei) compared with actually spending in 2012, within the intended context of substituting internal financing sources for investment with European funds. Final execution for 2013 registered a capital expenditures decrease by approximately 0.2 billion lei compared to initially programmed level (17.7 billion lei, excluding the swap impact), but these expenses were higher than projections related to budget revisions (by +0.3 billion lei).

Figure 27: Capital expenditures 2013 (bld. lei)



Source: Ministry of Public Finances

The projects funded by external post-accession grants, although higher compared to 2012 (+0.8 billion lei), had an evolution far below expectations, being significantly lower than both the level set by the initial budget (-3.3 billion lei) and the level programmed through the second budget revision (-2.6 billion lei). It is worth noting the unrealistic estimation was maintained on the occasion of the second budget amendment, operated at the end of October, given that operational results after 9 months (only 0.8% higher than those achieved in the first 9 months of 2012), indicated, unequivocally, the initial target failure by more than 2 billion lei. The estimates of the costs corresponding to the projects funded by external post-accession grants should be closely linked to developments of EU funds absorption, the revenues failure in 2013 compared to the initial programming being about 3.31 billion lei or 0.53% of GDP. Expenditure for reimbursable programs, that have a very low share of total investment expenditure were situated at the level programmed through the second budget amendment, but represents only 56% of the achievements of 2012.

Figure 28: Projects funded by external post-accession grants, 2013 (billion lei)

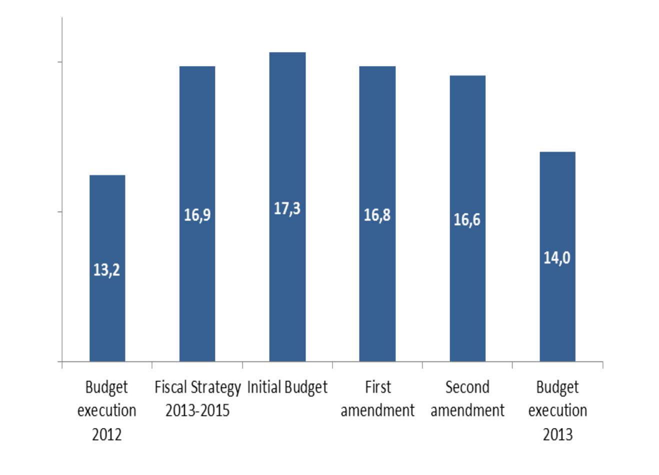
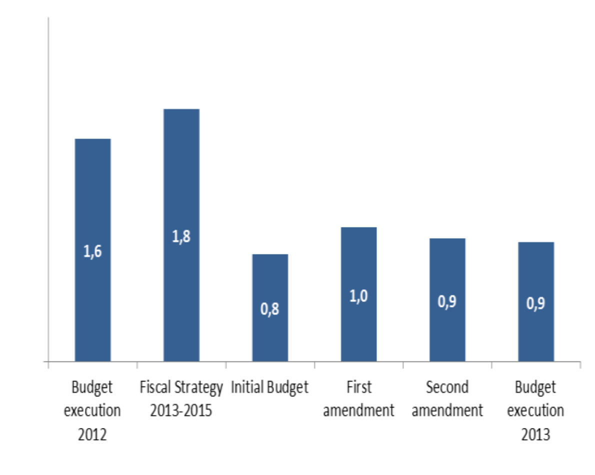


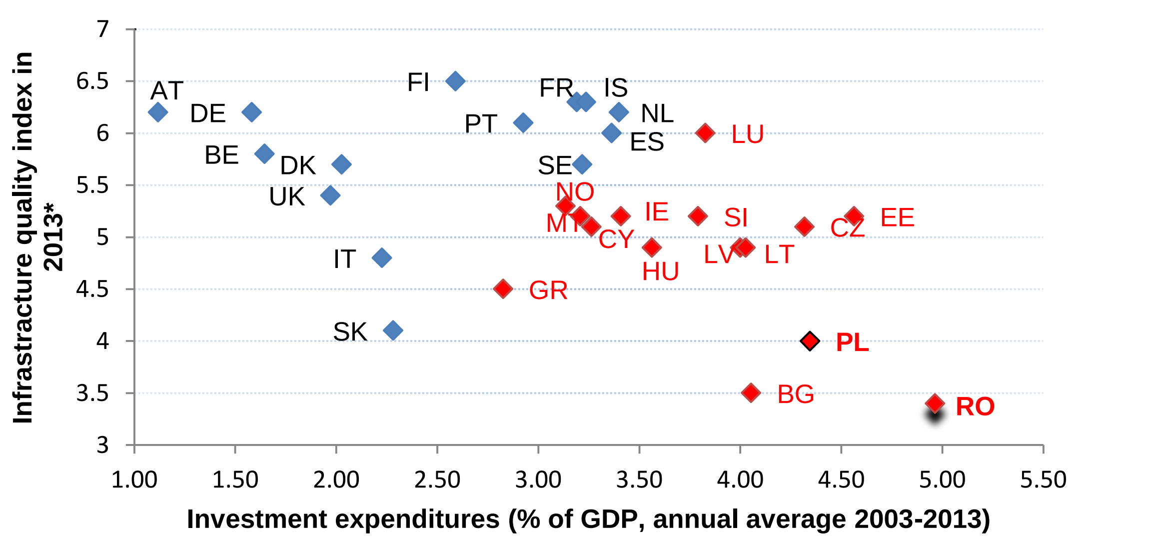
Figure 29: Expenditure funded from reimbursable funds, 2013 (billion lei)



Source: Ministry of Public Finances

Over the last decade, Romania ranked first among EU member states from the perspective of public investment as a share of both GDP and total budgetary revenues, but the infrastructure quality places our country on the last position in the same group of countries, demonstrating the low efficiency of this expenditure category. According to the Global Competitiveness Report 2013-2014, Romania is ranked on 106th position (out of 148 countries) in terms of overall quality of infrastructure, respectively on 145th position (out of 148 countries) regarding the quality of roads.

Figure 30: Public investment expenditures and infrastructure quality



Source: EUROSTAT, World Competitiveness Report 2013-2014

The poor management of public investment, the lack of a transparent system for prioritizing investment has been also noted in IMF[25] and World Bank[26] experts' reports. Following these analyzes, recommendations have been made to the Romanian authorities for better prioritization of investment projects, and the Government has assumed several commitments through the letters of intent submitted to IMF within the precautionary financial assistance packages. These commitments have materialized, with a considerable delay, by adopting the GEO 88[27]/September 23th, 2013 and the Methodological Norms regarding the public investment projects prioritizing in April 2014[28].

Box 1: Reform of public investment management
The reform of public investment management was initiated in 2013 with the support of World Bank experts, in order to optimize the processes of budget planning and prioritization of public investments projects, as well as for increase the absorption of EU structural and cohesion funds. The main objectives were represented by harmonization of investment projects portfolios financed by public funds with Government's objectives, as well as financing with priority those public investment projects with major social and economic impact. In this regard, it was set up the Evaluation Unit of Public Investment within the MPF and it was attempted a pilot prioritization in budget execution in 2013, as well as in the programming budget for 2014. The normative act adopted in September 2013, subsequently supplemented with methodological norms, proposed to create the necessary legal framework for public investment prioritizing, by setting up measurable evaluation criteria, as well as the analysis of sustainability and affordability of new investments projects. This has mandatory application to investment projects whose value exceeds 100 million RON, and if appropriate to investments with a value between 30 and 100 million RON, being targeted the central and local public institutions, respectively the self-financed ones, state-owned companies, as well as the public-private partnerships. Prioritization criteria refer mainly to: project opportunity in the context of sectoral and national strategies; economic and social justification; financial affordability and sustainability; arrangements for implementation and implementation performance.

[25] Reviews under the Stand-By Arrangement

[26] *Reviving Romania's Growth and Convergence Challenges and Opportunities- A Country Economic Memorandum*, World Bank, June 2013

[27] The Government Emergency Ordinance no. 88/2013 regarding the adoption of fiscal measures for the fulfillment of the commitments agreed with the international financial institutions, as well as for amending and supplementing certain normative acts.

[28] The Government Decision no 225/2014 for approving the Methodological Norms regarding the prioritization of public investment projects.

International financial institutions (IMF, World Bank, Organization for Economic Cooperation and Development – OECD) also perform analysis regarding the best practices in public investments. For example, in 2013 OECD published a comprehensive overview[29] of best practices in the form of basic principles for an effective management of public investment derived from the experience of other OECD member states. Those 12 principles, structured on 3 pillars, aim to counteract the undesirable effects of potential shortcomings in the investment process at national level, regarding the coordination, projection capacity – implementation and legislative environment.

Box 2: Principles identified by OECD for an efficient management pf public investments, structured on 3 pillars

Pillar I: co-ordinate public investment across all levels of government and policies: invest using an integrated strategy tailored to the different arrears; adopt effective instruments for coordinating across national and sub-national levels of government; coordinate horizontally among sub-national governments.

Pillar II: strengthen capacities for public investment and promote policy learning at all levels of government: assess upfront the long-term impacts and risks of public investment; engage stakeholders throughout the investment cycle, mobilize private actors and financing institutions to diversify sources of funding and strengthen capacities, reinforce the expertise of public officials and institutions involved in public investment, focus on results and promote learning from experience.

Pillar III: ensure a proper framework conditions for public investment at all levels of government: develop a fiscal framework adapted to the investment objectives pursued, require sound and transparent financial management at all levels of government, promote transparency and strategic use of public procurement at all levels of government, strive for quality and consistency in regulatory systems across levels of government.

Compared with the Fiscal Council's assessment of the 2012 Report , it can be appreciated that there have been made certain progresses towards creating the legal framework associated with the reform of public investment management by approving GEO 88/2013 and the related Norms, but achieving the intended benefits still remains a desideratum. The evaluation results should mandatory take into account a longer period, while the effects of the new legal

[29] OECD (2013), "Draft OECD Recommendation on Principles for Effective Public Investment – A Shared Responsibility Across Levels of Government" şi OECD (2013), Investing Together: Working Effectively across Levels of Government.

framework have not materialized, Romania being in an initial stage regarding the reform of the public investment management and the adoption of good practices of the European level.

III.3.4. 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.

During the recent years, the Government issued a series of emergency ordinances that establish the uses of amounts from contingency reserve fund beyond the framework stated in the Public Finances Law no. 500/2002. Thus, according to the Government Emergency Ordinance no. 41/2013 for the 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 certain amounts can be allocated by Government decisions to pay arrears recorded by the hospitals subordinated to the central and local public administration authorities, but only until the end of 2013. Moreover, according to Government Emergency Ordinance no. 103/2013 for the establishment of some financial measures of public expenditures, by government decisions can be allocated amounts from the contingency reserve fund also to pay arrears related to local budgets, as well as to finance certain expenses resulting from the outstanding payment obligations that cannot be provided from the approved budget. It should be noted that in 2012, 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.

Also, according to Government Emergency Ordinance no. 99/2013 regarding the revision of the state budget for 2013, by derogation from the provisions of article 30, paragraph (2) of Public Finances Law no. 500/2002, from the contingency reserve fund also can be allocated at the

Government's disposal, based on government decisions, amounts to supplement the budgetary expenditure of the Unique National Fund for Health Insurance in 2013.

In addition, based on Emergency Ordinance no. 107/2013 for the establishment of fiscal measures, by derogation from the provisions of article 30, paragraphs (2) and (3) of Public Finances Law no. 500/2002, from contingency reserve fund can be allocated sums to finance certain capital expenditures of airport autonomous administrations with outstanding specificity of local importance, by increasing the transfers from the state budget to local budgets, provided in the Ministry of Transport budget, until December 31st, 2014. Also, based on Emergency Ordinance no. 107/2013, from the contingency reserve fund at Government's disposal, based on government decisions, can be allocated amounts to the Ministry of Education for state higher education institutions to pay enforceable titles having as object salary rights.

It is noted thereby the Government's repeated appeal for exemptions from public finances law that establish uses of the contingency reserve fund that cannot be classified as urgent or unforeseen expenditures. Although the stock of arrears reduction or enforceable titles payment are valid objectives, they should be included in the draft budget or during budget revisions at corresponding expenditure items, and they should not affect the contingency reserve fund.

The utility of a contingency reserve fund lies in the flexibility given to the Government in the annual budget execution, particularly for covering urgent or unforeseen expenditures. 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.

According to an IMF study[30] on fiscal transparency, excessive use of the contingency reserve fund reduces fiscal transparency. Legal regulations in force at national level should specify clear and stringent conditions on accessing this fund, the nature of expenses that can be approved, as well as provisions requiring regular reports on the utilization of contingency reserve fund to the legislature and to the public.

In the international practice[31], national budgets include a contingency reserve fund whose level is limited, being usually between 1 and 3% of the total budgetary expenditure, the ceiling being

[30] Manual on Fiscal Transparency (2007), International Monetary Fund, Fiscal Affairs Department.

[31] Ian Lienert (2010), „Role of the Legislature in Budget Processes", Fiscal Affairs Department, International Monetary Fund.

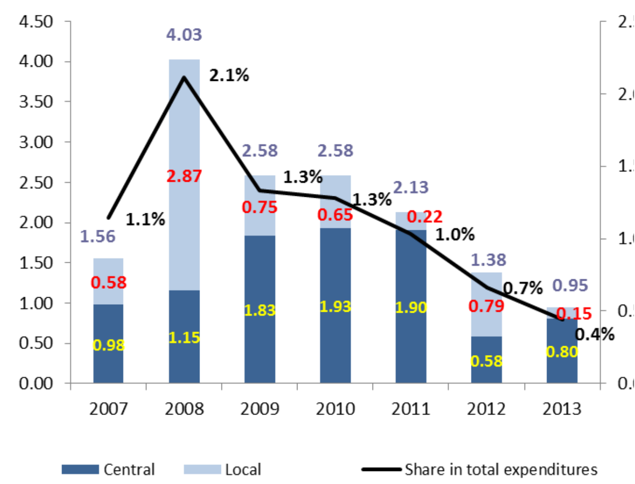
established by the national Parliaments, which are regularly informed by the Governments on the use of the fund, amount and destination of the spending funded from this source. Thus, in the UK, the utilization of contingency reserve fund is regulated by the United Kingdom's Contingency Fund Act 1974, and its level is limited to 2% of public expenditures from the previous year. In Spain, there are explicitly defined the types of expenses that can be accessed from the contingency reserve fund, which include personnel costs, debt service, transfers and investment expenditures; the contingency reserve fund may not exceed 2% of total public expenditures. Also, in other European countries there are legislative provisions regarding the utilization of contingency reserve fund: in Sweden it is annually established a fixed sum for the expenses that can be accessed from this fund, in Denmark there is a law that regulates the access to the contingency reserve fund. Moreover, in the Nordic countries (Denmark, Sweden, Finland, Norway) there are explicitly defined the types of expenses that can be accessed from this fund, as well as the conditions regarding the ex-post reporting to Parliament[32].

In its public report for 2012, the Court of Accounts identified in the above mentioned report the following 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, the malfunctioning of internal control systems, the absence of control by the MPF to verify the achievement degree of the final objective provided in the law through which have been allocated. It was also noted that there were no significant changes in the conduct of the legislative process by which the funds are allocated, the distribution and utilization of the funds being made, as in previous period, by leaving to the discretion of the project initiators of Government decisions the evaluation and classification of the expenditures that are to be financed from these funds. The Court of Accounts report concludes that "the contingency reserve fund at Government's disposal was not used for the purpose for which it was created, which gave the possibility that, in certain situations, this fund to be used as a way to supplement the budgets of authorizing officers, without the need for allocations to be included in the budget and approved by Parliament."

This report studies the use of the contingency reserve fund at Government's disposal during 2013, based on Government's decisions published in Romania's Official Journal which allocate amounts from the budget reserve fund to line credit officers and to specific destinations.

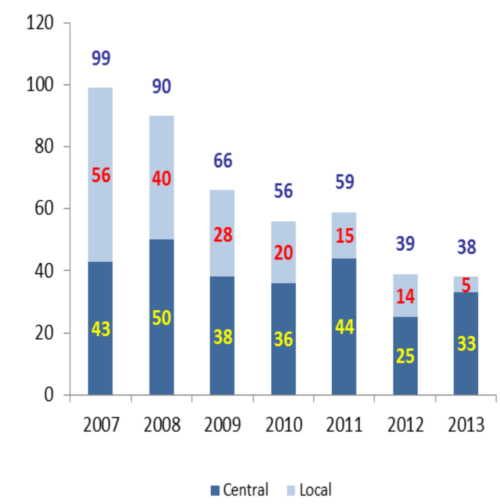
[32] OECD Journal on Budgeting Vol. 4 No. 3 (2004), The Legal Framework for Budget Systems – An International Comparison.

Figure 31: Total contingency reserve fund allocations (billion lei)



Source: Fiscal Council's calculations

Figure 32: Number of Government decisions regarding contingency reserve fund allocations



Source: Fiscal Council's calculations

Thus, during 2013, 950 million lei (0.4% of total expenditure) have been allocated from the contingency reserve fund, of which 800 million lei were allocated for the central administration and 150 million for local authorities). Compared to the previous year, the contingency reserve fund allocations were lower by 425 million lei, i.e. 30.95%, in the context of reduced amounts transferred to local authorities by 645 million lei and increased transfers to central administration by 219 million lei.

Also, this year in can be noted 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 in 2013 totaled approximately 207 million lei, representing about 20% 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. This practice makes it more difficult to pursue the amounts spent from the contingency reserve fund and constitutes an additional argument concerning the discretionary nature of the formation and utilization of this fund.

Considering the international best practice in the field and the Court of Accounts conclusions, the Fiscal Council reiterates the recommendation on the 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 limiting 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. It is true that in recent years there has been noted a significant improvement regarding the reserve fund utilization, but this must be accompanied by an increase in transparency – possible by implementing the principles of the type outlined in the IMF Manual on Fiscal Transparency, as well as by a definitive remediation of the deficiencies identified both by the Court of Accounts and Fiscal Council.

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 fully justified. During a year, this fund may be increased by amounts from the contingency reserve fund, depending on the needs regarding the ensured amounts that are necessary for the removal of natural disasters. In 2013, the amounts allocated from the intervention reserve fund at Government's disposal amounted to approximately 33 million lei and their destinations are in accordance with the Public Finance Law. The complete list of Government decisions that establish the use of the contingency reserve fund can be found in the Annex of this report.

III.4. The public debt

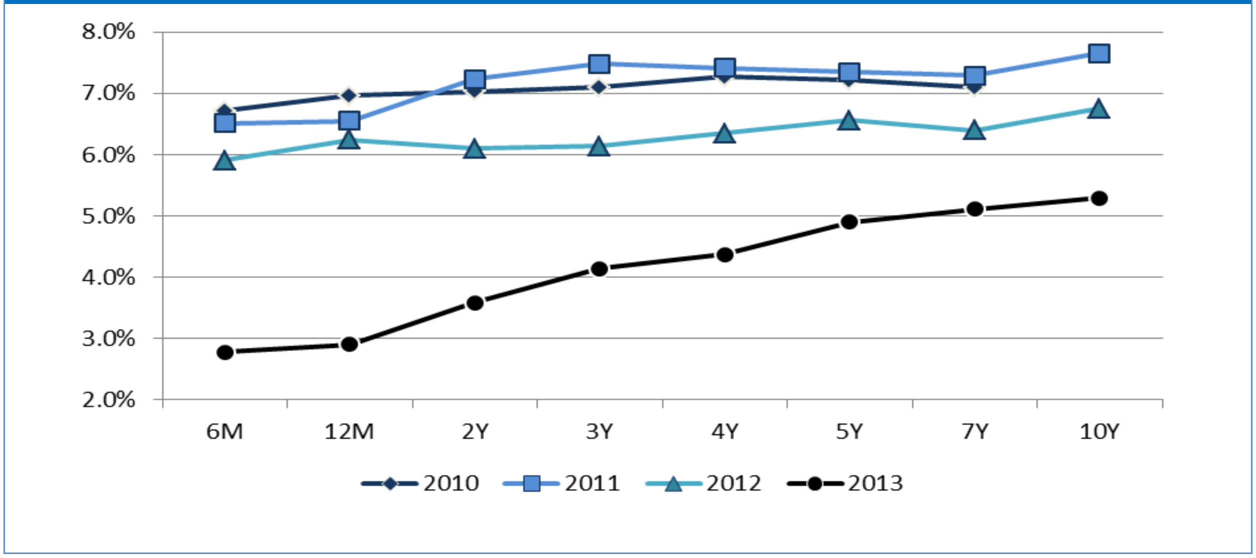
The interest expenses increased in 2013 by 45.4 million lei (i.e. 0.42%) compared to 2012, their share in GDP decreasing from 1.83% to 1.72%, in conditions of a 7.13% nominal GDP advance. The final value of this expenditure chapter was lower than projected in the original budget by 626 million lei (0.1% of GDP) as a result of the significant decrease in financing costs recorded in 2013, whose effect will fully manifest over time, as debt issued in the past will reach maturity and be refunded at currently most favorable costs. In an opposite way acted the decision of the Ministry of Public Finances to additionally raise the Treasury liquidity reserves, in order to finance in advance the budget deficit and create a buffer for adverse conditions in the financial markets. Thus, the MPF aims to ensure the necessary funding in advance for at least four months, the Fiscal Council considering this approach as an optimal one, agreeing with the considered size of the liquidity reserves.

The public debt continued to rise in 2013, but with a much lower pace, its value as a share of GDP increasing, according to ESA95 methodology, to 38.4%[33] from 37.9% at the end of 2012, in the context of a lower budget deficit in 2013, respectively 2.27% of GDP. The growth rate of the public debt decreased, compared to the 3.3 pp. of GDP advance in 2012, due to an economic growth above expectations, and as a result of lower interest paid for contracting loans. Thus, the average interest rate paid on public debt declined from 5.2% in 2012 to 4.5% in 2013. According to national standards, public debt increased to 42.47% of GDP at the end of 2013, compared to 41% in 2012 and 40.1% in 2011.

The cost of attracting new resources in national currency registered a positive development, government bonds yields dropping significantly compared to the level of about 6% at the end of 2012, as a result of the inclusion of the bonds issued by the Romanian state in the calculation of the index series GBI-EM Global Diversified by JP Morgan, reaching the fiscal targets and a liquidity surplus in the financial markets. Thus, considering the conditions of the end of 2013, one can observe a decline in bond yields in the short-terms (less than 1 year) at about 3%, these halving within 12 months, while in the longer-terms (over 5 years) the financing costs decrease is lower, i.e. up to a level of about 5%. Regarding the cost of attracting new resources in foreign currency from external markets, this was also on a downward path in 2013 compared to 2012, the government bonds yields denominated in euro (medium term notes) decreasing from 5.10% in September 2012 and 5.04% in November 2012 to 4.77% in September 2013, respectively to 4.15% in October 2013, while those denominated in U.S. dollars reducing from 6.88% in February 2012 and 6.45% in March 2012, to 4.5% in February 2013.

[33] According to Public Debt Report for December 31st, 2013, published by the Ministry of Finance. The Gross domestic product for 2013: 628,581 billion lei.

Figure 33: The evolution of financing costs in national currency during 2010-2013



Source: National Bank of Romania

Central Government public debt[34] represents 93.64% of the total debt, compared to 93.14% in 2012, while local public debt is 6.36%, slightly decreasing from the level of 6.86% registered in the previous year. Bonds have the largest share in total debt, accumulating 38.9% of the total (compared to 32.1% in 2012), followed by state loans which represents 31.2% (compared to 34.5% in 2012) and euro-bonds with 18.2% (compared to 14% in 2012), while the treasury bills provide 12% of total public debt (compared to 12% in 2012). Thus, two trends can be noted in the management of public debt: on the one hand, a higher proportion of maturing debt is refinanced through financial markets, being preferred longer maturities, while the attracted amounts from external markets experienced a significant increase in the desire to diversify the sources of funding, but also to strengthen the international reserves.

Regarding the maturity structure of government securities newly issued in 2013, certain substantial changes can be noticed compared to previous year, the Ministry of Public Finances succeeding to attract a higher share of resources in the longer-terms. Therefore, the treasury bills with maturities lower than 1 year totals only 19% of new loans in 2013, compared to 47% in 2012, while the share of funding over longer periods advanced significantly, the bonds with maturities longer than 1 year accumulating 81% of the loans. Under these conditions, the average residual maturity of government securities increased to 4.4 years in 2013, compared to

[34] According to ESA95 standards.

3.9 years at the end of 2012[35]. Increasing the share of longer-term state financing was favored by both lower yields and an improved risk perception regarding Romania.

The debt structure by currencies reveals a slight increase in the share of loans in national currency to 43.4% in 2013 from 41.1% in 2012, while the euro financing registered a slight decrease from 46.8% of total in 2013, from about 47.5% in 2012. The loans contracted by the state from the U.S. market increased the share of dollar funding from 5.5% in 2012 to 6.6% in 2013, under the conditions of materializing the intention to diversify the public debt financing.

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.

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

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

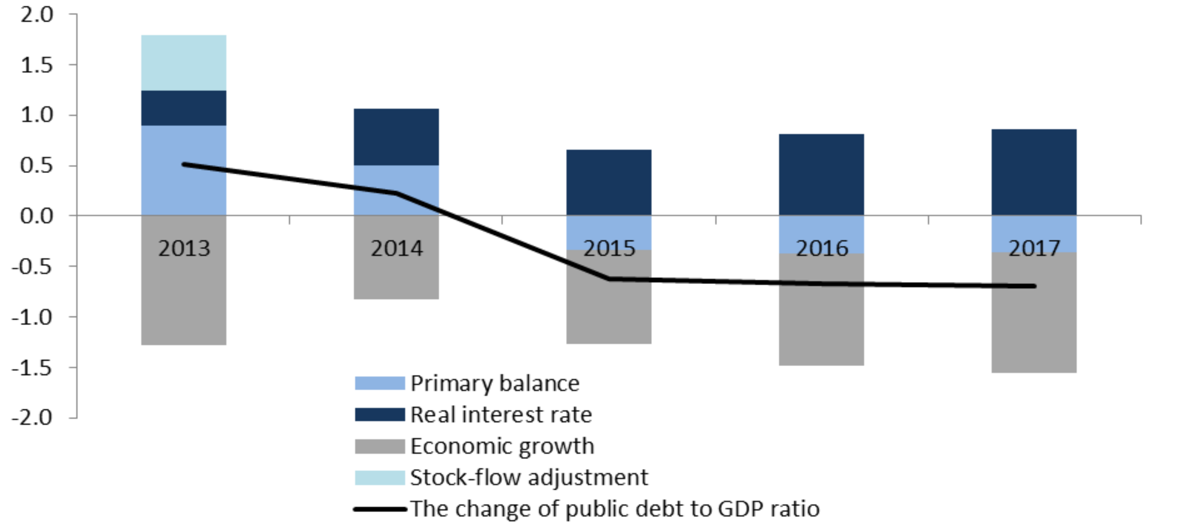
$$1 + \lambda_t = \frac{1 + i_t}{(1 + \pi_t) * (1 + \gamma_t)}$$

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.

[35] According to available data in the Management Strategy of the Government Public Debt 2014-2016, General Directorate Treasury and Public Debt.

Figure 34: Contributions to changes in public debt as share of GDP – 2013-2017 forecasts

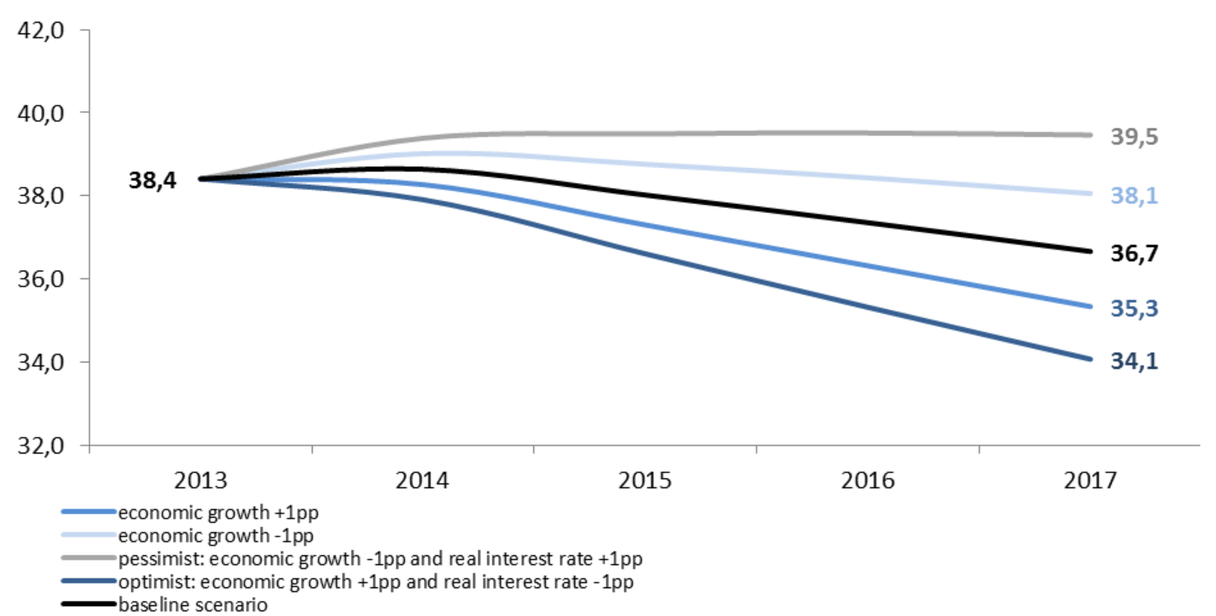


Source: National Prognosis Commission, Ministry of Public Finances, Fiscal Council's calculations

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 2013 and 2017. In 2013, the largest contribution to the increase in the stock of debt was generated by the primary deficit (0.9% of GDP), followed by the stock-flow adjustment (0.5% of GDP), 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. The 3.5% economic advance above expectations in 2013 contributed to the reduction of the debt-to-GDP ratio by 1.3 pp., being higher than the one of the real interest rate of 1%, which leads to a negative value of the coefficientλ_t. In the period 2014-2017, according to the baseline scenario, the public debt is projected to be at a level below that recorded at end of 2013, 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 2014-2017 being negative under the assumption of achieving the 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 an 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 35: Scenarios for the evolution of public debt (% of GDP)



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

Under the baseline scenario, the public debt will register a decrease during 2014-2017 and it is projected to reach a level of 36.7% 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 34.1% of GDP will be observed in 2017. 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 39.5%. Given the significant reduction in funding costs lately whose effect is not yet fully visible and the accelerated economic growth compared with official forecasts, an evolution closer to the one described by the optimistic scenario seems plausible at the time of writing this report.

The steep increase in the public debt from the level of 13.4% of GDP in 2008 to 38.4% of GDP in 2013, both because of the financial and economic crisis and because of the practice of unsustainable fiscal policies in the pre-crisis, will most likely end in 2014, the forecast for the coming years being of gradual reduction in indebtedness.

In the following years, the public debt will reach according to the current projections a lower level than the one of the attention threshold of 45%, defined by the Fiscal Responsibility Law no. 69/2010 with subsequent amendments. The aforementioned Law was amended at the end of 2013, one of the changes being represented by the introduction of public debt thresholds which trigger actions from the Government. Thus, if the public debt exceeds 45% of GDP, the Ministry of Public Finances presents to the Government a justification report for the debt increase and proposals for the maintenance of this indicator at a sustainable level; if the public debt exceeds 50% of GDP, the Government freezes the total expenditures for public wages and eventually adopts additional measures in order to reduce the public debt; if the indicator is higher than 55% the total social assistance expenditures of the public system will automatically freeze. These new stipulations are aimed at preventing the situation in which the public debt would exceed the 60% of GDP threshold, stipulated in the Treaty of Maastricht.

IV. The absorption of EU funds

In the period 2007-2013, Romania was granted 19.2 billion euro of EU structural and cohesion funds, plus 13.8 billion euro of Common Agricultural Policy. Coordinated through the EU cohesion policy, the structural funds are designed to support the convergence of the Member States, increasing competitiveness and employment. Considering these aspects, this report examines the absorption of EU funds in Romania considering only the structural and cohesion funds.

Considering the obligation of the Member States to contribute to achieving Europe 2020 objectives, each country draws up a National Reform Programme (NRP) which transposes the EU's overall objectives into national targets. This document is prepared for a period of three years and provides a platform framework for defining and implementing economic development policies in line with the EU policies with the priorities: achieving smart, sustainable and inclusive economy, delivering high levels of employment, labor productivity and social cohesion. The National Reform Programme 2011-2013, which was submitted by Romania in April 2011, comprised a series of measures targeting higher absorption rates of EU funds.

The annual assessment prepared by the European Commission (May 2013) regarding the progress projected by the National Reform Programme 2011-2013[36], revealed several factors that have contributed to a low absorption rate of EU funds in Romania:

- a public administration undermined by a lack of skills, poor transparency in staff recruitment and management and high management fluctuation rates;
- weak legal framework concerning financial management;
- irregularities encountered in public procurement;
- difficulties associated with the availability of adequate financing lines in the national budget.

Moreover, in the current financial programming period, Romania ranks the last position among the European countries. However, in January 2014 compared to December 2012, Romania registered a significant increase in the rate of absorption of structural and cohesion funds, respectively from 21.85% to 36.65%, according to data from the Ministry of European Funds. Even in these circumstances, the amount of the EU funds drawn stood at just over a third of the funds allocated for 2007-2013.

[36] Commission Staff Working Document, Assessment of the 2013 national reform programme and convergence programme for ROMANIA, Brussels, 29.5.2013, SWD(2013) 373 final.

Table 12: Structural funds absorption by operational programs (million euro)						
	Total allocations 2007-2013	Payments January 2014			Absorption rate	Absorption excl. pre-financing
		Total, out of which:	Pre-financing[37]	Refunds to EU		
Regional Development	3,966.0	1,830.6	551.9	1.278.8	46.16%	32.24%
Environment	4,412.5	1,434.9	574.7	860.1	32.52%	19.49%
Transport	4,425.9	1,064.1	-	1.064.1	24.04%	24.04%
Competitiveness	2,554.2	938.0	191.1	746.9	36.72%	29.24%
Human Resources	3,476.1	1,622.3	548.9	1.073.4	46.67%	30.88%
Administrative Capacity Development	208.0	104.9	5.6	99.3	50.45%	47.74%
Technical Assistance	170.2	47.7	1.2	46.5	28.00%	27.30%
Total	**19,213.0**	**7,042.4**	**1,873.4**	**5,169.0**	**36.65%**	**26.90%**

Source: ACIS, Fiscal Council's calculations

With the highest absorption rate (50.45%) for the Operational Programme Administrative Capacity Development under an initial allocation of only 208 million euros and the lowest rate (24.04%) for the Sectorial Operational Programme Transport that benefited from the largest initial allocation of 4.4 billion euros, Romania still faces serious challenges in terms of the capacity to absorb EU funds.

The absorption of structural and cohesion funds stagnated in the second half of 2012, due to systemic deficiencies revealed in the management and control system.

For certain operational programs (parts of transport and regional development operational programs, and all of the competitiveness, environment and human resources operational programs) which were pre-suspended, the Romanian authorities had to take action and to accept the financial corrections proposed by the European Commission. Following the positive

[37] According to GEO no. 64/2009, prefinancing is the amount transferred to the beneficiaries of structural instruments through direct payments or through indirect payment in the initial stage to support start carrying out projects and/or the implementation thereof, as provided in the agreement/ decision/order financing between a beneficiary and the managing authority/intermediate body responsible/accountable to ensure the proper conduct of the projects financed under the operational programs.

overall assessment on the actions taken by the Romanian authorities, the European Commission decided to resume the payments in December 2012 for the Operational Programme - Regional Development, in February 2013 for the Operational Programme - Human Resources Development, and in March 2013 for the Sectoral Operational Programme - Environment. For the Sectoral Operational Programme - Economic Competitiveness and Sectoral Operational Programme Transport, payments were resumed in the second half of 2013.

Thus, the overall financial corrections applied to Romania amounted to 253 million euros at 31 August, 2013, out of which 87.9 million euro were used for the European Agriculture Guarantee Fund (EAGF) and 35.6 million euros for the European Agricultural Fund for Rural Development (EAFRD).

With 1,064.1 million euros spent until January 2014 (about 24% of the total allocation for 2007-2013), the Sectoral Operational Programme - Transport remains one of the least efficient operational programs. There is however an improvement compared to 2012 when the absorption rate reached about 9%, so that we consider that 2013 is the best year for the Sectoral Operational Programme Transport in terms of EU funds absorption.

The Regional Operational Programme and the Operational Programme - Human Resources Development still remain the best performing programs in terms of structural funds absorption in Romania. The payments of these two programmes amount to 1,830.6 million euro, respectively 1,622.3 million euro, and registered the highest absorption rates of 46.16% and 46.67%, respectively. We can observe a significant dynamic in the case of the Sectoral Operational Programme – Environment, for which the payments amounting to 1,434.9 million euro (almost double compared to the level in the year 2012 of 791.8 million).

Compared to other new member states, the absorption rate in Romania remains the lowest, being only 36.9% after about seven years of EU membership, much less than Slovakia, the penultimate country in this ranking, with an absorption rate of 48.8%, or Bulgaria which registered an absorption rate of 48.8%. This low level of absorption is explained by blockages in attracting EU funds registered in the period 2011-2013. To minimize the risk of losing these funds, Romania received an additional year for drawing European funds for the financial period 2007-2013, respectively until 2015.

Table 13: Absorption of structural funds – comparison with other EU member states					
	Total allocations 2007-2013	Payments, November 2013	Absorption rate	Total allocations /inhabitant 2007-2013	Total payments /inhabitant 2007-2013
	bn euro	bn euro	%	euro	euro
Estonia	3.4	2.7	78.3%	2578	2019
Lithuania	6.8	5.3	77.9%	2280	1776
Poland	67.2	44.9	66.8%	1744	1165
Latvia	4.5	3.0	66.0%	2239	1477
Slovenia	4.1	2.5	61.9%	1992	1233
Hungary	24.9	14.6	58.5%	2515	1472
Czech Republic	26.5	13.4	50.5%	2524	1273
Bulgaria	6.7	3.3	48.8%	916	447
Slovakia	11.5	5.5	48.0%	2125	1021
Romania	19.2	7.1	36.9%	960	354

Source: European Commission

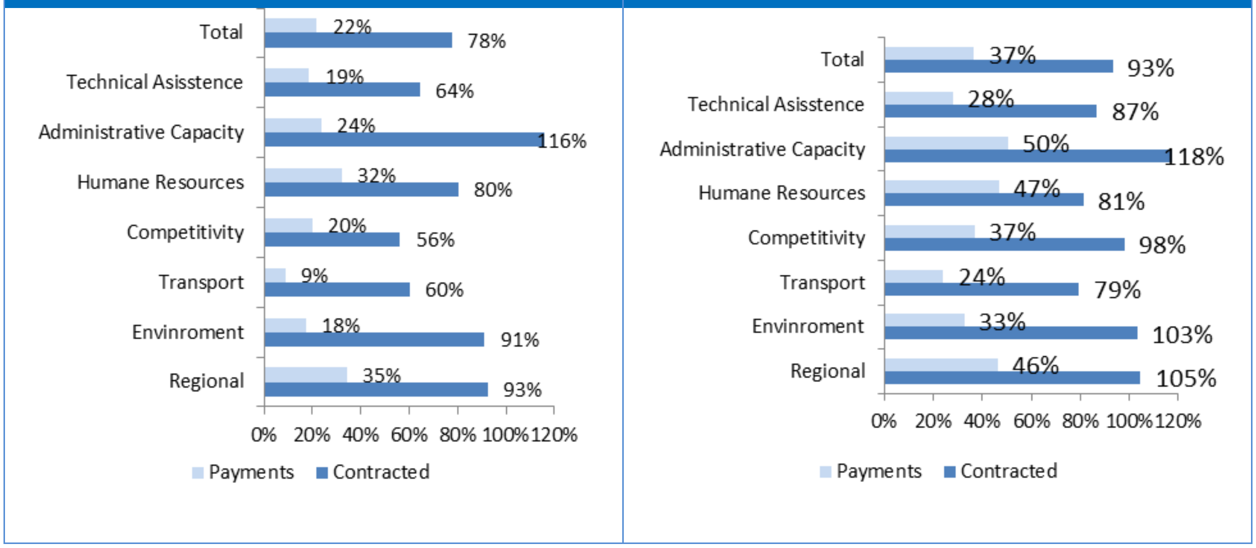
In terms of EU funds absorption, Estonia ranks first among the analyzed countries, with a rate of 78.3%, equivalent to using 2.7 billion euro out of the 3.4 billion euro allocated for 2007-2013. Similar situations are recorded for Lithuania, Poland, Latvia and Slovenia that succeeded to spend 77.9% (5.3 billion euro), 66.8% (about 45 billion euro), 66% (about 3 billion euro) and 61.9% (2.5 billion euro) of the money allocated until now.

Considering the EU funds allocated divided by the number of inhabitants, Romania is also ranked on the lowest position in the EU with 354 euro per capita in November 2013, compared to 2019 euro per capita in Estonia or 447 euro per capita in Bulgaria.

Although, in 2013, one can see an improvement in the process of contracting the structural and cohesion funds, as the contracting rate reached 93% compared to 78% in 2012.

However, there are significant differences between the seven operational programs, the most advanced being the Operational Programme - Administrative Capacity Development with 118% of the total contracted amounts out of the total allocated funds, Operational Programme Regional Development and Sectoral Operational Programme - Environment with 105% and 103% respectively. 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 closure of other contracts.

Figure 36: Absorption of funds: Payments and Contracted



Source: Fiscal Council`s calculations

In contrast, the worst performing program is the Sectoral Operational Programme - Transport, with a contracting rate of only 79% and effective payments of only 24%. The Sectoral Operational Programme – Increasing Economic Competitiveness recorded an enhanced performance, as the contracted sums augmented in 2013 to 98% of the allocated funds, compared with only 56% last year.

Regarding the breakdown by operational programs of EU funds to be contracted[38] in the total, the Sectoral Operational Programme - Transport registered the highest amount of about 909.79 million (55.73% of total), followed by the Sectoral Operational Programme - Human Resources Development (647.48 million euro, 39.66% of the total, respectively).

For the period 2014-2020, there was a shift of EU cohesion policy aiming to maximize the positive impact on growth and jobs, resulting the following directions to take actions (European Commission, Information Note, November 2013):

- Investing in all EU regions and adjusting the level of assistance and national contribution (co-financing rate level) for the development of each region;
- Directing resources toward key growth sectors;
- Establish clearly, transparent and measurable goals and objectives regarding accountability and follow-up;
- Ensure efficient investments using clear specifications when requesting EU funds;

[38] Considering only the programs with a contracting rate less than 100%.

- Establish a common strategy for better coordination and less duplication of efforts;
- Reduce bureaucracy and simplify the use of EU investments;
- Emphasizing the urban dimension of the cohesion policy by reserving an amount of resources from the European Regional Development Fund (ERDF) for the integrated projects in cities, in addition to other expenses in urban areas;
- Strengthening cross-border cooperation and simplifying the creation of projects at cross borders;
- Ensuring better links between cohesion policy and the economic governance of the EU as a whole;
- Encourage better use of financial instruments to support SMEs and facilitate their access to credit.

In addition, a new document is established, respectively the Partnership Agreement between the Member State and the Commission, that contain the essential parts for the management of EU funds programming: Cohesion Fund (CF), the European Regional Development Fund, European Social Fund (ESF) European Fund for Agriculture and Rural Development and the European Fisheries Fund (EFF).

A priority for 2014-2020 represents the research and innovation sector, thus the Horizon 2020 program received about 80 billion euros, the allocations being coordinated at EU level and not at national level.

The total budget for the cohesion policy for 2014-2020 was established in December 2013 and amount to 351.85 billion euro in current prices, being by 1.3% higher than for the period 2007-2013. Half of this budget (174.63 billion euro) is assigned to new EU Member States (Bulgaria, Czech Republic, Croatia, Hungary, Poland, Romania and Slovakia).

The Partnership Agreement proposed by Romania is the document which sets out the financing priorities of our country and the ways to achieve the Europe 2020 Strategy objectives.

The Partnership Agreement proposed by Romania for the programming period 2014 - 2020, in February 2014, establishes six Operational Programmes for the Cohesion Policy, compared to 7 as it was in 2007-2013. The Sectoral Operational Programme - Transport and the Sectoral Operational Programme - Environment will unite and together with the grants awarded for energy sector will form the Operational Programme - Large Infrastructure, the allocations for this program amounting to approximately 9.078 billion euro.

In the financial exercise 2014-2020, according to data from the Ministry of European Funds, Romania will benefit from a total allocation of about 21.1 billion euros of structural and cohesion funds for the operational programs, increasing by about 10% compared to the budget of 19.2 billion euro in 2007-2013. To these allocations can be added a sum around 17.5 billion euro for the Common Agricultural Policy (financed by both instruments EAFRD and EAGF), signifying an increase of 27% compared to the allocation for the Common Agricultural Policy budget in 2007-2013, of 13.8 billion , according to data from the Ministry of European Funds.

Table 14: Comparison between the allocations in 2007-2013 and 2014-2020			
	Total allocations 2014-2020		Total allocations 2007-2013
Regional Development	6,471.0	**Regional Development**	3,966.0
Large Infrastructure	9,077.9	**Environment**	4,412.5
		Transport	4,425.9
Competitiveness	1,266.8	**Competitiveness**	2,554.2
Human Resources	3,591.4	**Human Resources**	3,476.1
Administrative Capacity Development	382	**Administrative Capacity Development**	208
Technical Assistance	300	**Technical Assistance**	170
Total	**21.089,1**	**Total**	**19.213**

Source: Ministry of European Funds

In general, the financial allocations for the future programmes are higher than those of period 2007-2013, except for the Sectoral Operational Programme - Economic Competitiveness, which received only 1.26 billion euro, compared with 2.55 billion euro in the previous exercise, the allocations for the period 2014-2020, being halved. Sectoral Operational Programme - Human Resources Development (converted in the Operational Programme Human Capital Development) will receive 3.59 billion euro in 2014-2020, an amount similar to the level received in 2007-2013 - 3.47 billion euro. Operational Programs with the highest rates of absorption in the previous financial period (2007-2013) will be financed by more than 60% higher (Operational Programme - Regional Development - 6.47 billion euro compared to 3.96 billion euro, the Operational Programme - Development of Administrative Capacity - 382 million euro compared to 208 million euro and Operational Programme Technical Assistance - 300 million euro compared to 170 million euro).

In addition, in the programming period 2014-2020, it was introduced a simplification for the institutional activities, setting the management responsibilities for only 3 ministries:

- Ministry of European Funds will be managing authority for: Operational Programme - Large Infrastructure, Operational Programme - Competitiveness and Operational Programme - Transport;

- Ministry of Regional Development and Public Administration will be managing authority for the Regional Operational Programme and Operational Programme - Administrative Capacity, namely the European territorial cooperation programs;
- Ministry of Agriculture and Rural Development will be the management authority for the National Programme for Rural Development and Operational Programme for Fisheries.

Romania, like other new member states, has received for 2014-2020 a higher allocation for the structural and cohesion funds, compared with the previous financial period (22.9 billion euro from 19.2 billion euro), exception to this rule, being the Czech Republic (22 billion euro compared with 26.5 billion euro), Slovenia (3.1 billion euro compared to 4.1 billion euro), and Latvia, which received the same amount for the next period, namely 4,5 billion euro.

Table 15: Situation of the allocations of the European funds *: 2014 - 2020 compared to 2007 - 2013 - comparison with other EU countries

	Total allocations for EU Cohesion Policy 2014-2020 bn euro	Total allocations/ inhabitant 2014-2020 euro	Total allocations 2007-2013 bn euro	Total allocations/ inhabitant 2007-2013 euro
Poland	77.6	2013	67.2	1744
Romania	22.9	1144	19.2	960
Czech Republic	22.0	2090	26.5	2524
Hungary	21.9	2211	24.9	2515
Slovakia	14.0	2586	11.5	2125
Bulgaria	7.6	1042	6.7	916
Lithuania	6.8	2296	6.8	2280
Latvia	4.5	2229	4.5	2239
Estonia	3.6	2719	3.4	2578
Slovenia	3.1	1493	4.1	1992

Source: European Commission

**The amounts allocated to each Member State include, in addition to structural and cohesion funds, represent the performance reserve and cross-border and transnational cooperation funding, according to the data available on the European Commission website*.

Considering the EU funds allocated for the period 2014-2020 divided by the number of inhabitants, Romania is also ranked on the last but one position with 1149 euro/ inhabitant, exceeding only Bulgaria (1042 euro/inhabitant). It can be seen that the Baltic countries have among the highest allocation per capita also for the next period, respectively Estonia 2719 euro, Latvia 2229 euro and Lithuania 2296 euro.

Romania's performance in terms of EU funds remains poor, being on the last position among the other Member States, with an absorption rate of only 36.9%, well below Slovakia, the next country in the ranking. It is true that in 2013 progress has been made in terms of absorbing European funds, emphasized by the increase of the absorption rate with 15.05 pp compared to the end of 2012. However, given the deadline for drawing EU funds allocated for the period 2007-2013, respectively December 31st, 2015, there are significant risks of losing them and urgent measures are required in order to improve the absorption rate. In the last years, the official forecasts took into account the ambitious targets of attracting EU funds but they have not been achieved, an example being the amounts attracted to the general consolidated budget from EU funds designed to support public investment which accounted only 76.89% of the amounts projected for 2013.

Given that during 2014-2015 two financial exercises are overlapping (2007-2013 and respectively 2014-2020), Romania has a big chance to implement more EU funded projects, but the actions taken so far for the purposes of accessing the amounts related to the new financial exercise seemed to be insufficient for taking advantage of this opportunity in 2014. Considering this aspect, but also the intention of reducing the budget deficit by 0.3 pp of GDP in 2014 and by another 0.75 pp of GDP in 2015 which can be supported by a better degree of EU funds absorption, decisive action is needed in order to start attracting EU funds procedures under the new financial year together with the measures needed to reduce the risks of losing the funds allocated for the period 2007-2013.

The need to improve EU funds absorption becomes more stringent in the context of fundamental changes in the fiscal policy approach. Due to the Fiscal Compact, the fiscal policy's room for maneuver will be reduced in Romania compared to the past, as the rule regarding a maximum effective budget deficit of 3% of GDP is completed with the one of a maximum structural deficit of 1% of GDP. Moreover, the reduced effectiveness of automatic stabilizers is an additional constraint for Romania and in these circumstances, EU funds absorption appears as a solution to stimulate the economy.

V. The structural fiscal position

V.1. EU regulations to ensure fiscal discipline

The stability of public finances plays a distinctive role in ensuring the smooth functioning of the Economic and Monetary Union, as ensuring financial discipline is a prerequisite for achieving a stable price level over the medium term and a sustainable economic growth. In the context of abandoning the exchange rate policy and the independence of the monetary policy, the fiscal policy through automatic stabilizers and discretionary fiscal policy measures, plays a fundamental role in mitigating the economic fluctuations caused by asymmetric shocks that may affect the EMU countries.

More empirical studies show that in an economic union there are significant positive effects if macro policies are coordinated. As the monetary policy decisions are already taken by the Governing Council which brings together the Executive Board of the European Central Bank and the governors of the national central banks of all Member States in the euro area, the sovereign debt crisis in the euro area boosted also the coordination of fiscal policies, emphasizing the need for consistency of the fiscal governance at national level with the European Union one`s.

In this respect, several guidelines on fiscal policy were introduced in the European Union:

- **The Stability and Growth Pact** *(SGP)* - 1997 and **revised SGP** - 2005
- **The European Semester** - 2011
- **The package of six legislative measures on economic governance (Six pack)** - 2011
- **The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG),** including **Fiscal Compact** - 2013
- **The package of two regulations on economic governance (Two pack)** - 2013

Therefore, the economic governance structure of EU is based on three main elements: (a) the *European Semester* for coordination of macroeconomic policies aimed at synchronizing the development of the economies within the European Union, without considerable differences in the macroeconomic indicators and budget deficits below 3%; (b) *the package of six legislative measures on economic governance (Six pack)* and the *Fiscal Compact* that strengthen the Stability and Growth Pact and introduce macroeconomic surveillance; (c) *the package of two regulations (Two pack)* on economic governance which should detect the potential fiscal problems earlier, and provide a legal framework for countries in difficulty.

Table 16: Evolution of the main changes to the rules of fiscal policy during 1997-2013

1997		2005		2011	2013
Council Resolution regarding the *SGP* June 17, 1997 Legislative basis - TFEU Articles 121, 126, 136 and Protocol 12		**Revised SGP**		**Six pack legislative measures on economic governance** (**SGP**, second revision)	**TSCG** (**Fiscal Compact**)
Preventive arm of **SGP** – Council Regulation no 1466/1997	Revised through ->	Council Regulation no 1050/2005	Revised through ->	Council Regulation no 1175/2011	
Corrective arm of **SGP** – Council Regulation no 1467/1997	Revised through ->	Council Regulation no 1056/2005	Revised through ->	Council Regulation no 1177/2011	
				First **European Semester**	
					Two pack legislative measures on economic governance (euro area)

The Stability and Growth Pact[39] was initially adopted in 1997 and entered into force on 1 January 1999, aiming to ensure the macroeconomic stability and the quality of public finances within the European Union. In this first version, the actual government deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP (or at least diminish sufficiently towards the 60%) - limits set by the Maastricht Treaty in 1992. Through the preventive arm, the coordination of budgetary policies is implemented aiming to ensure that budgetary equilibrium converges to the medium-term objective[40] that should be close to balance or in surplus, this condition allowing the member states to manage the normal cyclical fluctuations without

[39] Legislative basis - the Treaty on the Functioning of the European Union (TFEU), Article 121 (preventive arm) and 126 (corrective arm), plus Article 136 and Protocol 12.

[40] MTO is set by Member States in their Convergence programs (for non-euro area countries) or Stability Programs (euro area); these programs are examined by the Council (which send an early warning).

exceeding the reference value. The medium-term objective should ensure a rapid progress towards a sustainable situation, while generating an appropriate fiscal space for discretionary fiscal policy measures.

Therefore, the MTO should allow the countries to deal with the normal cyclical fluctuations while keeping the deficit below 3% of GDP, being necessary that MTO position will ensure stabilization over the economic cycle (thus making the connection between the preventive and corrective arm), pursuing near optimal fiscal policies so as to ensure economic stability and guarantee room for maneuver for automatic stabilizers.

The first amendment to the Stability and Growth Pact was introduced in 2005, and the main purpose consists in considering the special economic circumstances and the specific characteristics of each country, as the uniform approach had shortcomings.

The first European Semester was introduced in the first half of 2011, being a common tool used for the coordination of the economic and fiscal policies for all EU member states, by monitoring fiscal discipline, macroeconomic stability and by promoting growth policies, including the 2020 Strategy. The Member States that do not follow the EU recommendations will be fined. The European Semester contains a clear timetable, under which Member States receive recommendations from the European Union therefore the consolidated financial supervision is ensured, under the Stability and Growth Pact.

To ensure the implementation of necessary policies and the widest possible participation, it requires both the cooperation with the European Parliament and other European institutions with advisory role (the Committee of the Regions, the Economic and Social Committee) and the full involvement of the national parliaments, social partners, regions and other stakeholders.

The European Semester begins in January, when the Commission shall submit a report assessing the extent to which Member States have taken into account the recommendations of the Council in the previous year. The European Council meets in March of each year, identifies the main economic challenges facing the European Union and provides strategic advice on policies, based on the report presented in January by the Commission.

Taking into account these recommendations the Member States shall present their medium-term budgetary strategies in their Stability and Convergence Programmes. At the same time, the national governments have to project national reform programs, which should determine the actions to be taken to consolidate their policies in areas such as employment and social inclusion.

All these programs should be launched simultaneously in April. In June and July, the Council of Ministers of Economy and Finance (ECOFIN) and the European Council elaborate the guidelines and the country-specific recommendations on fiscal and economic policies, under which the Member States finalize their budgets for the next year.

In order to eliminate the loopholes and weaknesses identified during the recent economic and financial crisis, a second amendment to the Stability and Growth Pact was introduced in 2011, being known as the Six pack - a legislative package on economic governance[41]. Whereas is applied to all 28 Member States of the European Union, there are specific rules for the euro area countries (financial sanctions that are applied gradually, from preventive arm until the last stages of the excessive deficit procedure, could reach 0.5% of GDP).

The macroeconomic imbalances procedure setting up aimed to attain both the macroeconomic and the fiscal surveillance. This legislative package includes for the majority of sanctions, the procedure of the reverse qualified majority voting, which means that a recommendation or a proposal of the Commission is deemed to be adopted in the Council unless a qualified majority of Member States vote against it. Besides this, it sets more rigorous fiscal rules, by defining in quantitative terms the "significant deviations" from the MTO or from the adjustment path (preventive arm) and reinforces the Stability and Growth Pact, strengthening both the preventive and the corrective arm, for instance the Excessive Deficit Procedure, for both the budget deficit and public debt.

Furthermore, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union[42] (Fiscal Compact) requires the contracting parties to ensure the convergence towards country-specific MTO (as specified in the Stability and Growth Pact), to a lower limit of the structural deficit (0.5% of GDP and 1% of GDP respectively for the Member States with a public debt significant below 60% of GDP).

Identifying the fundamental fiscal position is based on the definition and calculation of the structural or cyclically adjusted budget balance. The two indicators are similar, the difference being the elimination from the cyclically adjusted balance of the temporary and one-off measures. In essence, the cyclically adjusted budget balance represents the level of the budget balance which is obtained considering that the economy is at its potential level. Thus, it can be used to identify the measure in which the changes in the fiscal position (taxes, transfers, expenses) are the result of the macroeconomic circumstances or the consequence of discretionary measures regarding the fiscal policy. In practice, the effective budgetary position

[41] Entered into force on December 13th, 2011 and it is part of the EU secondary legislation. It contains 5 Regulations and 1 Directive.

[42] It was signed on March 2, 2012 and entered into force on 1 January 2013, after ratification by Finland on 21 December 2012. In Romania was published the Law 83/2012 for the TSCG ratification in the Official Gazette 410/2012.

is decomposed into two factors - temporary and permanent. Schematically, the cyclically adjusted deficit determination is based on the identity:

effective budget balance = cyclically budget balance (automatic stabilizers) + cyclically adjusted budget balance (discretionary policies)

The fiscal policy objectives can be defined much better in terms of the cyclically adjusted budget balance, ensuring long-term sustainability of public finances while allowing automatic stabilizers to reduce the 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 the case of economic boom, budget revenues from value added tax, excise tax, social security contributions, income tax and other tax will increase, reducing the incomes of economic agents and population, thus contributing to the economic growth slowdown and the return to its potential GDP. In the case of a recession, lowering tax revenue and increasing expenditure on unemployment benefits, with a positive impact on revenues of firms and households, thereby will help the economic recovery and the return to the potential GDP.

The effectiveness of automatic stabilizers depends on the size of the government sector and the elasticity of revenues and expenditures to cyclical variations in the economy. The larger the size of the government sector and the higher the changes of the revenues and expenditures with respect to the cyclical fluctuations of the economy, the stronger the softening effect of automatic stabilizers on the economic fluctuations.

The global economic crisis has shown that, in terms of demand shocks, the monetary policy is not able to provide a sufficiently strong response if the transmission mechanism is blocked by the conditions in the financial markets.

Expansionary discretionary fiscal policy can be used in this case, under the conditions of the existence of an adequate fiscal space, but has several disadvantages: requires a relatively long time for implementation, including the political deliberations and it is not automatically reversed when the position within the economic cycle changes. Automatic stabilizers do not have these disadvantages, but their effectiveness depends on fiscal policy and institutional choices. For example, the literature shows that the effectiveness of automatic stabilizers can be increased in particular by increasing the share of the government sector or increasing the tax progressivity[43].

[43]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.*

Using the cyclically adjusted budget deficit does not target only the issue of fiscal sustainability: its annual variation (the fiscal impulse) is a commonly used tool to assess the impact of the fiscal policy on the aggregate demand. Thus, a positive fiscal impulse, corresponding to an increase in the cyclically adjusted deficit reflects a simulative fiscal policy, while a negative fiscal impulse, corresponding to a reduction in the cyclically-adjusted deficit, indicates a restrictive fiscal policy. The fiscal impulse analyzed together with the cyclical position of the economy allows assessing the extent to which fiscal policy contributes to accomplish the role of macroeconomic stabilization - acting by diminishing the pressures from aggregate demand in times of economic expansion, or stimulate aggregate demand during recession.

Furthermore, the corrective mechanisms provided in TSCG must provide automatic actions to be taken in the case of deviations from the MTO or from the adjustment path, accompanied by escape clauses for exceptional circumstances. The rules regarding the budget must be implemented into national law by permanent provisions, preferably constitutional, and must be monitored nationally by independent institutions.

TSCG strengthens the surveillance and coordination of economic activities through ex ante coordination of plans for issuing debt securities for the contracting parties, and establish economic partnership with Member States regarding the excessive deficit procedure (structural reforms for sustainable correction of excessive deficits). Also, elements of economic governance in the euro area are introduced (by strengthening economic cooperation, the establishment of the Euro Summits at least twice a year) and the Stability and Growth Pact is reinforced through reforming the rules on public debt established by the Six pack.

The medium-term objective of the structural deficit that Romania needs to align accordingly to its status as EU member state, is determined based on the deficit that stabilizes the share of public debt stock in GDP plus an adjustment due to the incorporation of a share of the costs of aging over the long-term.

The MTO has been revised upward for Romania by the European Commission to 1.25% of GDP (from 0.7% of GDP previously) due to the favorable impact of structural reforms in pension system implemented in recent years over the costs related to aging, reassessed in the context of preparing the *Ageing Report 2012* by the European Commission.

However, given the fact that the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, ratified by Romania, sets a maximum limit of 1% of GDP for the structural deficit for countries with a low level of public debt (significant below 60% of GDP), the operational medium-term objective for Romania is set at the latter level.

The compliance with long-term medium-term objective will require a very strict control over public finances in Romania, and this has clear advantages and disadvantages. An important advantage is the impossibility of conducting pro-cyclical fiscal policies and imposing a tighter fiscal discipline, given that Romania has a negative historical experience in this field. The downside risk of the new European fiscal rules for Romania is that the room for maneuver available to help stimulate the economy in times of recession will be very low. In Romania, the limit of structural deficit of 1% of GDP is likely to be attained before the effective budget deficit to reach 3% of GDP, making it significantly more constraining than the Maastricht criterion *per se*.

The structural deficit is a measure of the budget position related to the economic situation, i.e. the fiscal policy effort resulted in changes in the structural deficit. In recent years, the role of the cyclically adjusted budget balance in the formulation of economic policies at the European level has significantly increased. Before reviewing the SGP in 2005[44], the cyclically adjusted budget deficit was used as a tool to assess more effectively the fiscal position of the Member States within EMU, while after the later SGP reform, it became a benchmark for the fiscal surveillance mechanism within the European Union. The key requirements imposed on fiscal policy for the euro area member states are expressed in cyclically-adjusted terms and net of temporary and one-off measures.

Table 17: The evolution of the main rules at EU level to ensure fiscal discipline
Corrective arm of **the SGP**
Prior to 2005: provisions related to the actual budget deficit less than 3% of GDP.
After 2005: provisions related to the actual budget deficit less than 3% of GDP and a structural deficit of maximum 1% of GDP.
Preventive arm of the **SGP**
The structural deficit should be at or converge towards the MTO. Annual improvement of the budget deficit should be 0.5% of GDP.
The role of the structural deficit is confirmed by:
Two pack (2011) and Six pack (2013)
TSCG (Fiscal Compact) in 2013

The package of two regulations on economic governance (applicable only to euro area countries) entered into force on 30 May 2013 and represents the European Parliament`s and

[44] Article 5, Council Regulation no. 1466/1997: "When assessing the adjustment path towards the MTO, the Council and the Commission shall examine if the Member State concerned pursues an appropriate annual improvement of the cyclically adjusted budget balance, net of one-off. Article 3, Council Regulation no. 1467/1997: "In its recommendation, the Council invites the Member State to achieve annual budgetary targets ... in accordance with a minimum annual improvement of at least 0.5% of GDP as a benchmark for the structural deficit to ensure the correction of the excessive deficit".

the European Commission`s regulations for monitoring and assessing of the initial budget plans, including the measures to correct the excessive deficits in the countries of euro area by strengthening the surveillance mechanism. Common budgetary rules should be monitored by independent institutions.

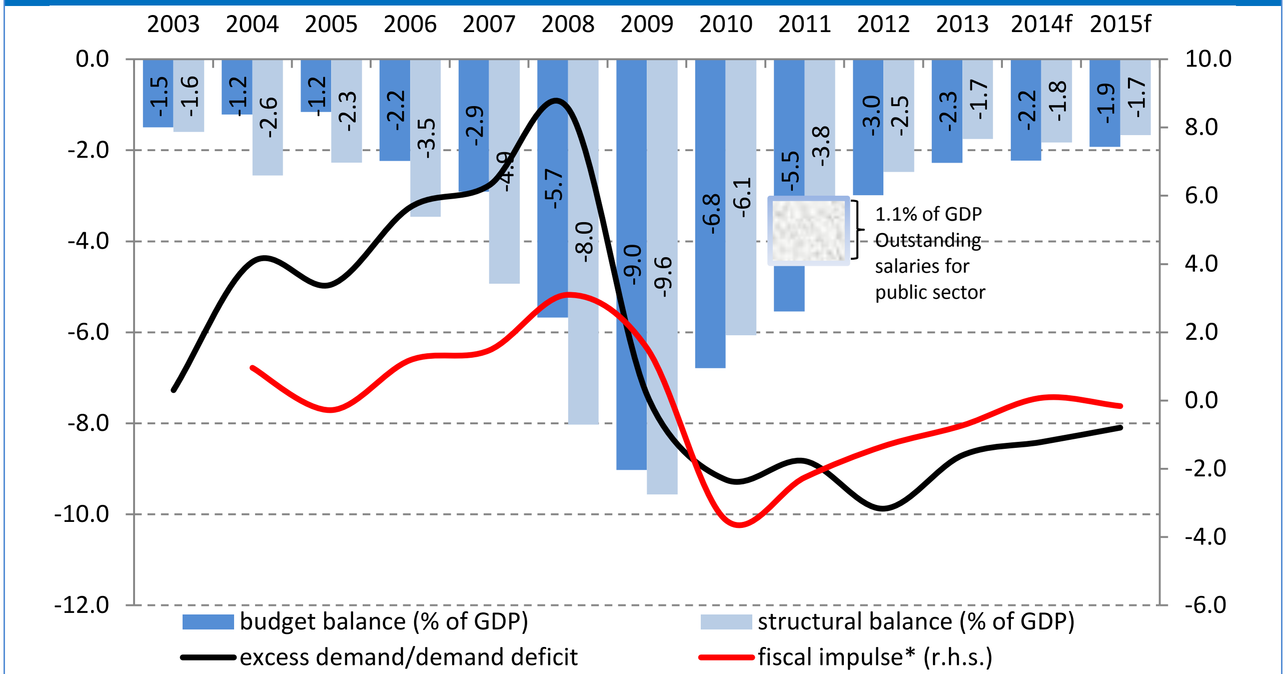
The expected results following the implementation of the new treaties are: (a) a more accountable budget allocation through better rules and better enforcement; (b) a gradual supervision (for euro area countries that have large debts and deficits or difficulties regarding their financial stability) to limit the spillover effects by means of preventive measures and early warning mechanisms; (c) a correction of macroeconomic imbalances by intensifying the monitoring of the economic policies; (d) coordination and guidance during the year, based on a clear timetable.

V.2. The structural budget balance in Romania

In Romania, during the period of the rapid economic growth before 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, the pro-cyclicality of the fiscal policy during the pre-crisis economic boom has exhausted the required fiscal space to stimulate the economy during the recession that followed; the need to reduce the budget deficit during the crisis (primarily due to funding constraints) therefore implied, inevitably, to maintain the pro-cyclicality of the fiscal policy. Consequently the automatic, beneficial and stabilizing action of the cyclically deficit (the automatic stabilizers) was canceled by the pro-cyclical discretionary policy.

Figure 37: Structural deficit, fiscal impulse and excess demand



*change in the primary structural balance (% of GDP) (+ stimulus effect , - c ontractionary effect)

Source: AMECO, Fiscal Council`s calculations

In 2009-2013 the structural deficit was reduced from 9.5% of GDP to 1.7%, the average rate of the adjustment of 1.56 percentage points per year being extremely fast (see *Figure 37*); at the same time we have to remember that the starting level was high, which required a rapid adoption of decisive measures to ensure the sustainability of the fiscal policy. It should be noted that this adjustment was made mostly in 2010 and 2011, when the structural deficit was reduced on average by 2.7 percentage points per year, achieved mainly on the expenditure side through reforms in the public personnel wages, in the pension system and in the budget programming. On the other hand, on the revenue side, the most important measure was the increase in the standard VAT rate from 19% to 24% since July 2010. According to the EC, the year 2013 recorded a structural adjustment of 0.8 percentage points of GDP, a level significantly lower than that of 1.4 percentage points of GDP recorded in 2012, but substantial in nominal terms. For the period 2014-2015, the EC expects a low variation of the structural deficit in the range of 1.7-1.8% of GDP, while the actual deficit is projected to decline by 0.4 pp of GDP at the end of 2015, due solely to improvements in the cyclical component. It is worth noting that the EC forecasts are different from those of the Romanian authorities included in the Convergence Programme 2014-2017, which take into account reaching the medium-term objective of 1% of GDP in 2015.

The European Commission notes that despite recording in 2014 of a slight deterioration in the structural balance, Romania comply with the Stability and Growth Pact requirements in 2014, taking into account the temporary deviation permitted for the jointly financed projects. For 2015, however, there is a risk of significant deviations from the necessary structural adjustment, taking into account the compensation for the temporary deviation permitted for the jointly funded projects. In addition, it is expected that in 2015 Romania will deviate from the expenditure benchmark. Based on its assessment of the Convergence Programme and based on the EC forecasts, on the base of the Council Regulation (EC) no. 1466/97, the European Council considers that in 2015, the program faces the risk of a significant deviation from the requirements of the preventive arm.

Consequently, after examining the Convergence Programme 2014-2017, the European Council recommended that Romanian authorities have to implement the budgetary strategy for 2014, to significantly improve the fiscal effort in order to ensure the achievement of the medium-term objective in 2015, in accordance with the commitments under the balance of payments program, as reflected in the 2014 edition of the Convergence Programme, in particular by specifying the measures to be taken for this purpose, and to preserve the level of the medium term objective afterwards.

The structural budget balance, even if it reflects more accurately the fiscal position of an economy, presents a number of disadvantages, the most important being related to the uncertainties associated with its assessment. Thus, the structural balance is dependent on the output gap, which is often subject to more or less significant revisions. Compared to the previous edition of the Fiscal Council`s annual report, the structural deficit has been revised from 4 to 3.8% of GDP in 2011, from 2.7 to 2.5% of GDP for 2012, the estimate of 1.7% of GDP for 2013 being validated by the currently available data.

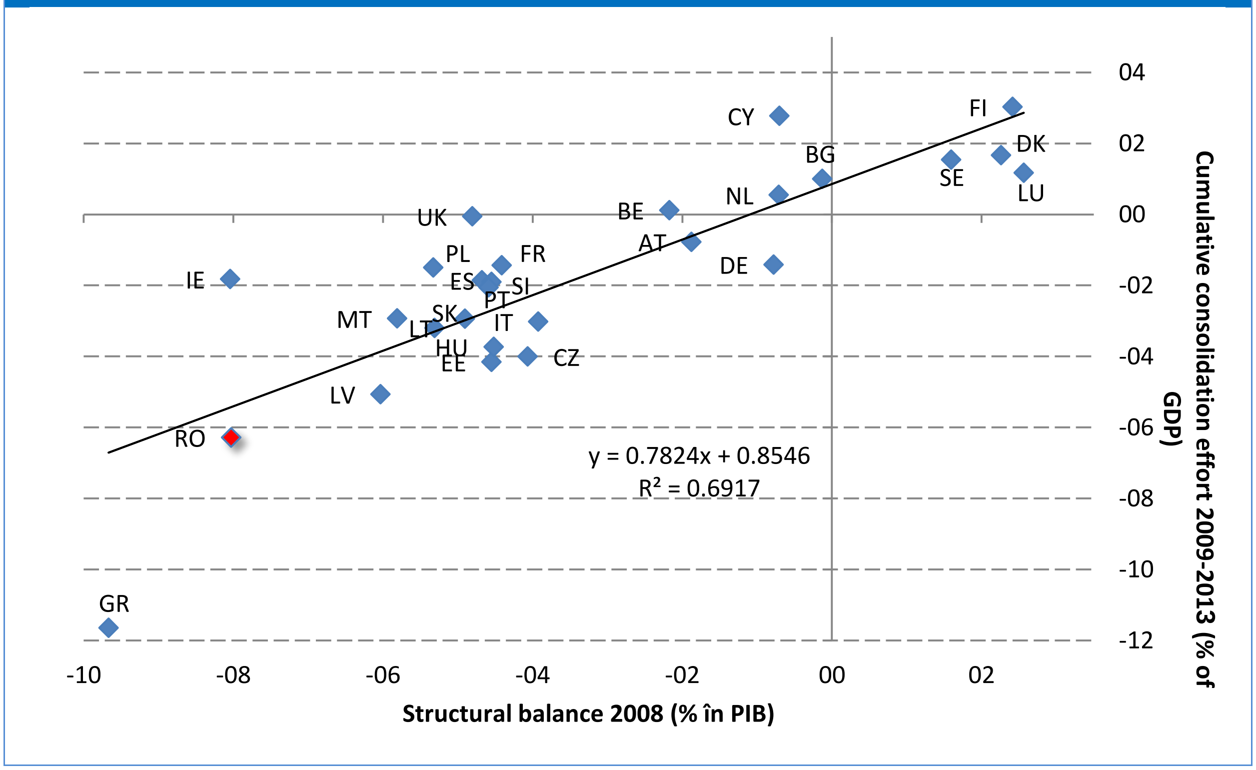
As it can be seen from the table below, the review for the year 2012 was due to the revision of the output gap from -2.1% of potential GDP in Spring 2013 to -3.2% of potential GDP a year later, which caused amending the cyclical component from -0.66% to -1% of GDP. In 2013, compared to initial projections of -0.81% of GDP, the cyclical component was at a level of only -0.5% of GDP and the structural deficit of 1.7% of GDP was achieved due to an effective deficit by 0.3 pp of GDP lower than the initial projections.

Table 18: Evolution of EC forecasts concerning output gap, cyclical component of the budget balance, structural deficit and actual deficit							
Indicator	Year	Autumn 2012	Winter 2013	Spring 2013	Autumn 2013	Winter 2014	Spring 2014
Output gap	2012	-3.10	-3.70	-2.10	-2.30	-2.90	-3.20
	2013	-3.30	-4.50	-2.60	-1.80	-1.40	-1.60
Cyclical component	2012	-0.98	-1.17	-0.66	-0.73	-0.92	-1.00
	2013	-1.03	-1.40	-0.81	-0.56	-0.44	-0.50
Structural deficit	2012	-1.90	-2.20	-2.70	-2.70	-2.50	-2.50
	2013	-1.40	-0.90	-1.70	-1.90	-2.10	-1.70
Effective deficit	2012	-2.80	-2.90	-2.90	-3.00	-3.00	-3.00
	2013	-2.40	-2.40	-2.60	-2.50	-2.60	-2.30

Source: European Commission

Regarding the estimated cumulative adjustment for the period 2009-2013, that undertaken by Romania is the second most ambitious in the European Union - however, the figure below shows that the adjustment effort is directly proportional to the size of the initial structural fiscal imbalance (2008).

Figure 38: The Size of the Consolidation Effort 2009-2013



Source: AMECO, Fiscal Council`s calculations

In conclusion, the performance of Romania in the period 2008-2013 in terms of amending fiscal imbalances, judged by the structural deficit criteria is very good considering its magnitude, so a necessary additional fiscal consolidation in the medium term objective is reduced compared to the adjustments made so far. However, Romanian authorities' commitment to achieve the MTO initially in 2014 and now in 2015, seems not to be sufficiently strong, as the currently EC forecasts assess that this target will be not achieved.

VI. The Sustainability of Public Finances

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

According to the Ministry of Public Finances, the arrears of state owned companies represent delayed payments by more than 30 days compared to contractual or legal terms that generate payment obligations to banks, state budget, social security budget, suppliers and other creditors.

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), because, if these companies fail to streamline their activity, the Government will eventually be forced to intervene with public resources, which may lead to a deterioration of public finances, respectively by increasing the budget deficit. It is worth noting that since 2000 reducing the arrears of the state owned companies has been a constant concern of the Government, the SOEs being closely monitored, inclusively under the agreements with international financial institutions (IFIs). However the pace of their decline was a slow one, the undertaken targets being missed on several occasions. Moreover, the last review[45] of the precautionary agreement completed with IFIs revealed that, of the five targets set with the Government for December 2013, only the target for SOEs arrears was not fulfilled (the achieved level being 7.2 billion lei compared with the target of 5.6 billion lei).

At the end of 2013, there were 1,086[46] SOEs that reported financial statements to the Ministry of Public Finances, most of them being organized as companies and autonomous administrations, with an aggregate turnover of nearly 46.9 billion lei (2.94 billion lei smaller than the value recorded in the previous year). Although the contribution of these companies to the overall economy turnover was only 4.4% in 2013, the accumulated outstanding payments represented 19.8% of the arrears registered in the economy, both indicators continuing the downward trend compared to the peak reached in 2009 (6% for the contribution of SOEs to the overall economy turnover and 35.5% for the accumulated outstanding payments by the SOEs of the total arrears registered in the economy). The stock of arrears for the 1,086 SOEs represented 3.6% of GDP, following the same downward trend as the above-mentioned indicators (6.9% of GDP, peak reached in 2009). The data show that although the share of SOEs

[45] IMF Country Report No. 14/87, March 2014.

[46] It should be noted that a number of state companies that reported financial data in previous years and which are still active are missing from the database of financial statements for 2013 received by the Fiscal Council from the Ministry of Public Finance.

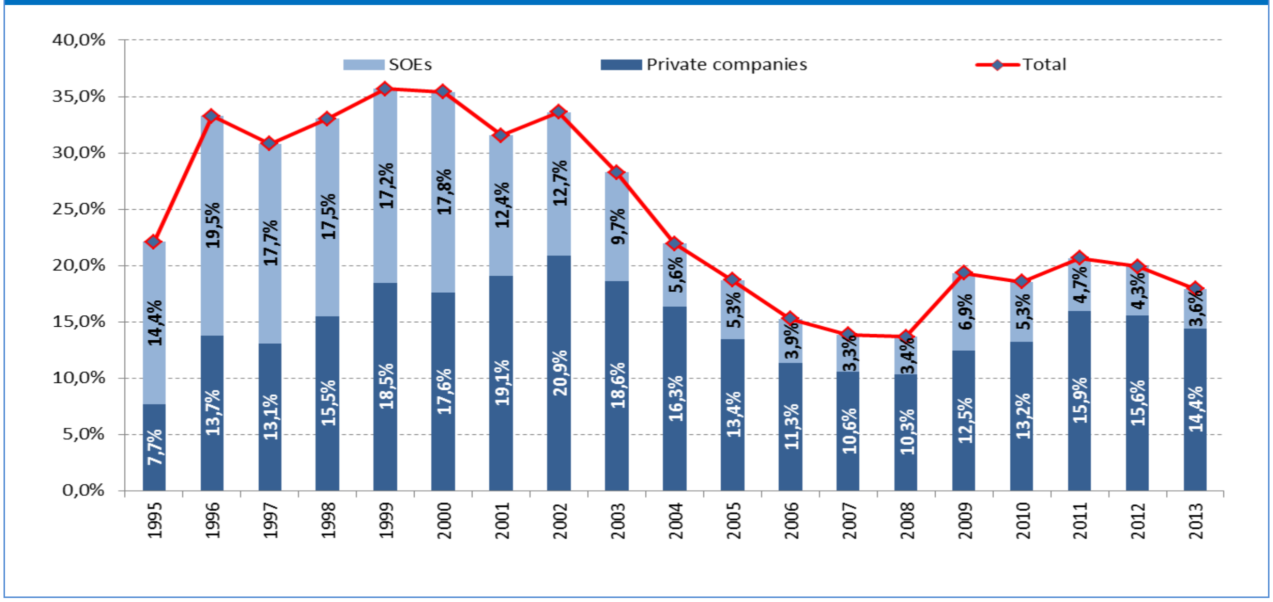
arrears remains important, their contribution to gross value added for the total economy is still modest (10.5%), close to the previous minimum recorded in 2008 (10.7%). The gross value added in absolute terms was marginally higher compared to the previous year (23,805 million lei compared to 22,339 million lei), but the growth rate was lower than that in the private sector. The number of employees in state owned companies continued to decline from the maximum level recorded in 2007 (406 thousand of persons), reaching 294 thousand of persons in 2013, representing 7.7% of total employees in the economy, and the gross profit of state owned companies was negative in 4 of the 8 years analyzed, 2013, however, recording the best performance in the period under review (i.e. a 3,093 million lei gross profit).

Table 19: The evolution of the number of SOEs that report financial statements by components								
	2006	2007	2008	2009	2010	2011	2012	2013
Autonomous administrations	129	128	117	150	152	173	180	184
Companies owned 100% by the state	411	385	358	333	389	437	431	456
National companies and societies	40	50	41	45	50	61	48	41
Other companies entirely owned by state or where the state is the major shareholder	80	62	51	51	57	130	132	148
State-owned companies, local and foreign state capital (state capital >= 50%)	7	13	5	25	9	44	40	55
State-owned companies, local and foreign private capital (state capital >= 50%)	23	21	7	20	9	16	18	19
State-owned companies and with local private capital (state capital >=50%)	158	105	85	87	82	98	85	93
State-owned companies and with foreign private capital (state capital >=50%)	5	5	4	11	12	15	12	18
State-owned companies, privatized in the reporting year	58	50	50	52	31	74	60	72
Total number of SOEs	**911**	**819**	**718**	**774**	**791**	**1048**	**1006**	**1086**

Table 20: The evol. of certain fin. indicators of Romanian companies that report financial statements considering the form of ownership									
		2006	2007	2008	2009	2010	2011	2012	2013
Companies number	SOEs	911	819	718	774	791	1,048	1,006	1,086
	Total companies excluding financial sector	564,408	617,272	663,860	602,190	613,080	644,379	630,066	627,545
	Share of SOEs in total	0.2%	0.1%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%
Total income, mn lei	SOEs	48,491	51,953	56,660	50,756	55,022	58,511	49,853	46,906
	Total companies excluding financial sector	625,162	779,968	977,619	845,396	920,600	1,056,190	1,072,777	1,061,016
	Share of SOEs in total	7.8%	6.7%	5.8%	6.0%	6.0%	5.5%	4.6%	4.4%
Gross value added, mn lei	SOEs	16,527	19,048	21,744	20,454	22,881	24,202	22,339	23,805
	Total companies excluding financial sector	135,261	166,722	203,875	189,633	195,849	196,151	197,392	227,615
	Share of SOEs in total	12.2%	11.4%	10.7%	10.8%	11.7%	12.3%	11.3%	10.5%
Employees number, thousands of persons	SOEs	396	406	390	364	364	343	327	294
	Total companies excluding financial sector	4,351	4,620	4,618	4,019	3,962	4,094	4,066	3,836
	Share of SOEs in total	9.1%	8.8%	8.4%	9.1%	9.2%	8.4%	8.0%	7.7%
Gross profit, mn lei	SOEs	1,525	1,400	-1,026	-2,777	-2,101	1,372	-561	3,093
	Private companies	42,614	43,008	23,513	19,914	27,934	10,421	15,623	23,856
Arrears, mn lei	SOEs	13,557	13,690	17,294	34,405	28,012	26,251	25,363	22,348
	Private companies	39,101	44,050	53,127	62,406	69,193	88,882	91,536	90,358
	Total companies excluding financial sector	52,658	57,740	70,422	96,811	97,205	115,133	116,899	112,707
	Share of SOEs in total	25.7%	23.7%	24.6%	35.5%	28.8%	22.8%	21.7%	19.8%
Arrears, % of GDP	SOEs	3.9%	3.3%	3.4%	6.9%	5.3%	4.7%	4.3%	3.6%
	Private companies	11.3%	10.6%	10.3%	12.5%	13.2%	16.0%	15.6%	14.4%
	Total companies excluding financial sector	15.3%	13.9%	13.7%	19.3%	18.6%	20.7%	19.9%	17.9%

Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

Figure 39: The evolution of SOEs' and private companies' arrears (% of GDP)



Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

After a significant reduction of the outstanding payments share in total economy from 35.4% of GDP in 2000 to 13.7% of GDP in 2008, the financial crisis that started in 2008 has led their increase to 20.7% of GDP in 2011, but without reaching the very high values from the early 2000s. The SOEs' and private companies' arrears as a percentage of GDP have declined starting with 2012 (19.9% of GDP), and the decreasing rate was more pronounced in 2013, reaching a level of 17.9% of GDP.

Figure 40: Arrears (% of turnover)

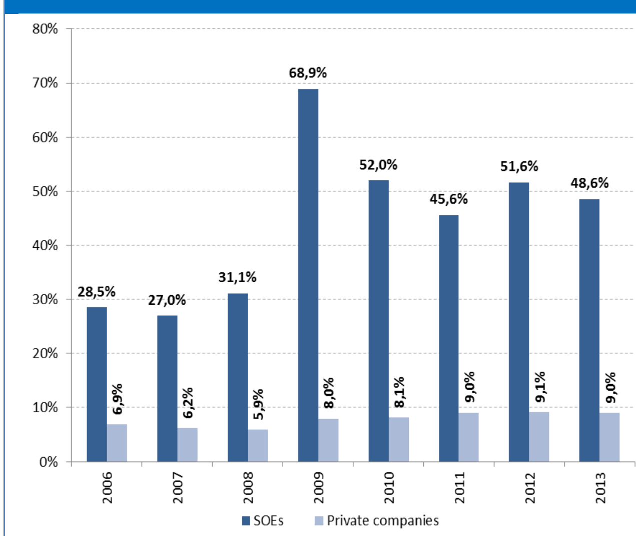
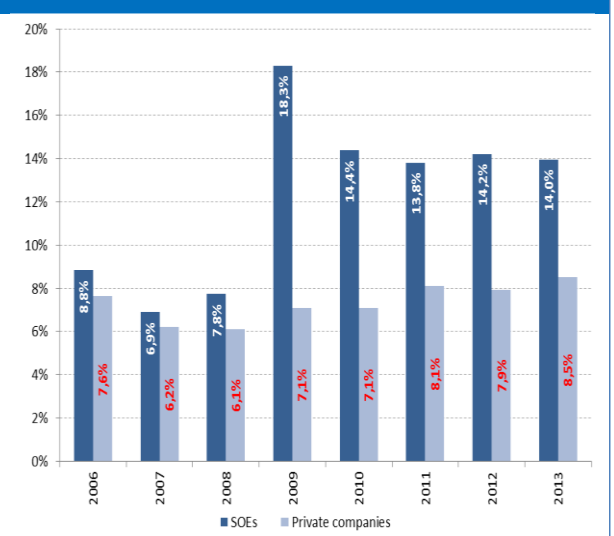


Figure 41: Arrears (% of total assets)



Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

In addition, most of the SOEs' arrears are to the general consolidated budget (50% of total arrears), especially to the social security budget, unlike the private companies that have arrears mostly to the suppliers (52% of total arrears). The total outstanding debts to the general consolidated budget amounts to 11.26 billion lei (1.8% of GDP) in December 2013, of which 6.1 billion lei are to the social security budgets (1% of GDP). In general, the state owned companies do not pay on time their debts to the general consolidated budget (especially to the social security budgets) and to other companies.

The suppliers rank second among creditors of SOEs in 2013, the amount due by them being 5.9 billion lei (1% of GDP and 26% of total arrears). The decrease in the share of SOEs' arrears to the suppliers by 40% in 2013 compared to the previous year can be explained mainly by the Law no. 72/2013 regarding the measures to combat the delay of the payment obligations resulting from contracts between professionals and between them and contracting authorities (the transposition of the Directive 2011/7/EC provisions on combating late payments in commercial transactions). Thus, in case of commercial transactions in the private sector, as well as for goods and services purchased by the state from private companies, the statutory payment period (if the payment date is not stated in the contract) is 30 calendar days, and the contractual payment period (stated in the contract) in case of economic transactions in the private sector can be maximum 60 days.

The law establishes that both the state and the economic agents from the private sector will owe penalty interest, if the goods or services purchased are not paid on time (the central bank's reference rate plus eight percentage points).

Figure 42: Structure of arrears - SOEs (million lei)

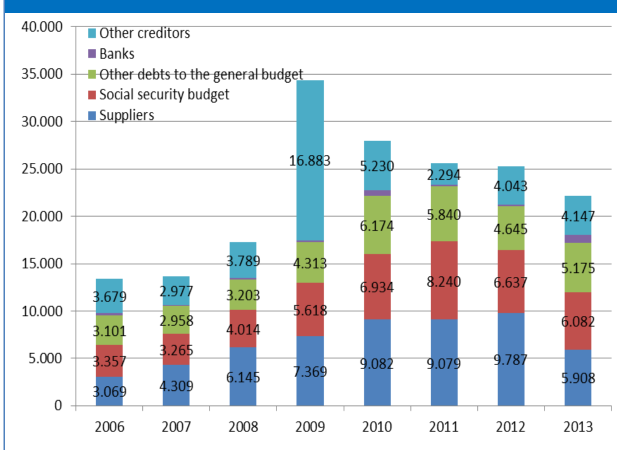
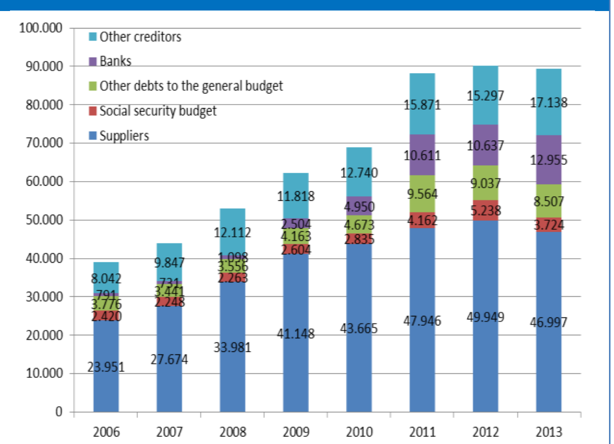


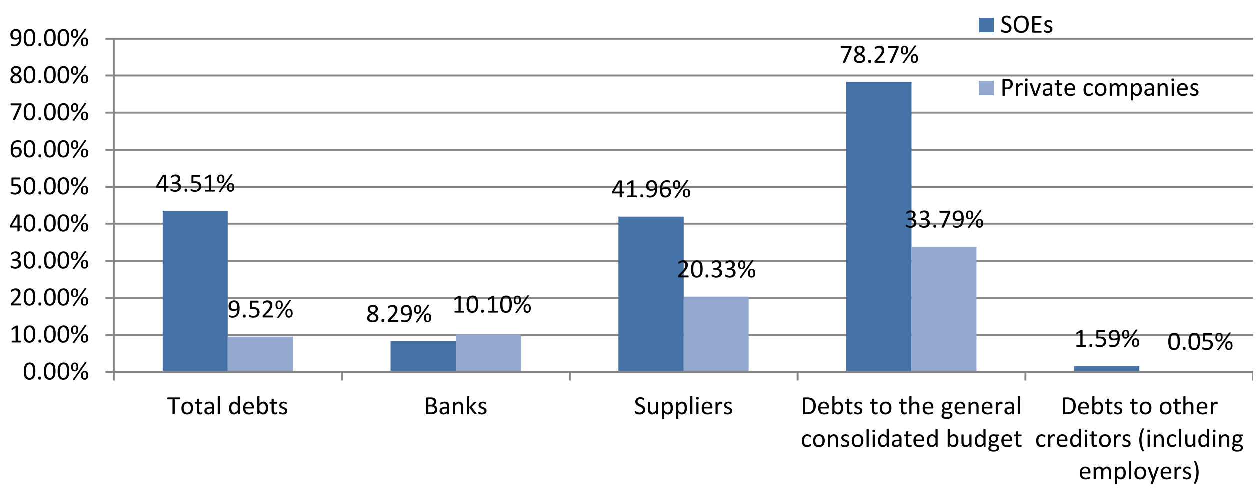
Figure 43: Structure of arrears – private companies (million lei)



Source: MPF, based on balance sheets data submitted by the economic agents from non-financial sector

The share of arrears in total debt in the case of state companies is 43.51% in 2013 compared to 9.52% for private companies, reflecting liquidity problems and a culture of late or non-payments. We notice again that most public companies arrears are directed towards the general consolidated budget, partly reflecting the accumulated historical debts, their share in total debts to the consolidated general government being 78.27%, followed at a great distance by the share of arrears in debt to the suppliers, especially to utilities suppliers, with a level of 41.96%. The hierarchies of arrears share in debt to creditors aforementioned holds in the case of private companies too, but at much lower levels. The arrears to the general consolidated budget registered in the case of private companies represents 33.79% of the budget debts and arrears to suppliers represent 20.33% of the debts owed to them.

Figure 44: Arrears as share of debts to certain creditors (December 2013)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

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 chemical sectors.

Table 21: Top 10 SOE's arrears

Top 10 arrears in Dec 2013

	Company name	Arrears (mil.lei))
1	COMPANIA NAȚIONALĂ A HUILEI SA ÎN LICHIDARE	4,978.38
2	SC OLTCHIM SA	3,372.78
3	CNCF CFR SA	1,051.87
4	REGIA AUTONOMĂ PENTRU ACTIVITĂȚI NUCLEARE	651.71
5	C.N.A.D.N.R. S.A.	592.86
6	C.N.M.P.N REMIN S.A	580.95
7	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	547.76
8	S.C. CET IAȘI S.A.	525.63
9	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI SA PLOIEȘTI	518.52
10	S.C.UZINA MECANICĂ CUGIR S.A.	459.72
	% total	**59.4%**

Top 10 arrears in Dec 2012

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI SA	4,904.60
2	SC OLTCHIM SA	2,505.96
3	RADET BUCUREȘTI	2,412.76
4	SNTFM CFR MARFĂ 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 CĂLĂTORI S.A.	762.28
8	C.N.M.P.N REMIN S.A	576.51
9	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI SA PLOIEȘTI	516.86
10	S.C.UZINA MECANICĂ CUGIR S.A.	457.00
	% total	**64.1%**

Top 10 arrears in Dec 2011

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI SA	5,228.03
2	CNCF CFR SA	4,454.50
3	RADET BUCUREȘTI	2,021.63
4	SC PENTRU ÎNCHIDEREA-CONSERVAREA MINELOR SA	1,762.82
5	SNTFM CFR MARFĂ SA	1,209.12
6	SC ELECTROCENTRALE BUCUREȘTI SA	920.55
7	C.N.M.P.N REMIN S.A	576.20
8	S.C.UZINA MECANICĂ CUGIR S.A.	439.64
9	S.N.T.F.C. CFR CĂLĂTORI S.A.	419.11
10	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI SA PLOIEȘTI	387.70
	% total	**66.4%**

Top 10 arrears to consolidated general budget in Dec 2013

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI SA ÎN LICHIDARE	4,968.50
2	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI SA PLOIEȘTI	505.37
3	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	501.87
4	UZINA MECANICĂ CUGIR S.A.	453.54
5	SC ELECTROCENTRALE BUCUREȘTI SA	421.53
6	S.C. CET IAȘI S.A.	388.18
7	SNCFR RA	267.51
8	S.C.MOLDOMIN SA	263.03
9	S. U.M.SADU SA	183.17
10	SC INTERVENȚII FEROVIARE SA	168.99
	% total	**72,1%**

Top 10 arrears to consolidated general budget in Dec 2012

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI SA	4,865.40
2	SNTFM CFR MARFĂ SA	876.92
3	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI SA PLOIEȘTI	505.30
4	C.N.M.P.N REMIN S.A	501.09
5	S.C.UZINA MECANICĂ CUGIR S.A.	449.80
6	CNCF CFR SA	304.98
7	SOCIETATEA ROMÂNĂ DE TELEVIZIUNE	273.70
8	SNCFR RA	267.55
9	S.C.FORTUS S.A.IAȘI	252.38
10	SC ELECTROCENTRALE BUCUREȘTI SA	220.80
	% total	**75.5%**

Top 10 arrears to consolidated general budget in Dec 2011

	Company name	Arrears (mil.lei)
1	COMPANIA NAȚIONALĂ A HUILEI SA	5,176.37
2	CNCF CFR SA	2,063.23
3	SC PENTRU ÎNCHIDEREA-CONSERVAREA MINELOR SA	1,239.19
4	SNTFM CFR MARFĂ SA	673.88
5	C.N.M.P.N REMIN S.A	500.27
6	S.C.UZINA MECANICĂ CUGIR S.A.	431.11
7	SOCIETATEA NAȚIONALĂ A CĂRBUNELUI SA PLOIEȘTI	374.64
8	SNCFR RA	267.47
9	S.C.FORTUS S.A.IAȘI	240.61
10	S.C.MOLDOMIN SA	225.88
	% total	**79.5%**

Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

Table 22: SOEs arrears evolution by type of company								
Total arrears (million lei)	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Autonomous administrations	1,120.11	960.09	1,130.70	1,411.14	2,019.32	3,153.75	3,662.52	1,776.35
Companies owned 100% by the state	8,272.53	5,876.08	6,802.97	8,102.41	9,648.19	7,670.87	5,605.94	6,325.26
National companies and societies	1,945.73	5,511.38	7,945.22	23,710.69	15,032.90	12,773.24	10,350.17	7,582.41
Other state – owned companies or majority-state – owned companies	71.38	74.93	77.60	184.32	298.81	769.32	879.87	1,484.01
State – owned companies, local and foreign state capital (state capital >= 50%)	6.91	4.65	5.52	1.05	0.26	46.28	3.27	1.35
State –owned companies, local and foreign private capital (state capital >=50%)	32.39	529.42	717.28	35.38	78.59	330.44	2,551.90	3,412.91
State –owned companies and with local private capital (state capital >=50%)	2,098.41	552.79	609.37	957.00	932.08	1,504.96	2,308.42	1,764.89
State –owned companies and with foreign private capital (state capital >=50%)	0.00	2.11	0.86	1.66	0.37	0.47	0.43	0.77
State –owned companies, privatized in the reporting year	9.38	178.37	4.81	1.38	1.79	2.06	0.62	0.51
TOTAL arrears	**13,556.86**	**13,689.81**	**17,294.33**	**34,405.02**	**28,012.31**	**26,251.39**	**25,363.13**	**22,348.45**

Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

The year 2013 witnessed a favorable development of the financial performance of state-owned companies, as they registered a higher efficiency of their activities. The rate of operating surplus increased compared with 2012 by about 5.6 percentage points, even higher than that recorded by private companies. Regarding the ability of state companies to cover debts with their assets, reflected by the degree of solvency, they have a favorable position, respectively the debt to total assets was 31.8%, significantly lower than that recorded by the private ones. It is worth to mention that before the onset of the financial crisis, the position of state companies in terms of solvency was a favorable one (50.9% in 2008), registering a downward trend due to a more pronounced reduction of debt in the period 2008-2013.

Figure 45: Operating surplus (%)

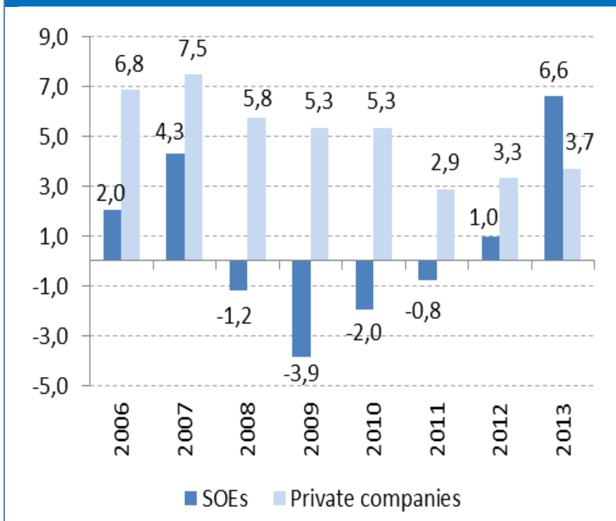
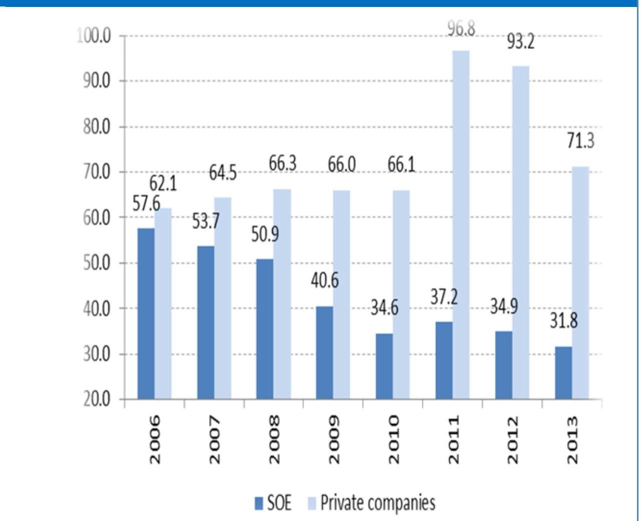


Figure 46: Solvency ratio (%)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

*Note: Operating surplus (%)=Operating surplus/ Total income * 100*
*Solvency ratio (%)=Total debt / Total assets * 100*

Figure 47: Profit margin (%)

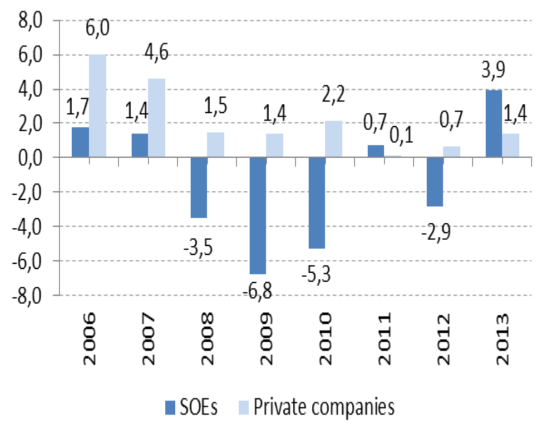
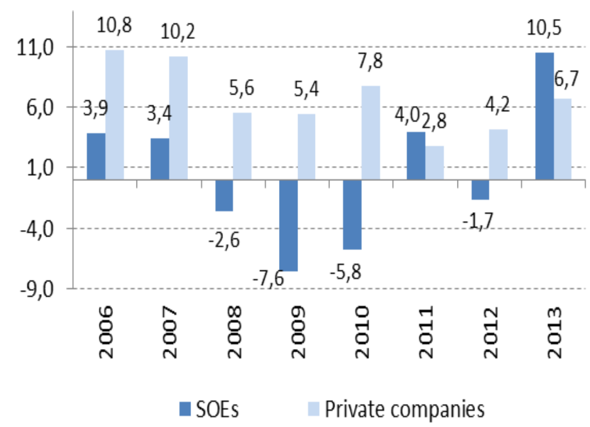


Figure 48: Gross profit per 1000 employees (thousands lei)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

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

The profitability of state-owned companies has improved significantly in 2013, while being higher than that of private companies, given that in the period 2008-2012 their financial position was precarious, as shown in the profit margin or gross profit per 1000 employees.

The profitability of state-owned companies has advanced considerably in 2013 due to a favorable dynamic net profit (1.8 billion lei). Return on equity has reached a level of 1.7%, while return on assets was 1.2%, benefiting from the negative dynamic of equity, respective assets. It is worth noting that despite the advance recorded this year, the return for state-owned companies was lower than that of the private sector.

Figure 49: ROE (%)

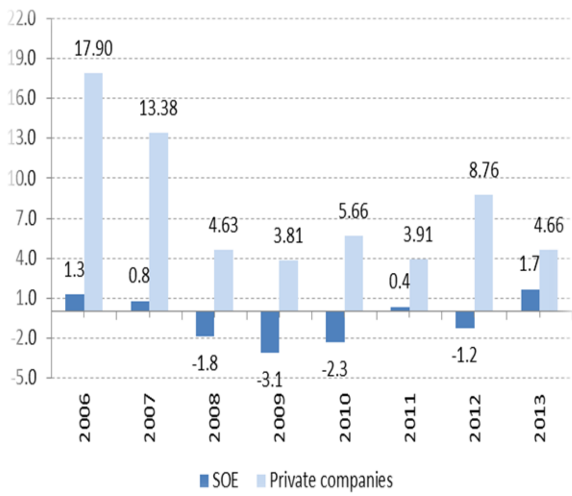
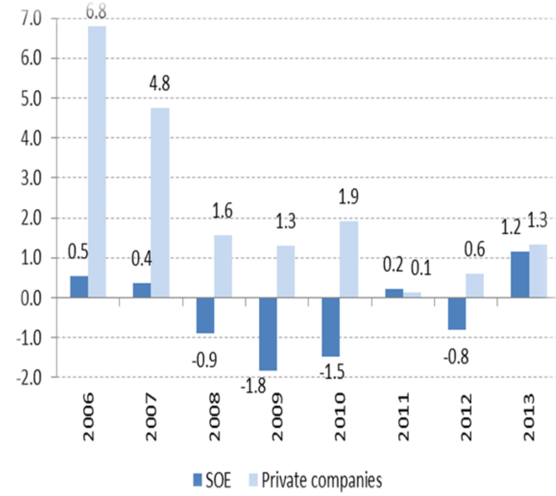


Figure 50: ROA (%)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

Note: ROE(%) = Net Profit / Equity; ROA(%)=Net income / Total assets

The state-owned companies' position has improved also due to their ability to pay interest costs, reflecting a better ability of state companies to service their debts. Thus, in 2013, the coverage of interest expenses was 2.5, equal to that of private companies, while in 2009, 2010 or 2012 this indicator had very low values.

Figure 51: Interest coverage ratio

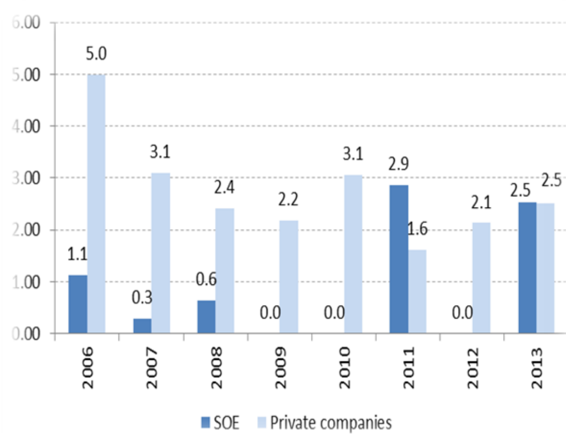
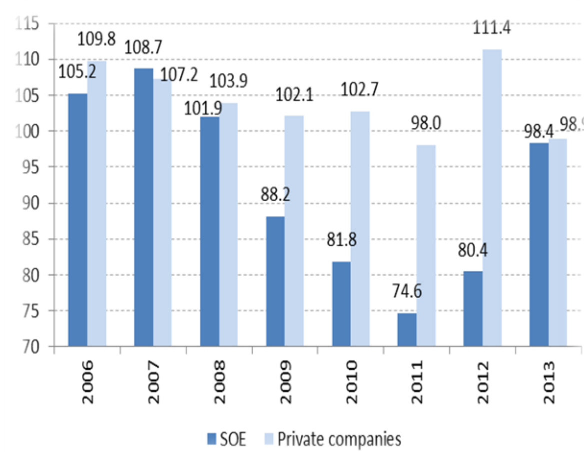


Figure 52: Liquidity ratio (%)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

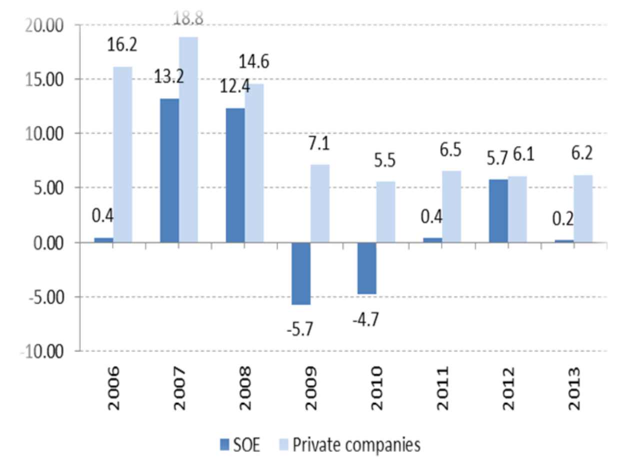
Note: Note: Interest coverage ratio = (Profit or current loss + interest expenses – interest incomes)/interest expenses
*Liquidity ratio (%) = current assets / short term debts *100*

In terms of liquidity, state companies were significantly affected by the financial crisis, their liquidity rate being significantly lower than in the private sector, in 2009-2012; in 2013 this gap was reduced, the liquidity ratio in the two sectors being approximately equal (98.4% and 98.8%).

Regarding the ability of state-owned companies to make new investments, this was very low in 2013 compared to the private sector, despite increases in profitability achieved in 2013, which is justified in the light of dividends imposed by the state.

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

Figure 53: New investments (% of total assets)



Source: MPF, based on the balance sheets submitted by the economic agents from non-financial sector

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 a direct and 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 2013 the unpaid debt to the general consolidated budget represented 1.8% 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% 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 methodology for accrual accounting (ESA95), several SOEs have been reclassified in the government sector. The 83 SOEs consolidated in central government sector had a positive influence on the general consolidated budget deficit in ESA95 standards in 2010-2013, except the year 2012. The table below shows the contribution to consolidated budget deficit of the first 20 state-owned companies included in the central government according to the influence they have on the consolidated deficit in ESA95 standards. Regarding state-owned companies consolidated in the local government, they had a slightly negative contribution to the consolidated deficit in ESA95 standards in 2010-2013, except the year 2011.

Table 23: Contribution of state companies included in the public sector to the consolidated budget deficit (mn. lei), ESA95 standards

	2010	2011	2012	2013
1. Total central companies	**693,9**	**1.240,1**	**-335,1**	**1.654,5**
Compania Naţională de Autostrăzi şi Drumuri Naţionale	863,5	1.100,5	-1.435,0	1.394,1
Metrorex	-31,3	-18,1	-6,1	82,3
Administraţia fluvială Dunărea de Jos Galaţi	7,4	-0,6	-20,6	32,7
CFR Călători SA	158,0	62,6	-186,3	72,6
CN a Huilei Petroşani	-81,0	-205,5	-57,9	-35,8
SN a Cărbunelui	-6,0	-0,2	-0,4	-0,5
CN de Radiocomunicaţii Constanţa	2,5	0,2	-0,2	0,1
SC Intervenţii feroviare SA	-38,0	-4,5	-8,3	-6,2
Fondul Proprietatea	-12,8	192,3	-6,6	0,0
SC Electrificarea SA (SC Electrification SA)	-43,0	-24,1	-9,2	-54,0
SC TERMOELECTRICA SA	-94,9	-24,5	-89,0	-60,0
CN de Căi Ferate CFR SA	77,4	181,5	1532,8	262,1
CN Administratia Canalelor Navigabile Constanţa SA	-2,3	-1,7	4,9	12,3
Societatea Națională Aeroportul Internațional Mihail Kogălniceanu	-49,4	-0,4	-0,1	-1,8
SC CN Romarm SA Buc - Filiala SC Uzina Mecanică Cugir SA	-44,5	4,0	-37,3	-24,7
SC Uzina Mecanica Orăștie	-0,4	-9,9	-9,4	-8,2
SC Avioane Craiova SA	-3,5	-5,9	-2,1	-5,2
SC Construcții Aeronautice SA	-3,0	-0,8	-0,9	-1,8
SC Sanevit 2003 SA	-3,3	-0,8	-1,4	-0,7
SC Uzina AutoMecanica SA Moreni	-1,5	-4,0	-2,0	-2,8

2. Total local companies	**-51,2**	**11,5**	**-53,8**	**-74,9**
Local airports	18,1	14,5	-15,4	-13,0
Central heating of local subordination	161,4	-64,2	-24,0	-42,2
Other local units	-230,7	61,2	-14,4	-19,7
3. Total SOEs	**642,7**	**1.251,6**	**-388,9**	**1.579,6**
% of GDP	**0,12%**	**0,22%**	**-0,07%**	**0,25%**

Source: NIS

The financial performance of SOEs experienced a significant improvement in 2013 in terms of profitability, solvency and liquidity indicators, their dynamics being superior to the ones from the private sector, but there is still an imbalance between the contribution of these companies to the turnover of the total economy and the share in total arrears of the outstanding payments or of the number of employees in total employment of the economy. The Fiscal Council considers that further efforts are needed in order to obtain sustainable efficiency of SOEs activity, including through the transposition of corporate governance principles and through strengthening private management of these companies on performance basis.

VI.2. Arrears of the general consolidated budget

In 2013, the general consolidated budget arrears[47] to the private sector have improved significantly compared to the previous year, when all quarterly targets assumed in the agreement with the international financial institutions were exceeded. Following the legislative measures adopted in 2012 and the exclusion of a part of the outstanding payments from the statistics, based on the inspections conducted by the National Agency for Fiscal Administration (NAFA) who challenged the legality of such expenditure, the arrears decreased at both central and local level. Thus, since the second quarter, the targets set by agreement with international financial institutions have been complied.

Table 24: Quarterly evolution of general consolidated budget arrears in 2013 (million lei)

	2012 QIV	2013 QI	2013 QII	2013 QIII	2013 QIV
State budget	**331.4**	**293.8**	**204.4**	**199.3**	**180.2**
Under 90 days	303.7	223.7	168.8	180.9	160.3
Over 90 days	12.3	30.9	21.3	6.5	5.0
Over 120 days	9.3	31.3	12.1	10.0	12.7
Over 360 days	6.1	8.0	2.2	1.8	2.3
Local authorities	**1922.2**	**1488.7**	**995.0**	**957.6**	**1011.2**
Under 90 days	1082.0	915.0	852.5	719.8	815.0

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

Over 90 days	210.7	249.2	50.7	126.2	69.1
Over 120 days	323.9	174.4	85.7	87.7	7.1
Over 360 days	305.6	150.1	6.1	23.9	120.0
Social security budget	**1525.5**	**1462.9**	**1269.7**	**1119.8**	**717.1**
Under 90 days	1524.6	1461.8	1269.6	1119.6	717.1
Between 90 şi 360 days	0.9	1.1	0.1	0.2	0.1
Total	**3780.8**	**3247.6**	**2469.4**	**2277.0**	**1908.7**
Under 90 days	2910.2	2600.5	2290.8	2020.3	1692.3
Over 90 days	223.9	281.1	72.2	132.9	74.1
Over 120 days	334.2	206.8	98.0	97.9	19.9
Over 360 days	312.5	159.2	8.4	25.9	122.4
Total arrears (90-360 days)	**870.6**	**647.2**	**178.6**	**256.7**	**216.4**
IMF target (arrears 90 - 360 days)	**320**	**320**	**320**	**320**	**320**
Overrun	**550.6**	**327.2**	**-141.4**	**-63.3**	**-103.6**

Source: Ministry of Public Finance

Analyzing the evolution of arrears during 2013, a decrease in the first quarter can be observed only due to the disposal of the amounts disputed by NAFA. Thus, locally registered arrears were reduced by 360 million lei in March, according to the Memorandum of Economic and Financial Policies[48], these amounts being disputed for one of the following reasons: non-compliance with the relevant legal dispositions or regulations, inappropriate billing or purchasing, respectively no evidence regarding the performing of the charged works. Excluding the impact of excluding these amounts from the statistics, the arrears would have registered an increase of about 136 million lei, or up to a level of about 1 billion lei. It should be noted that these amounts in litigation can generate future payment obligations for the general consolidated budget and their simple disposal of records is not equivalent with the final extinction of debt. The consistent reduction in general government arrears occurred in the second quarter of 2013, the decrease by approximately 468 million lei compared to the end of March being sufficient for compliance the target on the stock of arrears. In the third quarter, arrears grew by 78.1 million lei, being followed by a decrease of approximately 40 million lei in the fourth quarter, which ensured the fulfillment of targets set in the agreement with the international financial institutions in both periods.

[48] IMF, Letter of Intent, June 2013.

With a share of over 80% of the arrears (respectively 40-50% of the total outstanding payments), 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.

Continuing the legislative efforts initiated in 2012, a series of measures were also adopted in 2013 in order to reduce the stock of outstanding payments registered locally[49]: the provision of a treasury loan to settle arrears, the priority use of deducted quotas from the state budget for the payment of local arrears, these funds couldn't be used to initiate new investment projects in terms of outstanding payments registration and property tax indexing with inflation rate in the case of administrations that record arrears. Moreover, the adoption of the Emergency Ordinance no. 46/2013 *regarding the financial crisis and the insolvency of local authorities* creates the premises for a better correlation of the local authorities' expenditure with the real possibilities of the public budget.

Other measures adopted in 2013 aimed arrears recorded in healthcare: allocation of clawback tax revenue to settle outstanding obligations from the pharmaceutical field, transferring 3.5 billion lei (according to the information provided by the Ministry of Finance, the effective amount used for this purpose was about 2.5 billion lei in 2013) from the state budget in order to implement Directive 2011/7/EU on combating late payment in commercial transactions, allocation of some resources from the reserve fund to the Government for payment of arrears recorded by hospitals, establishment of a monthly report system which prevents the accumulation of new arrears, introduction of co-payments for medical services (this initiative aims to reduce spending pressure in the case of hospitals).

Regarding the outstanding payments with a delay of less than 90 days which do not fit into the category of arrears, a clear downward trend can be observed, reducing by over 40% during 2013. The decrease was mainly located in the arrears from social security budget, of about 53% or 807.7 million lei. It stands thus an improving payment discipline of the state that succeeded to pay a substantial part of the outstanding obligations. This development is appreciated given that the deadline for the payment of bills was reduced due to the implementation of Directive 2011/7/EU on combating late payment in commercial transactions.

In conclusion, the evolution of general consolidated budget arrears has been positive in 2013, the reduction recorded being in line with the targets undertaken by agreement with international financial institutions and the adopted measures took into account both the reduction of outstanding payments stock and the prevention of their accumulation. The Fiscal Council salutes/welcomes this evolution and considers that a continued fiscal discipline is

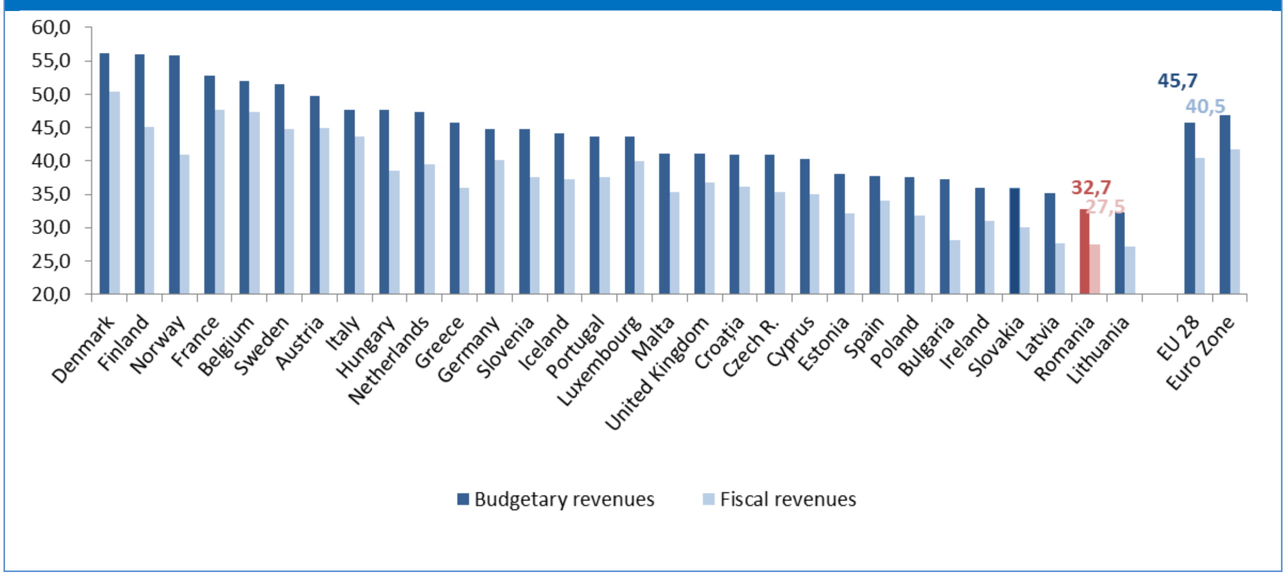
[49] IMF, Staff Report, July 2013.

essential to strengthen macroeconomic stability and the efforts in this area should continue in order to achieve a complete and permanent disposal, including through the establishment of an efficient system.

VI.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 32.7% of GDP in 2013, 13 percentage points of GDP lower than the EU average. Tax revenue to GDP (taxes and social contributions) in Romania was equal to 27.5% in 2013, 13 percentage points of GDP lower than the EU average (40.5%). Moreover, the gap between Romania and the EU average increased in 2013 compared to the previous year by 1.1 pp of GDP in the case of total revenues and by 0.8 pp of GDP in the case of tax revenues. The share of tax revenue to GDP is significantly lower than in similar economies like Hungary (38.6%), Slovenia (37.8%), Czech Republic (34.8%) and Poland (31.8%).

Figure 54: Budgetary revenues and fiscal revenues (% og GDP, ESA95, 2013)



Source: EUROSTAT; Tax revenues include social contributions.

The structure of tax revenue in Romania, relatively unchanged from 2012, reveals a high share of revenues from indirect taxes, respectively 46.18% of total tax revenue compared to the EU 27 average of 33.08%, while the share of revenue from social security contributions was 32% (EU 27 34.56%) and from direct taxes - only 21.81% (EU27 32.34%). 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, 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 the "Paying taxes 2013" report published by the World Bank, Romania is placed on the 134th rank from 189 countries worldwide regarding the ease of paying taxes (a better position compared to the previous year when it was on the 136th place). A remarkable improvement can be observed in 2013 in the case of Estonia, ascending on 32th place, 18 positions higher than the rank from 2012, due to the abolition of some local taxes. Also, a company from Romania has to initiate 39 payments per year in order to pay taxes (a slight decrease as compared to 41 in 2012), significantly higher than in other surveyed countries. In terms of time to comply (hours) required for fulfillment of tax obligations for a financial year, Romania is on a relatively favorable position in the sample, with 200 hours required per year, pointing out also a reduction of 16 hours compared to the previous year.

Table 25: Efficiency of tax administration

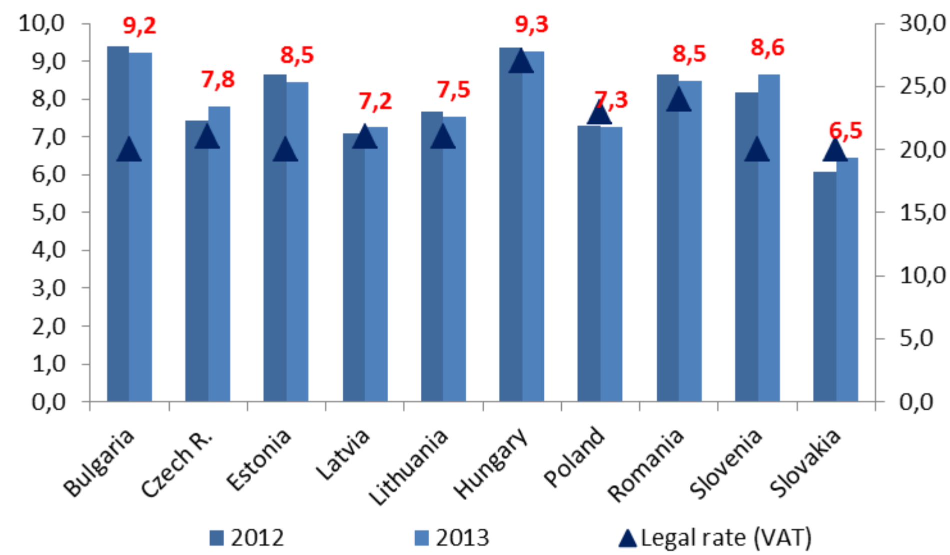
	Estonia	Latvia	Slovenia	Lithuania	Bulgaria	Slovakia	Poland	Czech R.	Hungary	Romania
Year	**Ease of paying taxes (rank)**									
2012	50	52	63	60	91	100	114	120	118	136
2013	32	49	54	56	81	102	113	122	124	134
	Number of payments per year for the fulfillment of tax obligations*									
2012	8	7	11	11	15	20	18	8	12	41
2013	7	7	11	11	13	20	18	8	12	39
	Number of hours per year for the fulfillment of tax obligations**									
2012	85	264	260	175	454	207	286	413	277	216
2013	81	264	286	175	454	207	286	413	277	200

Source: World Bank

** 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.*
***This index shows the time to comply for preparing, filing and payment of tax obligations three main types: corporate income tax, personal income tax and social security contributions.*

As an example of poor tax collection, Romania collected 8.5% of GDP from VAT revenues in 2013, 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 2013, respectively 9.2% of GDP.

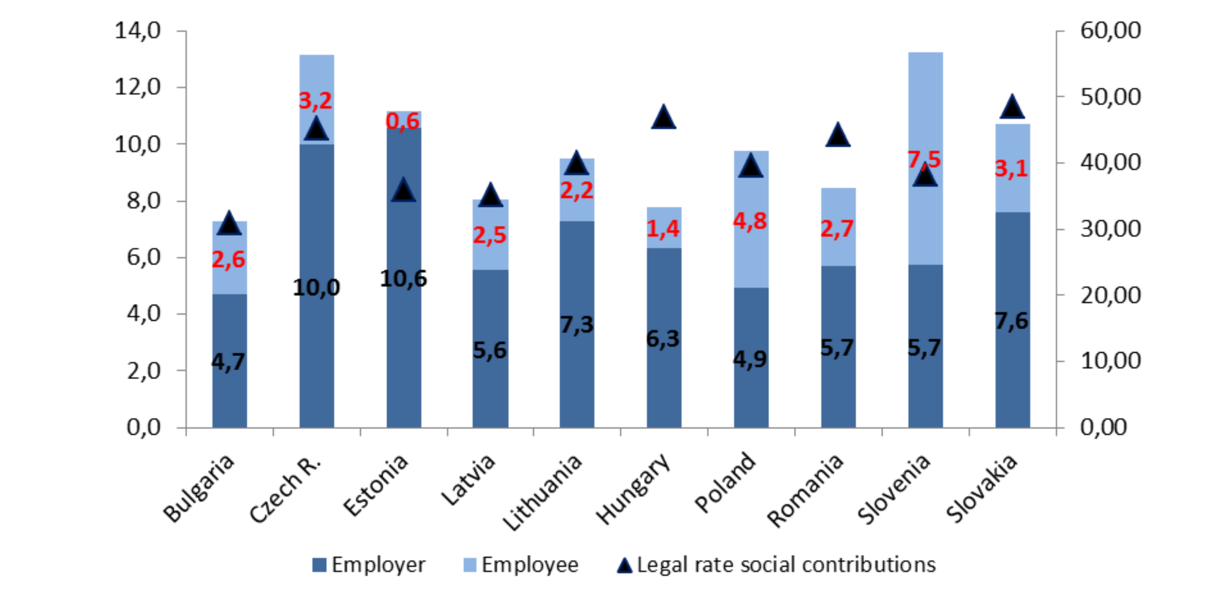
Figure 55: VAT revenues (% of GDP) – 2013



Source: European Commission, Eurostat

Regarding social contributions paid by both employees and employers, the revenues collected in 2013 amounted to 8.4% of GDP, a much lower figure than in the Czech Republic (13.2% of GDP), but much better than in Hungary (7.7% of GDP), these three countries having relatively similar legal contribution rates. Slovenia (13.2% of GDP), Estonia (11.2% of GDP), Lithuania (9.5% of GDP), and Poland (9.7% of GDP) registered budget received revenues related to this category higher than in Romania, given that the statutory social contribution rates are significantly lower.

Figure 56: Social contributions revenues (% of GDP) – 2013



Source: European Commission, Eurostat

** total contributions*

Romania has initiated in 2013 a reform of the tax collection system which aims a significant increase in the long run of the revenue collection and a decrease of the administrative costs. The program is supported by the World Bank that approved on April 26, 2013 the project "Revenue Administration Modernization in Romania" of 70 million euro, on five years. Through this project, the World Bank conducts a partnership with Romania aimed at increasing efficiency and effectiveness in the collection of taxes and social contributions, increasing the compliance and reducing the administrative burdens for taxpayers to meet their tax obligations. NAFA will manage the project implementation, the organization restructuring being a precondition for starting the modernization of the tax administration agreed with the World Bank.

Thus, in 2013, NAFA has undergone a complex process of reorganization, the new structure became operational on August 1st, 2013. Reorganization process aimed several courses of action, including:

- transformation of those 42 county general directorates in those 8 regional general directions of the public finance;
- the General Directorate of Large Taxpayers Administration (GDLTA) has acquired legal personality and will operate under NAFA, with a similar status to the new regional general directions of the public finance;
- merger by acquisition and takeover activity of General Directorate of Customs and Financial Guard by NAFA, having the status of no legal personality therein;

- on October 30, 2013 the Financial Guard was dissolved and from November 1st 2013, an antifraud structure has been set up through reorganizing the operational control within the apparatus of NAFA, called the General Directorate for Tax Fraud (DGTF), being meant to be a national structure with 8 directions under the direct coordination of the central apparatus.

On the other hand, according to a press release published by NAFA, the number of jobs in the institution remained the same after restructuring NAFA, the employees being retrained and redistributed to weak areas (fiscal inspection, customs control, contributors assistance, structures dedicated to large and medium taxpayers or to units with a large number of taxpayers), along with the recruitment of specialists for high value-added functions (information and communications technology, legal, certain management positions).

The Fiscal Council notes that, in the short term, this process seems to have had negative effects on budget revenues, pointing out a significant underperformance of revenue collection program during the reorganization of NAFA. However, the effects of this program will be seen in time and the Fiscal Council will closely monitor the results of this process.

A similar program conducted in collaboration with the World Bank took place in Bulgaria during 2002-2008, with positive results. Thus, due to the program implementation, five regional tax administrations were reached (initially being 340[50] territorial tax administrations) and the level of tax collection has improved by 5 percentage points of GDP during the program, considering that the tax rates in Bulgaria have been reduced to one of the lowest levels in the EU.

The Fiscal Council welcomes the initiation of reform tax collection that it considers essential in the current context, characterized by a low efficiency of the system of taxes and believes that this process has the potential 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.

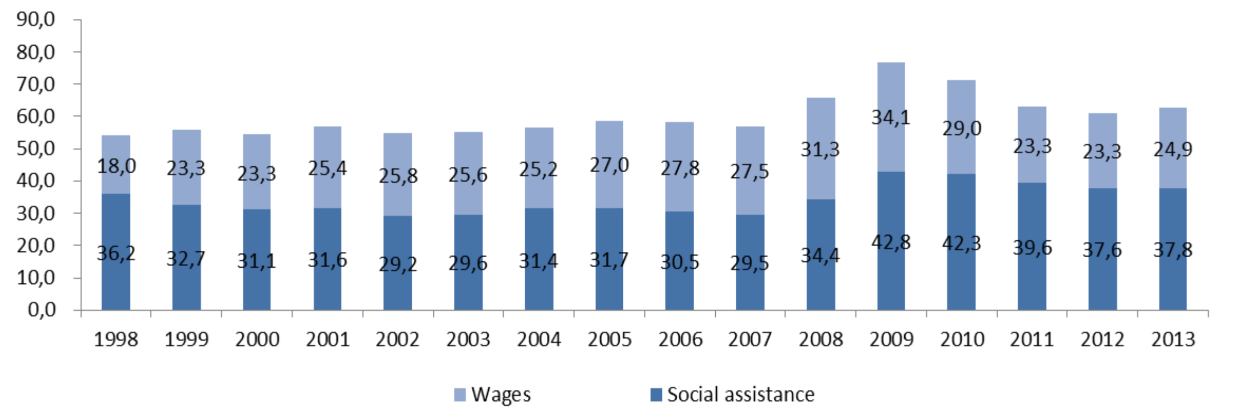
VI.4. Public expenditure – structure and sustainability

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 – 2013 as a result of the fiscal consolidation (*Figure 57*). After a relatively stable evolution of these items of expenditure, as a share of the

[50] According to the data provided in the document named "Implementation Completion and Results Report – Revenue Administration Reform Project for Bulgaria", elaborated by the World Bank in 2009.

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 2013 is lower than during 2002-2007, despite the increase of 1.6 pp registered in 2013 due to wage recoveries, 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 years. Compared to the previous year, the share of social expenditure in the total budgetary revenues increased slightly by 0.2 pp, but the total revenues increasing more slowly than this category of expenditure.

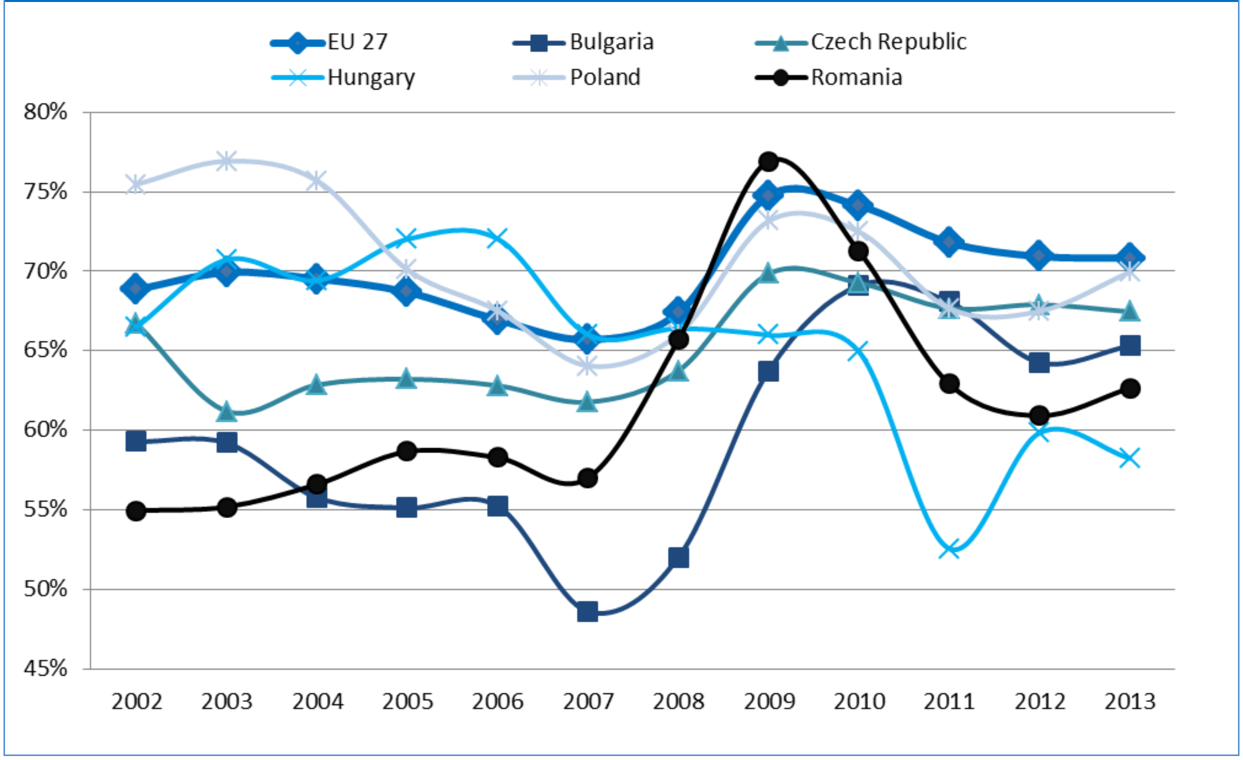
Figure 57: Social assistance and personnel expenditure as share of total budget revenues (%)



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, but 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.

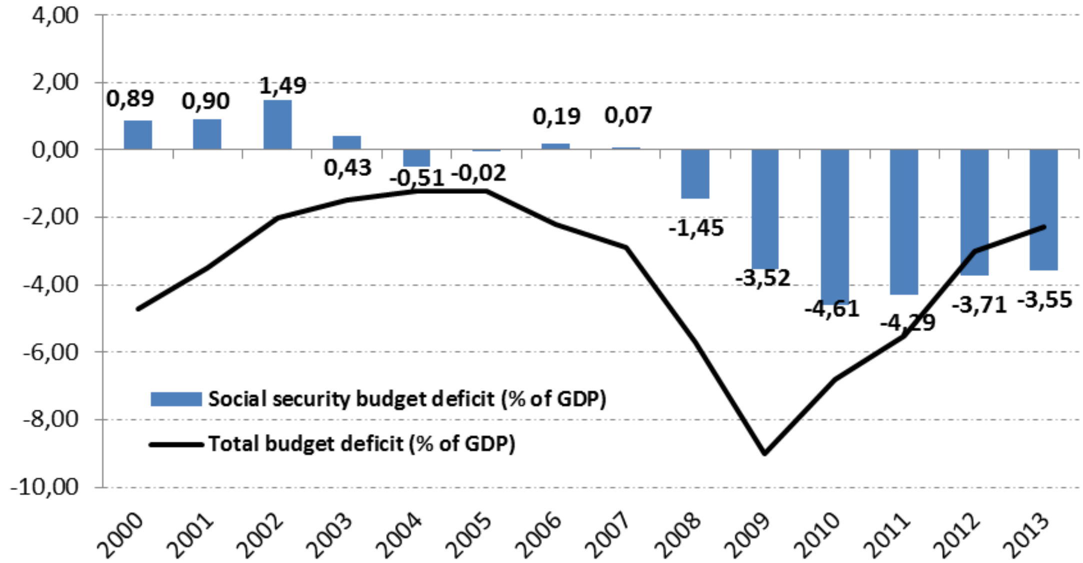
Figure 58: Social assistance and personnel expenditure (including pensions) in EU 27 and CEE during 2002-2013



Source: EUROSTAT

If in 2000 – 2007, social security budgets (pensions, unemployment and health) 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 155% in the period 2010 – 2013. Basically, in the latter year, Romania would have had a budgetary surplus if the social security budget had been in equilibrium. In particular, the deficit recorded in the public pension system (-1.86% of GDP) significantly affects the public finance position, representing a relevant risk to the sustainability of fiscal policy in the medium and long-run.

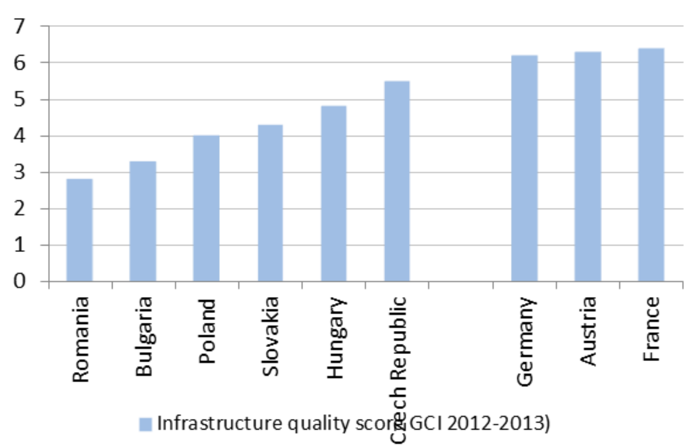
Figure 59: Social security budget deficit (pensions, unemployment and health) and total budget deficit – ESA95 (% of GDP)



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 – 2013; 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.

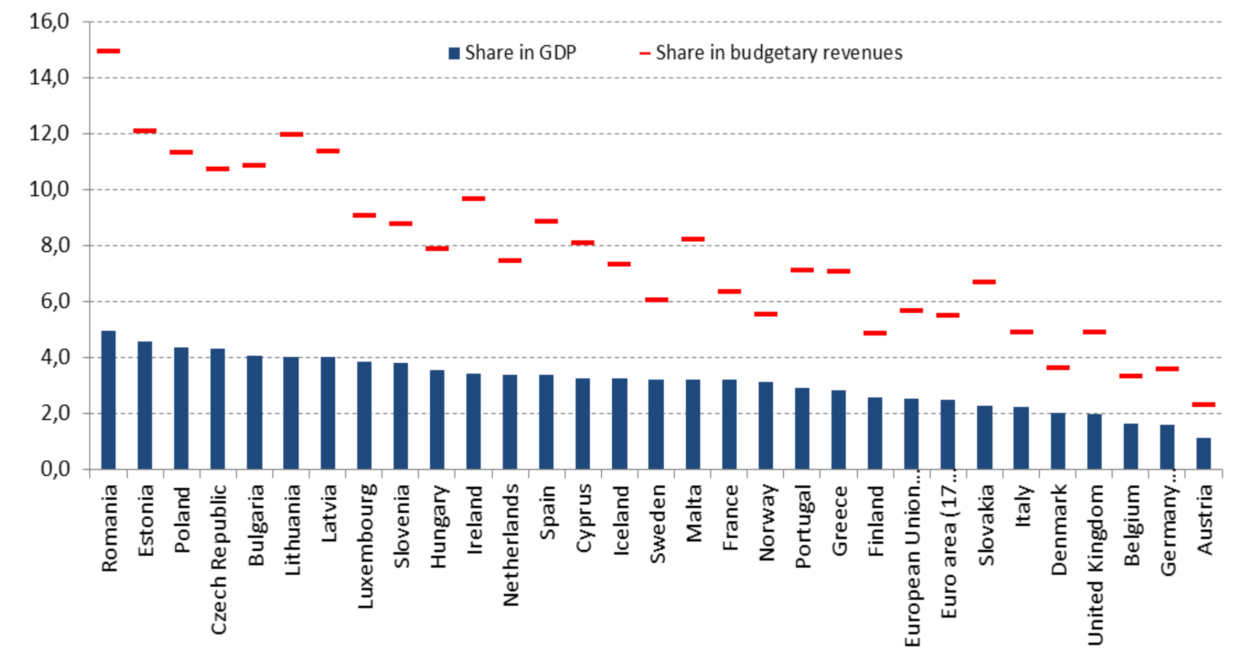
Figure 60: Infrastructure quality



Source: EUROSTAT, World Economic Forum, The Global Competitiveness Report 2013-2014

However, it should be mentioned that in the past two years, the share of public investment expenditures decreased significantly, this practice being used as a way of achieving fiscal targets. Thus, the emphasis should fall on increasing the efficiency of money spent for this purpose and on a better prioritization of projects, Romania making steps in this direction as shown above.

Figure 61: The share of investment expenditure in GDP and in total budgetary revenues (average 2008-2013)



Source: EUROSTAT

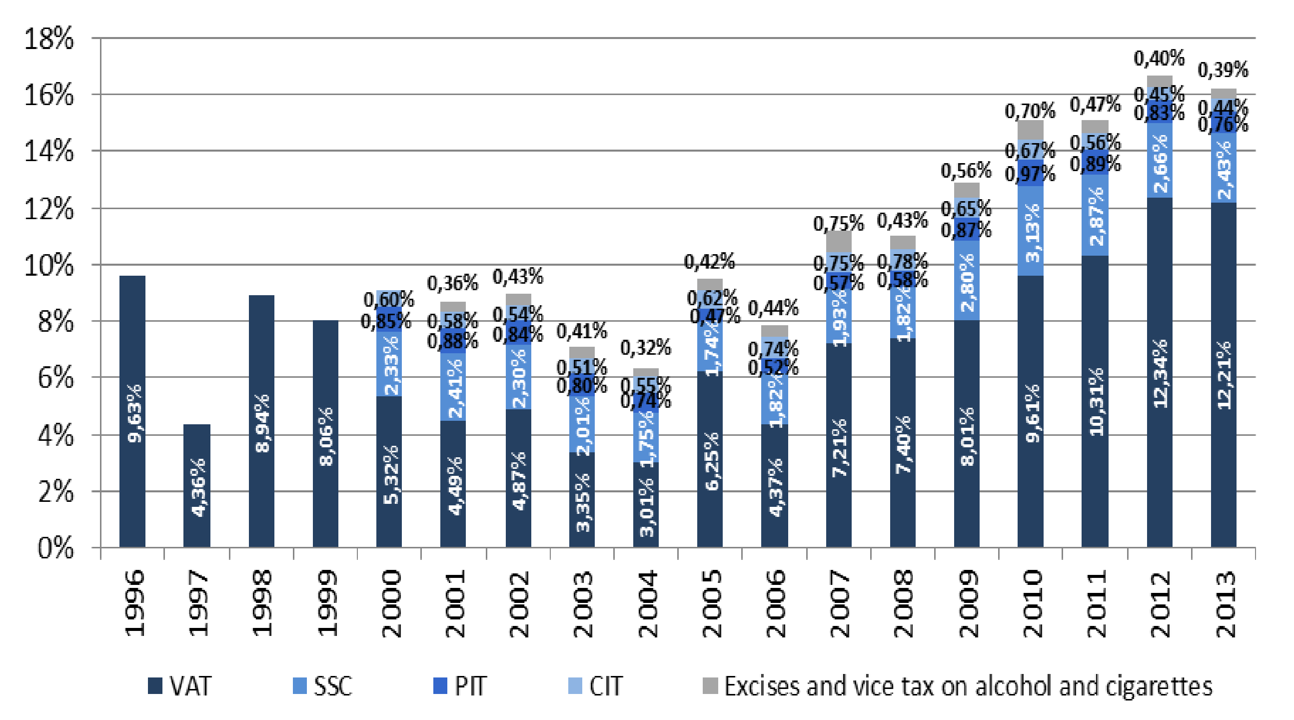
VI.5. Tax evasion

According to the Fiscal Council's calculations based on NIS data, tax evasion has a large share in the Romanian economy, accounting for 16.2% of GDP in 2013[51]. 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, while the legal level of the main taxes in Romania is higher than the European average (Romania has the 3rd largest standard rate of VAT in the European Union and the 7th highest tax burden on labor – generated mainly by the social security contribution; at the same time, Romania has one of the lowest legal corporate and personal income tax rates in the European Union, but they have a low share in budgetary revenues). A profound reform of the tax administration in Romania targeted towards increasing tax collection is absolutely necessary, being able to create fiscal space to reduce the tax burden on labor, currently situated at a very high level.

[51] Data on tax evasion in the period 2011-2012 presented in this report have been updated compared to those presented in the annual report of the Fiscal Council for 2012 due to the revision of the national accounts data for the years 2011 and 2012 by the National Statistics Institute.

About 75% of the tax evasion is generated by VAT fraud, which reached a maximum of 12.34% of GDP in 2012, followed by a slightly decrease to 12.21% of GDP in 2013. It is worth noting that in 2010, when the legal VAT rate was increased from 19% to 24% in the second half of the year, tax evasion rose from 8% of GDP to 9.6% of GDP in 2010, maintaining this upward trend in the following years.

Figure 62: 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 3: VAT tax evasion computation

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:
    - 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).

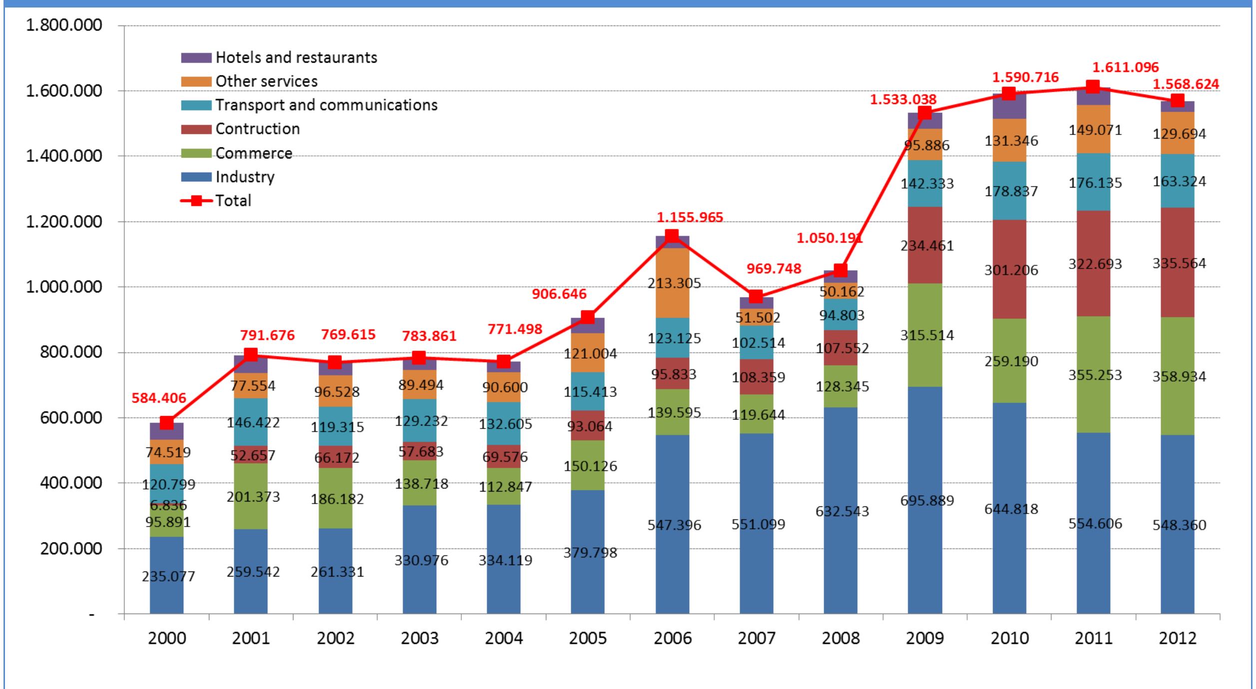
Table 26: Development of tax evasion for main taxes														
Million lei	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Tax evasion for undeclared work:	1,353	2,310	2,989	3,905	4,278	4,546	5,891	7,671	8,973	14,652	16,665	17,510	16,966	16,414
- PIT	362	618	799	1,106	1,273	969	1,313	1,763	2,183	3,473	3,950	4,151	4,022	3,891
- SSC	991	1,693	2,190	2,799	3,005	3,577	4,578	5,908	6,790	11,179	12,715	13,359	12,944	12,523
Tax evasion for informal sector (households)	1,225	1,565	1,784	1,645	1,877	1,855	2,174	2,736	3,393	3,766	4,821	3,448	3,504	3,620
- PIT	328	418	477	466	558	396	485	629	825	893	1,143	817	831	858
- SSC	897	1,146	1,307	1,179	1,319	1,460	1,689	2,107	2,567	2,873	3,678	2,630	2,673	2,762
Total tax evasion for PIT	689	1,036	1,276	1,572	1,831	1,365	1,798	2,392	3,009	4,366	5,093	4,968	4,852	4,749
Total tax evasion for SSC	1,889	2,839	3,497	3,978	4,324	5,037	6,267	8,015	9,357	14,052	16,393	15,989	15,617	15,285
Tax evasion for VAT	6,198	9,468	10,712	12,763	18,683	18,050	15,067	29,982	38,085	40,156	50,347	57,476	72,399	76,747
Tax evasion for CIT	489	680	815	1,012	1,351	1,780	2,555	3,126	3,993	3,237	3,512	3,126	2,624	2,795
Tax evasion for vice tax for cigarettes and alcohol		425	656	803	786	1,207	1,505	3,137	2,194	2,805	3,663	2,616	2,323	2,438
TOTAL tax evasion	9.265	14,448	16,957	20,127	26,975	27,439	27,192	46,650	56,638	64,615	79,008	84,175	97,816	102,013
Gross value added in unobserved economy	14.642	21,163	26,763	30,381	35,814	47,849	66,117	83,063	100,741	104,667	129,769	135,450	143,906	143,907
% of GDP	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
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%	3.14%	2.89%	2.61%
- PIT	0.45%	0.52%	0.53%	0.56%	0.51%	0.34%	0.38%	0.42%	0.42%	0.69%	0.75%	0.74%	0.69%	0.62%
- 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%	2.21%	1.99%
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%	0.62%	0.60%	0.58%
- PIT	0.40%	0.35%	0.31%	0.24%	0.23%	0.14%	0.14%	0.15%	0.16%	0.18%	0.22%	0.15%	0.14%	0.14%
- SSC	1.11%	0.97%	0.86%	0.60%	0.53%	0.51%	0.49%	0.51%	0.50%	0.57%	0.70%	0.47%	0.46%	0.44%

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%**	**0.89%**	**0.83%**	**0.76%**
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%**	**2.87%**	**2.66%**	**2.43%**
Total tax evasion for VAT	**5.32%**	**4.49%**	**4.87%**	**3.35%**	**3.01%**	**6.25%**	**4.37%**	**7.21%**	**7.40%**	**8.01%**	**9.61%**	**10.31%**	**12.34%**	**12.21%**
Tax evasion for CIT	**0.60%**	**0.58%**	**0.54%**	**0.51%**	**0.55%**	**0.62%**	**0.74%**	**0.75%**	**0.78%**	**0.65%**	**0.67%**	**0.56%**	**0.45%**	**0.44%**
Tax evasion for vice tax for cigarettes and alcohol		**0.36%**	**0.43%**	**0.41%**	**0.32%**	**0.42%**	**0.44%**	**0.75%**	**0.43%**	**0.56%**	**0.70%**	**0.47%**	**0.40%**	**0.39%**
TOTAL tax evasion	**9.11%**	**8.71%**	**8.98%**	**7.08%**	**6.36%**	**9.50%**	**7.89%**	**11.21%**	**11.00%**	**12.89%**	**15.09%**	**15.10%**	**16.67%**	**16.23%**
Gross value added in unobserved economy	**18.08%**	**17.94%**	**17.61%**	**15.39%**	**14.48%**	**16.56%**	**19.18%**	**19.97%**	**19.57%**	**20.89%**	**24.78%**	**24.30%**	**24.53%**	**22.89%**

Source: Fiscal Council's estimations based on NIS data

Social security contributions contribute with about 15% 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 1.57 million employees, owners and individual entrepreneurs in the unobserved economy, representing roughly 27.7% of all employees, owners and individual entrepreneurs in the economy.

Figure 63: Development of undeclared work[52] and unregistered individual entrepreneurs[53] (number of persons)



Source: Fiscal Council's estimations based on NIS data

Note: The number of employees working in the informal economy is calculated as the difference between the number of employees based on the Household Labor Force Survey (HLFS[54]) and the number of employees from the Structural Business Survey (SBS), except the public sector, for homogenous industry and equivalent to full-time work. All the economic activities are covered by HLFS, except agriculture and public administration. The Structural Business Survey does not include the budgetary sector (public administration, health, education) and a part of services. Transformed in full time equivalent = including both employees who worked full time/standard time of 40 hours per week (according to the law) and those who worked part-time transformed

[52] Employees and owners from institutional sector Non-financial corporations (S11).

[53] From institutional sector Households (S14).

[54] Statistical surveys based on samples.

in equivalent full-time. Transformed into homogeneous industry = the national accounts operates with homogeneous industry, HLFS operates with major industries and SBS provides information on homogeneous industries. Therefore HLFS requires specific procedures based on the analysis of the national accounts. Individual workers = self-employed, small businesses, family businesses, craftsmen, authorized person, any form of organization for market production within unincorporated households, according to the law. The number of unregistered individual workers is determined by the difference between the HLFS employment and the number of employees and owners according to HLFS, minus the number of individual entrepreneurs registered at MPF.

On economic sectors, the most important contribution to "undeclared work" is registered in the industry (548.4 thousand persons), followed by trade (358.9 thousand persons), construction (335.6 thousand persons) and transport and communications (163.3 thousand persons). Considering two-digit NACE codes, among the sectors with the highest share of "undeclared work" in the total labor force are listed: construction of buildings (66.2% of the workforce is undeclared) repair, maintenance and installation of machinery and equipment (63.6% of the workforce is undeclared), information service activities (60.3%), manufacture of textiles (48.1%), land transport and transport via pipelines (40.6%) .

Table 27: The evolution of “undeclared work” and individual entrepreneurs not registered in the industry in 2010-2012 (number of persons)

	2010	2011	2012
Industry - Total	**644,818**	**554,606**	**548,360**
Manufacture of wearing apparel	85,066	105,012	111,670
Repair, maintenance and installation of machinery and equipment	50,957	52,962	50,357
Manufacture of metallic construction and metal products, except machinery etc.	37,744	37,161	45,345
Metallurgical industry	49,668	39,579	35,698
Manufacture of electrical equipment	38,953	39,117	30,529
Manufacture of food products	65,570	25,506	28,348
Manufacture of wood, products of wood and cork	28,549	21,570	28,007
Manufacture of textiles	24,551	27,688	27,741
Manufacture of other non-metallic mineral products	24,259	22,506	23,369
Production and supply of electricity, gas, hot water and steam	46,004	44,383	23,148
Manufacture of furniture	26,710	21,771	21,848

Tanning and dressing of leather; manufacture of luggage, handbags	16,579	15,620	21,674
Manufacture of other transport equipment	18,955	18,466	15,772
Manufacture of computer, electronic and optical products	2,902	6,148	14,126
Manufacture of machinery and equipment	18,476	13,546	13,129
Mining of coal and lignite	10,240	10,034	11,987
Manufacture of motor vehicles, trailers and semi-trailers	292	6,314	9,457
Other industries	99,342	47,223	36,156

Source: Fiscal Council's calculations based on NIS data

Box 4: Identification of unobserved economy in Romania [55]

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 four-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

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

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. This fiscal fraud is included in the value of production, and also in the gross value added for each corresponding 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 Public 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. The income statements of family associations and self-employed, submitted to the Ministry of Public 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 category 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.

For assessing the social security contribution and the personal income tax evasion, it was taken into account the NIS estimation regarding the employees' remuneration corresponding to the added value related to the undeclared work and to the informal sector (population). Regarding the tax evasion on corporate income tax, it was considered 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 the total gross operating surplus of the economy.

Regarding the excise and "vice tax"[56] on alcohol and cigarettes evasion, according to the estimates of the Fiscal Council, the largest contribution to the evasion is attributable to cigarettes as, on the average, the illicit trade with cigarettes represented around 20% of the market in the period 2003 - 2013. The evasion in the cigarettes market increased in 2007 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 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 estimated at 45.9% of the market, with a much higher value for ethylic alcohol and distillates and intermediate products and significantly lower for 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 51.08 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 101.44 million lei in 2008 to net repayments of excise in 2012, and in 2013 to excise revenue of only 1.53 million lei. Moreover, at the level of the alcohol excise tax, although in the period 2007 – 2013 the level of excises has grown very rapidly (from 550 euro/hl of pure alcohol in the case of ethylic alcohol and distilled products in 2007 to 750 euro/hl of pure alcohol in 2010, and then 1.000 euro/hl of pure alcohol in 2013), the revenues from excises increased slowly (by only 8.7% in the period 2006 – 2013).

Table 28: Fiscal Council's estimations regarding tax evasion for excises and „vice tax" for cigarettes and alcohol

		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. Tax evasion for alcohol excises, out of which*:	million lei	394	270	421	623	432	617	718	790	1.132	1.023	882	943
	% of market	54,1%	31,9%	38,0%	42,6%	30,6%	41,5%	41,1%	45,9%	53,3%	51,1%	46,3%	46,9%
a. ethyl alcohol and distilled beverages	million lei						412	626	647	822	514	346	479
	% of market						57,9%	63,0%	69,8%	70,5%	57,8%	45,7%	55,8%
b. intermediate products	million lei						40	-2	16	174	379	389	389
	% of market						40,7%	-2,4%	12,1%	68,1%	96,7%	104,5%	99,6%
c. beer	million lei						164	95	127	136	131	147	75
	% of market						24,6%	14,7%	19,5%	19,7%	18,4%	19,3%	10,0%
2. Tax evasion for alcohol vice tax	million lei					235	101	250	238	192	92	69	72
	% of market					79,9%	39,2%	69,4%	70,7%	61,7%	38,9%	34,2%	33,8%
3. Total tax evasion for	million lei	394	270	421	623	667	718	969	1.028	1.324	1.115	951	1.014
	% of market	54,1%	31,9%	38,0%	42,6%	39,0%	41,3%	46,1%	50,2%	54,7%	50,1%	45,4%	45,9%

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

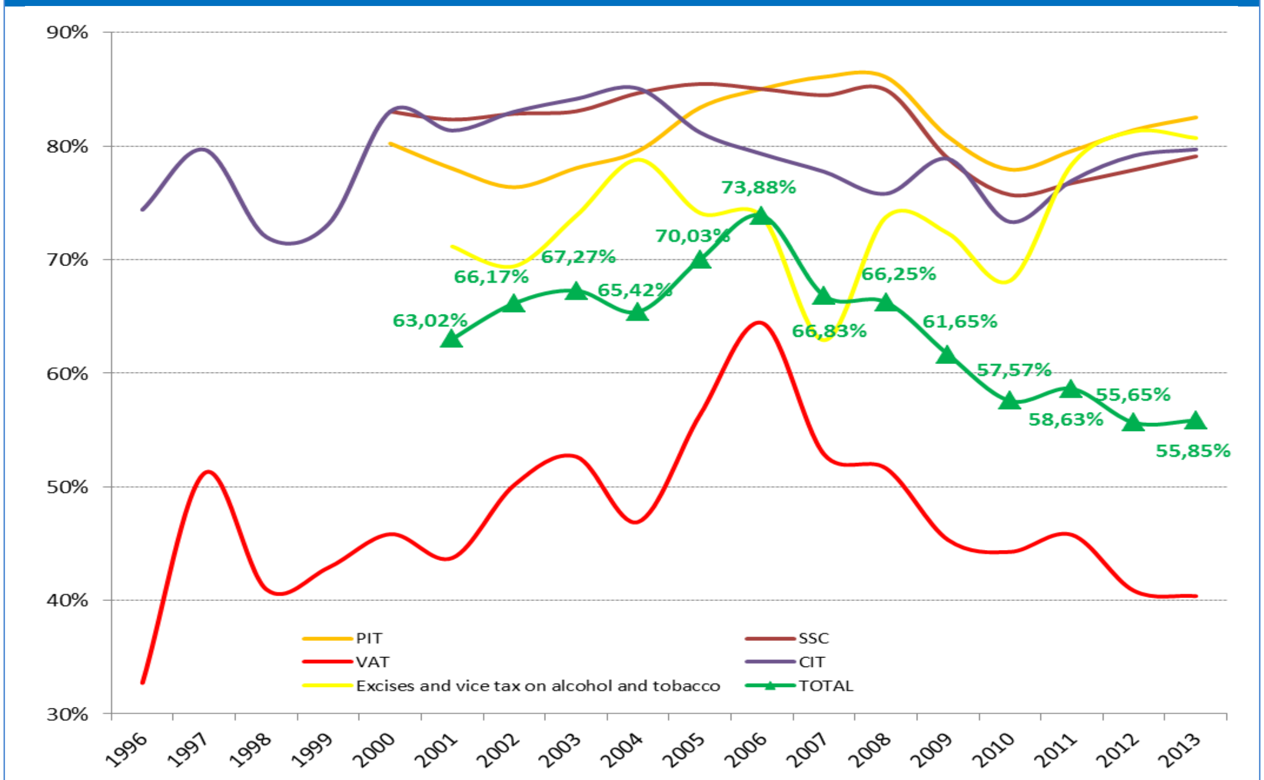
alcohol	% of GDP	0,26%	0,14%	0,17%	0,22%	0,19%	0,17%	0,19%	0,21%	0,25%	0,20%	0,16%	0,16%
4. Tax evasion for cigarettes excises**	million lei	263	533	365	584	675	1.750	944	1.436	1.999	1.294	1.185	1.238
5. Tax evasion for cigarettes vice tax	million lei					164	668	281	341	341	207	187	185
6. Total tax evasion for cigarettes	million lei	263	533	365	584	838	2.418	1.225	1.777	2.339	1.501	1.372	1.423
	% of market	18,5%	23,9%	14,0%	18,3%	20,8%	36,0%	19,6%	22,0%	25,8%	15,2%	13,3%	13,7%
	% of GDP	0,17%	0,27%	0,15%	0,20%	0,24%	0,58%	0,24%	0,35%	0,45%	0,27%	0,23%	0,23%
7. Total tax evasion for alcohol and cigarettes (excises and vice tax)	million lei	656	803	786	1.207	1.505	3.137	2.194	2.805	3.663	2.616	2.323	2.438
	% of GDP	0,43%	0,41%	0,32%	0,42%	0,44%	0,75%	0,43%	0,56%	0,70%	0,47%	0,40%	0,39%

Source: Fiscal Council's calculation based on NIS 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 during 2008-2013, 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 2013 at the level of 55.8%, a slight improvement over 2012 when the minimum of the last 12 years was recorded. The highest collection rate during 2001-2013 was reached in 2006, respectively 73.9% taxes collected compared to the theoretical payment obligations. The lowest degree of compliance is registered for VAT, of only 40.38% VAT collected from theoretical obligations for the payment of VAT in 2013. However, it can be observed a slight deterioration of the compliance degree in the case of VAT, excise duty and vice tax on alcohol and cigarettes during 2012-2013. On the other hand, in the case of SSC, corporate tax and personal income tax it can be observed an improvement of the compliance degree during 2012-2013. Also, in the case of the personal income tax there is an improvement of the compliance degree during 2005-2006 after the introduction of a flat tax of 16%. During 2007-2013 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 2009-2013, after increasing the SSC rates in 2008, but a slight improvement compared to 2012.

Figure 64: Evolution of compliance degree for major taxes



Source: Fiscal Council's calculation

VII. Fiscal Risks

VII.1. Fiscal risks – concept, classification and approaches

The fiscal risks are defined as government control external factors that can cause different fiscal results of the initial forecasts.

In practice, the fiscal results often differ from projections. These differences may result from deviations to growth expectations, unanticipated trade shocks, natural disasters, the use of government guarantees, etc.

Thus, fiscal risks refer to potential differences between actual and expected fiscal results. These occur due to the fact that budgets are built on assumptions with a certain probability to materialize, but also because of introducing one-off measures. Deviations are usually small and can be handled properly, but there are also shocks that generate an unexpected major burden on public finance. Therefore, policy makers must take into account the possibility of such risks materializing and to adjust in line their fiscal policy.

Investigation of fiscal risks sources supports avoiding fiscal instability and the achievement of long term objectives. Four categories of sources of fiscal risks can be identified: **direct vs. contingent and explicit vs. implicit.**

Direct vs. contingent

Direct liabilities – obligation whose manifestation is predictable.

Contingent liabilities – obligation if a particular event occurs. Their likelihood can be exogenous to government policies (eq. natural disasters) or endogenous (eq. If government programs create moral hazard).

Explicit vs. implicit

Explicit liabilities – specific obligation, as recognized by a law or contract, that the government is bound to respect.

Implicit liabilities – moral obligation or duty which, although not stipulated in the law, has a high probability to be covered by the government due to political or public expectations.

Box 5: Government fiscal risk matrix

Direct liabilities:

- Explicit:
  - Domestic and foreign government loans (loans contracted and securities issued by the government);
  - Budgetary expenditure;
  - Budgetary expenditure legally binding in the long term (public sector wages and pensions).
- Implicit:
  - Future public pensions (1st pillar), when not required by law;
  - Financing public health sector, when not required by law;
  - Social security schemes, when not required by law;
  - Future recurrent costs related to public investment.

Contingent liabilities:

- Explicit:
  - State guarantees for non-sovereign borrowing and for local administrations, public and private companies;
  - State guarantees for different types of loans (mortgages, student loans, agricultural loans, small business loans, etc.);
  - Trade and exchange rate guarantees issued by the state;
  - Guarantees for private investment;
  - Insurance schemes offered by the state (deposit insurance and income from private pension funds, crop insurance, flood insurance etc.).
- Implicit:
  - Default of some local public administrations or of some private or public companies (nonguaranteed debt or other obligation);
  - „Clean" of entities debt that will be privatized;
  - Banking Default/ bankruptcy (additional support guarantees);
  - Failure of an unsecured pension fund, of an employment fund (unemployment fund) or of a social security fund (protection for small investors);
  - Failure of the central bank to honor its' obligations (arising from exchange contracts, currency defense action, promotion activities of the balance of payments stability etc.);
  - Bailouts due to a reversal of private capital flows;
  - Environmental rehabilitation, disaster aids, military funding.

Source: World Bank (2002)

Each fiscal risk should be analyzed considering both the effects observed in the past due to its manifestation, likelihood and other anticipated consequences. „Backward looking” analysis provides the necessary implementation of policies aimed at reducing such risks in the future. For example, a systematic overestimation of revenues highlights the need for a more detailed analysis of the underlying assumptions and methods of income estimation, including assumptions about economic growth. Similarly, frequent bailouts of public-private partnerships, SOEs, local administrations impose the strengthening of their monitoring. Estimating the probability of occurrence and of some different effects from those manifested in the past is a difficult task, but should be taken in the analysis of fiscal risks.

Analysis of fiscal risks may also draws attention to country practices in order to assess the risks, such as:

- Sensitivity analysis on key macroeconomic variables, stress tests for fiscal aggregates or graphs illustrating the probability distribution for the results;
- Analysis of public debt sustainability, deterministic or stochastic;
- Description and quantification of the state budget exposure to guarantees granted by the state;
- Description of state guarantees in public-private partnership projects along with the nominal value of the projects, the government prepayments and their net present value;
- The nature and purpose of the ongoing litigation against the state.

The presentation of fiscal risks, valuation models and measures of coverage is an exercise of transparency from the fiscal authorities, recommended in fact by international financial institutions.

The coverage of government obligations can be achieved by using several categories of **potential revenues**. These sources can also be divided into **direct vs. contingent and explicit vs. implicit**.

Direct vs. contingent

Direct sources of financial safety – based on the stock of existing assets.

Contingent sources of financial safety – depend on the future events, such as the value generated in the future.

Explicit vs. implicit

Explicit sources of financial safety – based on the government legal power.

Implicit sources of financial safety – based on government indirect control.

Box 6: Sources of financial safety

Direct sources:

- Explicit:
  - Assets recovery (recovery or selling non-performing loans);
  - Privatization of SOEs and other public resources;
  - Recovery of previous government loans.
- Implicit:
  - Stabilization and contingency funds;
  - Positive net worth of central bank.

Contingent sources:

- Explicit:
  - Government revenues from resource extraction and sales;
  - Fiscal revenues:
    - Minus fiscal expenditures (exclusions, exemptions and deductions, which reduce taxable income);
    - Minus commitments on transfer income (to local administrations);
  - Hedging instruments and insurance/reinsurance policies purchased by government from the financial institutions.
- Implicit:
  - Profit of SOEs;
  - Contingent credit lines and financing commitments from official creditors;
  - Current account surplus in foreign currency.

Source: World Bank (2002)

The implementation of fiscal policy in an uncertain context is a challenge for policy makers. Providing information on fiscal risks, public reporting of their size and measurement methods used may lead to a better understanding of the actual state of public finances, while ignoring them reduces the ability of authorities to respond to shocks and may affect the sustainability of public finances.

VII.2. Analysis of fiscal risks in Romania

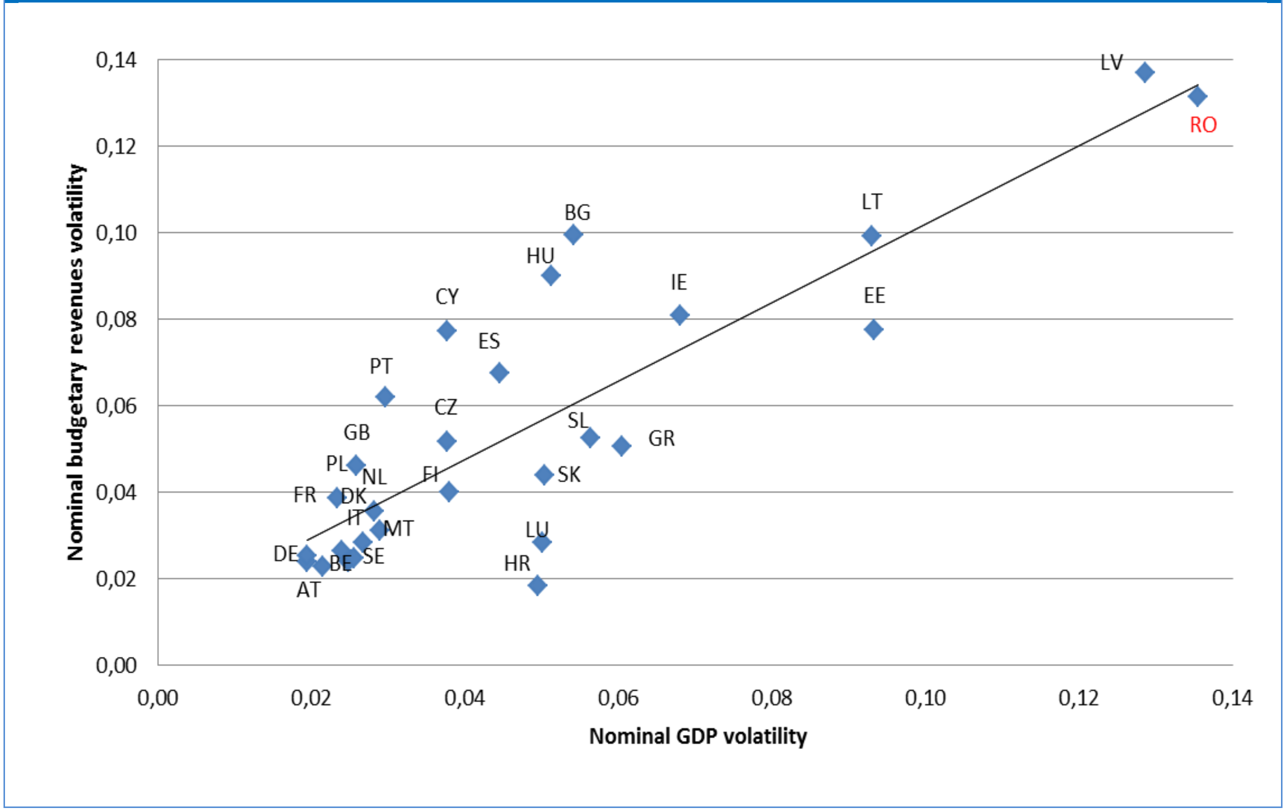
According to art. 20, paragraph (2), letter (d) from the Fiscal Responsibility Law no. 69/2010, the fiscal framework from the fiscal strategy must contain: „a fiscal risk statement, including, any commitments and contingent liabilities not included in the fiscal forecasts, and all other circumstances which may have a material effect on the fiscal and economic forecasts and which have not already been incorporated into the fiscal forecasts”.

In this context, the present report aims to assess how the aforementioned analysis is made in programming documents prepared by the Ministry of Public Finance (”Convergence Programme 2013-2016”, ”Report on macroeconomic situation for 2014 and the projections for the years 2015-2017” and ”The updated version of the 2014-2016 Fiscal Strategy”). Thus, the following risks will be considered: *the risk associated to the change of macroeconomic framework, fiscal sustainability risks, the risks associated with the payments of the Ministry of Public Finance as guarantor for the issued guarantees by the state and risks generated by public-private partnerships*.

In none of the above programmatic documents the risk associated *to the change of macroeconomic framework* is highlighted given that fiscal instability is often favored by an uncertain growth rate***, the economy’s volatility representing an important source of fiscal risk***. However, the income uncertainty is usually greater for catching-up countries, the revenue projections being more difficult in these conditions, with possible negative consequences of fiscal targets (especially given that some budgetary expenditures are required, regardless the revenues).

Moreover, during 2001-2013, the volatility of nominal GDP in Romania was the highest in the EU, while in terms of budgetary revenues volatility, Romania ranks the second position after Latvia. In contrast, Germany, Austria, Belgium are characterized by a low volatility of output and of the budgetary revenues.

Figure 65: The volatility of nominal GDP and budgetary revenues

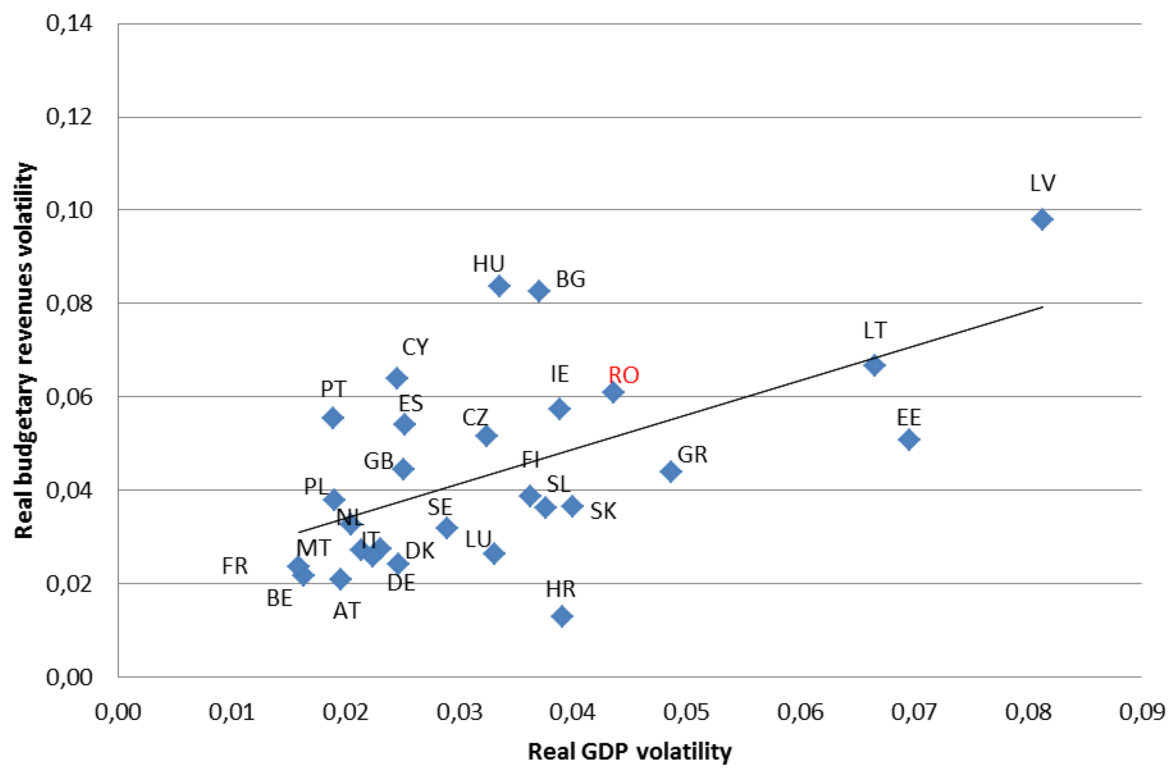


Source: Eurostat, Fiscal Council calculations

**In the case of Croatia, the data are for the period 2010-2012*

In order to isolate the influence of prices the volatility of GDP and of budgetary revenues in real terms has been calculated. In this case, Romania does not appear in the top volatilities, Latvia, Lithuania, Estonia and Greece recording higher volatilities of real GDP and Latvia, Hungary, Bulgaria and Lithuania being characterized by higher volatilities for the real budgetary revenues. Even in these circumstances, Romania is in the top of the ranking, at the opposite side being found France, Belgium, Austria. The reason for which Romania is in a better position than in the first case derives from the fact that in the analyzed period a high volatility of inflation was registered. In this context, it is even more necessary a government revenues projection based on several scenarios for the evolution of the macroeconomic framework.

Figure 66: The volatility of real GDP and of real budgetary revenues



Source: Eurostat, Fiscal Council calculations

**In the case of Croatia, the data are for the period 2010-2012*

The Report on the macroeconomic situation for 2014 and the projections for the years 2015-2017 presents some analysis of the risks to the sustainability of public finances, containing assessments that consider the sensitivity of government debt to the economic growth rate change and the interest payments sensitivity to the interest rate and exchange rate change. However, the analysis is performed in a deterministic framework and it should be supplemented by the stochastic one, taking into account the links between the variables. For example, based on the iterative approach, it may be decided to implement a fiscal consolidation package, which in turn will affect GDP and possibly interest rates or inflation, so the initial trajectory taken into account by the consolidation plan is no longer valid.

Moreover, a sensitivity analysis should be done also for the budget deficit changes to the key macroeconomic variables, stress tests for the fiscal aggregates or graphs illustrating the probability distribution for the results.

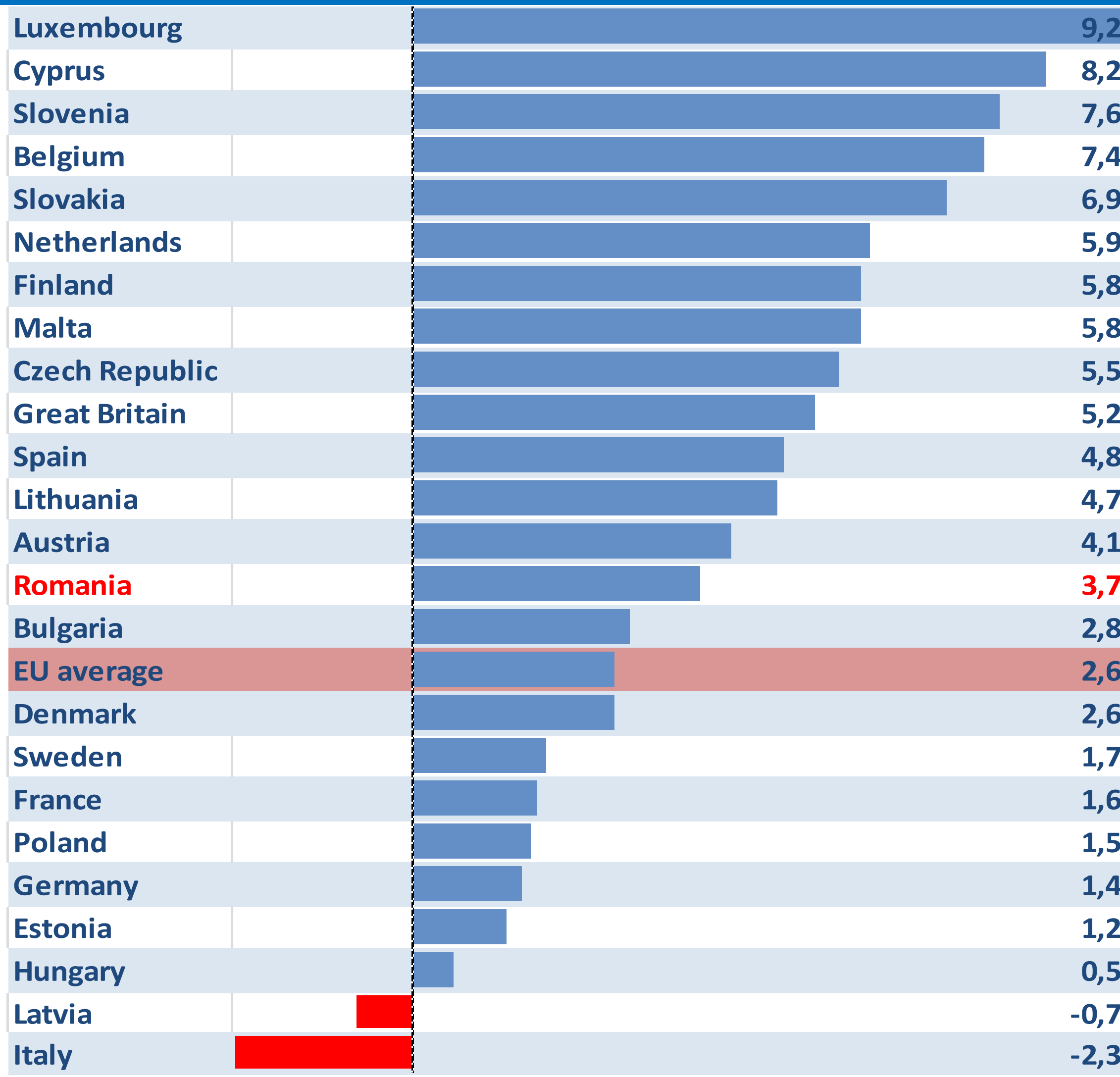
The risk generated by the cost of ageing population and by the rising cost of health services is analyzed in the programming documents prepared by the Ministry of Public Finance only through the European Commission data from ”Fiscal Sustainability Report 2012”, as there is a lack of a national source. Furthermore, the analyzed documents do not contain proposals for measures to mitigate this risk and any projection of total revenues and expenditures in the long term, so that the hedging to be assessed.

The long term sustainability is assessed in the ”Fiscal Sustainability Report 2012” through S2 indicator, that is showing the adjustment to the current structural primary balance required to fulfill the infinite horizon inter-temporal budget constraint. It comprises the outstanding government debt and the present value of future expenditure, including paying for any additional expenditure arising from an ageing population. So, the S2 indicator considers the projected changes in age-related expenditure over a considerably longer time horizon (to 2060 and beyond[57]). The indicator is measured as a percentage of GDP and as its values are higher, the need for fiscal adjustment and risk to fiscal sustainability is higher. Thus, in the case of an adjustment less than 2% of GDP, the European Commission considers a low risk associated with the fiscal sustainability. If the adjustment is placed between 2% and 6% of GDP, the risk associated with fiscal sustainability is medium and if the S2 indicator is greater than 6% of GDP then the risk to fiscal sustainability in the long term is high.

Compared to other EU countries, Romania is positioned in the first part of the ranking, with a S2 indicator of 3.7% of GDP, but close to the EU average of 2.65 of GDP, data that can be observed in the below table, thus resulting an average risk for Romania considering long-term fiscal sustainability. The S2 indicator has two components: the initial budgetary position and the long term costs of ageing (consisting of pensions, healthcare and others). According to the ”Fiscal Sustainability Report 2012”, the initial budgetary position in the case of Romania is 0.1% of GDP in 2012 and the long-term costs of ageing are 3.6% of GDP, of which 2.4% of GDP are pension expenditures and 1.3% of GDP are health expenditures.

[57] For the period after 2060 the projections for ageing costs are considered constant as a share of GDP at the level from 2060, given the fact that after that date no data are forecasted.

Figure 67: Long term fiscal sustainability measured by S2 indicator (% of GDP)



Source: European Commission, 2012

Compared with 2009, Romania recorded a significant progress by considering S2, decreasing from 9.1% of GDP to 3.7% of GDP, the adjustment being realized both by improving the initial budgetary position (-4.1 pp) and by reducing the costs of an ageing population (-1.3 pp), in the context of the public pension reform.

Top countries presenting the highest risk to the long term sustainability consists of Luxembourg, Cyprus, Slovenia and Belgium, recording a level of S2 indicator of 9.2%, 8.2%, 7.6% and 7.4% of GDP for 2012. The high value of the indicator in those countries is driven mainly by the considerable long term costs associated with ageing population.

The risks associated with the payments of the Ministry of Public Finance as guarantor for the issued guarantees by the state are evaluated in the ”Report on macroeconomic situation for 2014 and the projections for the years 2015-2017”, concluding that they are reduced although the guarantees exposure is growing. Thus, their stock at the end of 2013 represented 14.7 billion lei (2.35% of GDP), with 0.9 billion lei more than the level of 13.8 billion lei registered in the previous year and payments expected to be made from the state budget on behalf of such guarantees is less than 0.1% of GDP in the coming years. However, the probability of using the guarantees is not concretely estimated. The Report on public debt from December 2013 provides information on the size and destination of guarantees granted in 2013 for new loans that are amounting 1725.2 million lei and being provided for:

- The ”First House” governmental program;
- The support program for the projects beneficiaries from Romanian economy's priority areas, financed from EU structural instruments;
- Mihail Kogălniceanu program to support SMEs;
- The thermal rehabilitation program of housing assemblies.

None of the analyzed documents do not present public-private partnerships (PPPs) as potential fiscal risks, but rather as goals to be followed in subsequent years. The main arguments in favor of the PPPs development, especially in infrastructure, consider a higher efficiency of the private sector in the implementation of considerable value investments, manifested by higher standards of infrastructure and its maintenance without immediate impact on public spending. The most important feature of PPP is the combination of a significant investment with a long term service delivery. The private partner provides funding and infrastructure construction and in the same time receives the right to operate and to provide services through the realized infrastructure. Under certain conditions, the costs related to infrastructure construction do not increase public debt (if they are registered as off-balance sheet projects), but bear in mind that payments for the operation of such infrastructure can increase the deficit in the future.

So, the PPP allows the reduction of the current deficit in exchange for increased public spending in the future, an acceptable trade only under certain conditions (such as avoiding to burden future generations with a high public debt or implicit liabilities related to the pension system) since the payments are made over the years in which the infrastructure project is used. If the PPP is performed only to exclude project costs from the public debt, then it should not be done and such an approach would be irresponsible and would only mean a shift of public spending in the future. The objective of PPP should not be addressing constraints to the budget, but should combine the need of the public sector for infrastructure and the private sector experience to ensure a greater value for money.

The key point of success or failure of a PPP project is the appropriate risk distribution between the two partners. Important risk sharing by the private partner is the main tool that could be used to provide not only the exclusion of public investment spending from the budget, but also achieving the efficiency of the project for the public sector. However, transferring excessive risks to the private partner can generate an excessively expensive project or even impossible to finance.

In Romania, during 1999-2011 PPP investments were insignificant[58], but there is a new law on PPP in Parliament in order to develop PPP investments. Moreover, Government's intention in the case of Comarnic-Brașov highway construction is the use of a PPP, in this regard being already selected a bidder for a contract of 29 years, the capital cost of the project being estimated at 1.5-1.8 billion euro. For the moment, it is not clear which will be the conditions in this partnership and in the Fiscal Council's opinion transparency is a key condition for the success of the project, being extremely important to realize an ex-ante comprehensive evaluation of benefits, costs and risks associated with the PPP. For example, while the Romanian state would guarantee to the constructor a certain annual amount from collected usage fees, committing to pay from the state budget the difference between this level and the actual charged fees, the risks regarding the deterioration of the fiscal position are obvious, their size depending on the characteristics of the contract.

In conclusion, the fiscal risks are partly and disparately assessed in the programming documents prepared by the Ministry of Public Finances and a comprehensive and integrated analysis seems necessary to improve budget programming. Thus, it is necessary to include the risks associated to the change of macroeconomic framework in the Fiscal Strategy, possibly with the determination of some alternative trajectories for budgetary aggregates assuming different scenarios of macroeconomic development, but also the risk generated by the PPP development. In addition, the deterministic analysis on the public debt sustainability should be supplemented by a stochastic one, and the analysis of every mentioned fiscal risk should be supplemented by a set of measures aimed at reducing them.

[58] Kappeler, A., (2011) – "Recent trends in the PPP market in Europe: slow recovery and increasing EIB involvement"

VIII. 2014 – Macroeconomic and fiscal perspectives

VIII.1. Macroeconomic framework

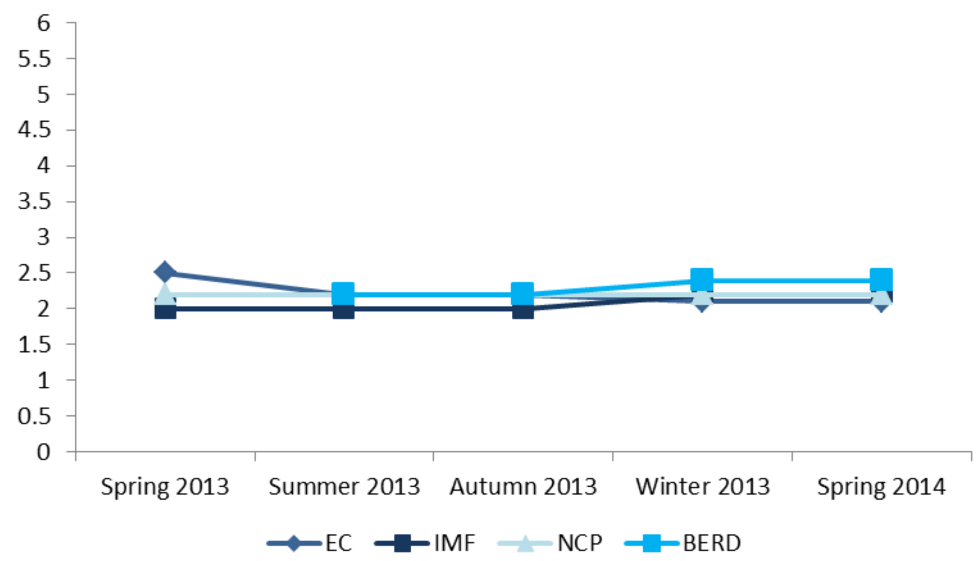
In the spring forecast published in May 2014, the European Commission projects for the current year an economic advance of 1.6% in the **European Union**, while in the euro area the real GDP is expected to increase by 1.2%. The economic growth is expected to rely mainly on the returning on an upward path of the domestic demand, due to an increased consumer confidence also favored by the dissipation of the financial crisis effects. In the period 2010-2013, the EU economies evolved divergently, certain countries returning on an upward trend, while others experienced a significant economic contraction. Instead, for 2014, the EC forecast positive growth rates for almost all EU countries, except Cyprus (-4.8%) and Croatia (-0.6%). Thus, the best performing countries in terms of expected real GDP growth are Latvia (3.8%), Poland (3.2%) and Sweden (2.8%), but robust growth is expected also in the UK (+2.7%), Germany (+1.8%), as well as in the Central and Eastern Europe countries, the growth rates in the region being expected to range over 2%.

For 2014 it is estimated a low inflation rate, respectively 1% for the European Union and 0.8% for the euro area, this evolution being favored both by external factors such as falling commodity prices and by internal factors – continuing the process of macroeconomic adjustment and dissipating the effect of increasing administered prices, energy prices and indirect taxes in many Member States.

In **Romania**, the European Commission's spring forecast has anticipated a slowdown in economic growth to 2.5% compared to 3.5% recorded in 2013. The real GDP growth is projected to rely especially on improving public and companies' confidence, relatively favorable international context, as well as on the manifestation of the positive effects of structural reforms regarding the new Labor Code and liberalization of the energy market. Thus, the domestic demand is expected to replace the net exports as the main driver of economic growth. Investments may register a positive trend as a result of profit tax exemption for reinvested profit in technological equipment, starting with June of this year, as well as in the context of an improvement in the EU funds absorption. Also, there are favorable expectations regarding the consumption trend as a result of an increasing consumer confidence and a moderate increase of the real wage. On the other hand, lending will remain, most likely, in the negative territory, being influenced by the ongoing process of debt reduction (deleveraging) in the commercial banks.

Dynamically analyzing, the economic growth forecasts for 2014 have been revised only marginally in the last year, a situation significantly different from the large negative revisions made in the previous years, proving an increased optimism regarding the economic recovery in a sustainable manner.

Figure 68: The evolution of the Romania's economic growth forecasts for 2014



Source: EC, IMF, NCP, EBRD

According to the Inflation Report released in August 2014 by NBR, in Romania the inflation rate is expected to remain within the target band throughout this year, and is projected to record at the end of the year a level of 2.2%, this projection being revised down significantly from the 3.3% level predicted in the previous version of the same report. The reassessment of the inflation projection was due both to contextual factors – a good agricultural year, and to fundamental factors - the persistence of the negative output gap and the downward adjustment of inflation expectations.

In Fiscal Council's opinion, the risk balance to real GDP growth in 2014 is rather tilted on the negative side, respectively a lower economic growth than the originally anticipated due to very weak developments both in public and private investments in the first half of 2014, as well as unfavorable external environment, the EU economies having a below expectations performance.

VIII.2. The fiscal framework

In the agreements with the IMF and European Commission, the Government committed, in formulating the budget for 2014, to a reduction of the consolidated budget deficit according to cash methodology to 2.2% of GDP from 2.5% of GDP, while according to ESA95 the budget balance is projected to marginally fall to 2.2% of GDP, from 2.3% of GDP, the size of fiscal consolidation being reduced both in absolute terms and compared to the previous years. Likewise, the pace of structural adjustment proposed for 2014 is only 0.1 percentage points of GDP, while in the previous year was of 0.7 pp. The 2014-2017 Convergence Programme reaffirms the Government's commitment to achieve the medium term objective, namely a structural deficit of 1% of GDP for 2015, given the fact that the significant slowdown of the fiscal consolidation pace in 2014 would be fully recovered in 2015. Thus, the budget deficit target for 2015 has been set to 1.4% of GDP, both according to cash and ESA methodology.

According to the Fiscal Council's opinion on the State Budget Law, written in November 2013, the institution appreciated that the revenue projections for 2014 are consistent with the dynamics of the relevant macroeconomic bases and with the assessed impact of discretionary measures, with reservations about the lack of precision on taxation impact upon the special constructions tax. Thus, given the information available at that time and assuming unchanged collection efficiency, the budget deficit target for 2014 appeared as realistic. Meanwhile, the projected budget revenues were negatively affected by the 3 months delay of the additional excise duty on fuel and the introduction of reinvested profit tax exemption measure in technological equipment from the 1st of July 2014. The Fiscal Council warned of overly optimistic assessment of the Ministry of Finance on the budgetary impact of this measure that is likely to significantly affect the receipts from profit tax, especially starting with 2015.

In addition, given the stated intention of the government to reduce social security contributions, the Fiscal Council reiterates that the impact of such measures is not in the current budget projection for 2014 and neither in the medium term one (ceteris paribus, the annualized net impact of reducing the pension contribution by 5 pp for employer would imply a higher deficit by about 0.5 - 0.6% of GDP). The Fiscal Council considers that the adoption of such legislative measure, although desirable from the business environment point of view, is not possible under the commitment of pursuing the fiscal consolidation envisaged (derived from adopting European treaties) without identifying equivalent compensatory measures (of significant amplitude), represented either by the increases/extensions in the tax base of other taxes or by expenditure cuts.

The Fiscal Council finds again the adoption of amendments from the Fiscal Code, without being subjected to public debate for a reasonable time, contrary to the spirit of article 4, paragraph 1 of the Fiscal Code which states that ”the present code is amended and supplemented by law, usually promoted 6 months before the date of entry into force”. In this context, the fiscal policy is less predictable, is lacking a medium term vision, with consequences both from a microeconomic perspective, the economic agents decisions being influenced by the major changes in the tax system, but also from a macroeconomic perspective, considering the achievement of the fiscal targets.

Both revenues and expenditures were, at the end of June 2014, significantly below the semester program corresponding to the initial form of the general consolidated budget (GCB). Thus, the total revenues of the GCB were below the amount programmed by about 4.5 billion lei (only 95.7% achievement rate of the revenue program), and the expenditures by about 9.4 billion lei (91.7% achievement rate of the revenue program), generating a favorable impact at the level of the budget deficit (namely a deficit lower than the target set for the first semester) of 4.9 billion lei.

The largest **revenue** failures compared to the initial program were registered in the case of the *amounts received from EU* (-2.8 billion lei), *VAT* (-1.49 billion lei), *social security contributions* (-478 million lei), *non-tax revenues* (-478 million lei), *personal income tax* (-426 million lei) and *excises* (-301 million lei), while revenues higher than the semestral targets were recorded in the case of *property taxes* (+507 million lei), *other taxes on goods and services* (+431.5 million lei) and *corporate income tax* (+261 million lei).

On the **expenditure** side, all the expenditure categories, except the personnel spending – which was higher than programmed by 107 million lei, registered below programmed levels at the end of the first semester. More than half of the 9.4 billion lei deviation of the total expenditures compared to the half-year program target was recorded by the projects funded by external post-accession grants (-4.4 billion lei), also a major deviation being registered in capital expenditures, whose achievement ratio is only 69.3% of the half-year program (-2.13 million lei). An underperformance of lower magnitude compared to the program can be observed in the case of expenditures related to: goods and services (-740.3 million lei), transfers for public entities (-518 million lei), social assistance (-503.7 million lei), subsidies (-110 million lei) and interest (-131 million lei).

Therefore, the budget execution at the end of the first half of the current year reveals an underperformance of about 1.2 billion lei at the level of the budgetary revenues, excluding the EU funds absorption below estimates, as well as the underachievement of the non-tax revenue program, given that this was caused by the postponement of the dividends receipts compared to the initial program. The underperformance of the budgetary revenues was more than compensated by significant cost savings compared to the program, which resulted in a significantly lower level of the budget deficit, both compared to the previous year and to the half-year program.

The first semester budget execution shows an improvement of the budget revenues in June this year, that have performed relatively well compared to the same period of the last year, but cumulatively from the beginning of the year the dynamics are significantly lower than those projected for the whole year 2014. Thus, the amounts received from the EU in the account of payments made (-10.8% compared to a considered advance of 66.5%), non-tax revenues (-11.5% compared to a considered advance of 1.3%), personal income tax (+0.6% compared to the projected increase of 5.6%), VAT receipts (+1.9% compared to a projected advance of 5.4%), receipts from excises (10.9% compared to 14.2%), social security contributions (+5.6% compared to a projected growth rate of 6.3%) registered an unfavorable growth rate compared to that being considered for the current year. Positive developments were recorded in the case of profit tax receipts (+12.7% compared to an estimated growth rate of 4.1% till the end of the year), but these are not likely to compensate the revenue gap recorded in the other categories. The Fiscal Council notes some reserves in the case of interest expenses (which decreased by 1% in the first six months compared to the projected advance of 4.3%), but also at the level of social assistance expenses (annualized growth rate at 4 months of 3.6% compared to 4.6% throughout the whole year).

In the initial budget for 2014, an increase of the share of EU funds absorption in total investments was intended, a correct approach and welcomed in the Fiscal Council's opinion, but the budget execution for the first half of 2014 shows, so far, a failure in this regard. In this context, it is more necessary to urgently adopt corrective measures, the present situation raising questions about achieving the targets regarding EU funds absorption across 2014.

Another important aspect of how the fiscal policy is conducted in 2014 is represented by the decision taken in the first budget amendment for non-distribution and non-use by the principal authorizing officers of the retained amounts at a rate of 10%, according to article 21, paragraph (5) of the Law no. 500/2002, these amounts following to be most likely a source of covering immaterializing budget revenues projections.

In Fiscal Council's opinion, the risk balance regarding the fiscal policy stance is relatively balanced for the current year and is tilted downside for 2015 (a budget deficit higher than the projected one). Thus, the underperformance of revenues in the first six months of the year, mainly due to a development well below expectations of the amounts from EU funds will be probably be accommodated, under the assumption of maintaining this trend by reducing the investment spending and/or by non-using the amounts retained in a ratio of 10%, according to article 21, paragraph 5 of the Law no. 500/2002, while other fiscal measures recently adopted (reinvested profit tax exemption) will produce effects mostly in the following years.

Achieving the budget deficit target in 2014 is an attainable objective and as a result of a proposed fiscal consolidation for this year of reduced size, but the fulfillment of targets for 2015, appears as a major challenge given both the fiscal consolidation pace (0.8 pp of GDP both according to cash and ESA95 methodology) and the much undervalued negative impact of the adopted fiscal measures upon profit tax receipts. Thus, achieving medium term objective in 2015, respectively a structural deficit of 1% of GDP, assumed through the 2014-2017 Convergence Programme, seems unlikely. Also, the decision of reducing with 5 pp of the employer's social security contribution would make more difficult the compliance of assumed targets in the absence of some major compensatory measures. The biggest risk to the conduct of fiscal policy in the following years seems to be represented by the decrease of the political commitment for fiscal consolidation, especially given the fact that the exit from the excessive deficit procedure, based on Romania's good performance in adjusting accumulated fiscal imbalances is likely to reduce the existing constraints on fiscal policy.

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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 – the monetary policy interest rate represents the interest rate used for the main open market operations of the NBR. At present, these are one week repo operations, 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 – Starting with September 1st, 2011, the NBR’s reference interest rate is the monetary policy interest rate, established by decision by the NBR’s Board of Directors.

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.