Fiscal Council's preliminary Opinion on the draft of the second budget revision for 2020

At the end of August 13th, 2020[1], the Ministry of Public Finance (MPF) sent to the Fiscal Council (FC), by address no. 474594/13.08.2020, the Report on the economic and budgetary situation for the first six months of 2020[2], the draft revision of the general consolidated budget for 2020, the explanatory note and the draft of the Government Emergency Ordinance on the revision of the state budget for 2020, the modification of some normative acts and the establishment of some budgetary measures, as well as the explanatory note and the draft of the Government Emergency Ordinance for the revision of the social security budget for 2020, requesting, under art. 53, para. (2) of the Fiscal Responsibility Law (no. 69/2010, republished, hereafter referred to as FRL), the opinion of the Fiscal Council.

According to art. 53, para. (4) of the FRL, the Government and the Parliament have the obligation to analyze the opinions and recommendations of the Fiscal Council when they work out the Fiscal Strategy, the annual budgetary laws, as well as other measures determined by the implementation of this law. Given the Government's intention to approve the above-mentioned documents at the meeting scheduled for August 14th 2020, the time available to the Fiscal Council for document analysis and working out the requested opinion is insufficient, which makes it impossible to formulate a complete opinion. Another reason that makes it impossible to produce a complete opinion is some lacking information which has been required to assess the budget revision[3]. Under these circumstances, the Fiscal Council decided to formulate a preliminary opinion, which will be limited to certain considerations, as well as to assessing the compliance of the proposed revision with the regulations established by the FRL, while the complete opinion will be finalized subsequently, conditioned by receiving the necessary information requested from the Ministry of Public Finance.

[1] At 10.41 p.m.
[2] Received on 13th of August at 11.33 p.m.
[3] FC requested information on: (i) swap compensation schemes, (ii) the dynamics of European funds, (iii) the list of adopted measures and their budgetary impact.

Considerations concerning the economic situation and the second budget revision for 2020

The Fiscal Council begins its considerations from the special circumstances determined by the pandemic caused by the SARS-CoV-2 virus, as well as from its profound economic and social impact. This reality induces uncertainties, which are unprecedented in recent history, regarding the interconnected evolution of economies, that are significantly dependent on the health situation. We can note, however, that the most acute moment of the current crisis, determined by the initial health restrictions, seems to have passed, and the process of economic recovery appears to have begun in most national economies, including Romania. In this respect, the unfavorable developments in the second quarter of this year (reflected in the dynamics of more frequent sectoral data, such as industry, trade, etc.) which were anticipated and highlighted by the previous opinion of the Fiscal Council (on the first budget revision) are: (i) confirmed by the new data from the signal estimate of the National Institute of Statistics published on August 14, respectively a contraction of 10.5% in Q2 2020 (year on year), which is compatible with the FC estimates (average scenario of a contraction between 4 and 6% of real GDP in 2020 from the previous opinion), (ii) validated by the new macroeconomic projection of the Government which, in the forecast published on August 13 by the National Commission for Strategy and Prognosis (NCSP), anticipates for this year an economic contraction of 3.8%, significantly revising the previous figure of -1.9%, (iii) compatible with a recovery of the economy in the last two quarters of the year - compared to Q2 2020 -, the magnitude and speed of the recovery strictly depending on the evolution of the health situation in Romania and in the EU.

The Fiscal Council notes the unprecedented fiscal and monetary measures taken in the EU and internationally to combat the effects of the pandemic. However, the extent of these measures depends, from one economy to another, on parameters such as existing fiscal space (the size of the pre-pandemic deficit and debt) and monetary space (whether the zero-lower-bound is reached or not, that is a value of zero - or even nominal negative interest rates - for the monetary policy rate), being or not an issuer of an international reserve currency and institutional capacity. From this point of view, Romania's budgetary situation has been increasingly tense, a fact also reflected by Romania's singular case in the European Commission's (EC) excessive deficit procedure at the beginning of this year. This situation has occurred despite the temporary suspension of EU fiscal rules.

The economic and financial situation of a country is reflected by the sovereign risk rating and is judged by financial markets – since they take care of financing and refinancing needs.

For Romania, the issue of macroeconomic imbalances - current account deficit and a relatively large structural budget deficit - requires a macroeconomic correction in order to maintain access to financing on the markets and to avoid a downgrade of the country's rating. This correction is also necessary given that Romania is subject to the excessive deficit procedure and with the perspective of the resumption of observing European fiscal rules.

The absorption of European funds from the multiannual financial framework and the European Recovery Plan, which together amount to approximately 80 billion euros (from which, however, Romania's contribution to the EU budget and the recovery plan must be deducted), will reduce the financing needs from financial markets, thus, allowing a smoother macroeconomic correction path, compatible with promoting a short-term anti-cyclical fiscal policy.

FC appreciates that the revised macroeconomic scenario of the Government (published on August 13) is more realistic than the previous one. However, the revised scenario could prove to be too optimistic when compared to the latest developments of macroeconomic indicators (for example, the GDP deflator, due to its relatively large increase in 2020, almost offsets the reduction in economic activity, thus, contributing at maintaining nominal GDP at a level similar to the previous year; or, the economic contraction for 2020 could be deeper than the updated NCSP forecast).

FC notes that the analysis of the revision proposal is based on data provided by the MPF - consisting mainly of newly adopted discretionary measures and their budgetary impact, swap operations, volume and destination of European funds. The list of measures and the quantification of their impact appears, in the current context, to be particularly important because their number and volume seem relevant to the past and future level and dynamics of many budgetary aggregates.

Thus, we can list, non-exhaustively, the measures identified by the Fiscal Council: (i) for the year 2020: (i.1) measures for the management of the pandemic crisis[4]; (i.2) elimination of the additional excise duty on fuel; (i.3) elimination of the minimum threshold for the tax base in the case of part-time jobs; (i.4) elimination of the tax on energy turnover; (i.5) elimination of the tax on banking assets; (i.6) increase in the excise duty on cigarettes in January and April; (i.7) increase in the minimum wage (reflected in the dynamics of wages in the private sector, with an impact on revenues from social security contributions); (ii) for the year 2021: (ii.1) introduction of the minimum inclusion income; (ii.2) increase in the excise duty on cigarettes.

It should also be noted that, in addition to the lack of an assessment of these measures by the MPF, their impact is different - some influencing the budget deficit and others only transiting the general consolidated budget. A rigorous assessment of these measures is essential for a thorough analysis of fiscal developments in the first half of the year and is a critical element of any fiscal projection for 2020 and beyond. Given that the size of all these measures, including those affecting the deficit, can vary greatly, up to several percentage points of GDP, the Fiscal Council considers that their unavailability, together with the very limited time, prevents a rigorous assessment of both current developments., as well as of the new targets for 2020 proposed in the second budget revision. The Fiscal Council will issue a subsequent opinion, subject, however, to the provision of this strictly necessary information.

FC notes that the new deficit target (8.6% of GDP) belongs to the 8.1-8.9% of GDP range that the FC previously estimated for 2020, according to a GDP decline scenario of 4-6% (considering it to be more realistic), which is a sign of calibrating the anticipated evolution of the economy to reality. The Fiscal

[4] These include: (i) the provision of SME guarantees, (ii) early VAT reimbursement, (iii) the provision of technical unemployment benefits, as well as new labor market support regulations (partially subsidizing the income of employees in the event of reductions in the work program, the Romanian version of *Kurzarbeit)*, (iv) subsidizing the re-employment of the unemployed, (v) sick leave, financing of quarantine centers, (vi) support payments for freelancers, (vii) granting parental leave, (viii) bonus paid for corporate and personal income taxes, (ix) interest subsidies, (x) incentives for healthcare personnel from EU funds, (xi) reduction of social security contributions, (xii) HoReCa specific tax exemptions.

Council also notes the increase in the projection of public debt to relatively high levels in 2020, which are close to the threshold values provided by the FRL. Particularly important are, from the perspective of the budgetary impact, as well as on the public debt, the measures taken regarding pensions and allowances (the pension point will increase by about 14%, while the allowances will undergo a staggered increase). These measures with a significant fiscal impact, but also other measures, are a source of uncertainty in future developments. Modifying or invalidating the budgetary impact of the measures already adopted, as well as new legislative initiatives can be as many sources for a different evolution of the public budget situation and the economy in general, to which can be added the effects of Constitutional Court decisions. Apart from the risks to the trajectory described by the second budget revision for 2020, there are additional risks generated by a possible new wave of the pandemic, the economic evolution of Romania's main trading partners, as well as the world economy, the uncertain impact of fiscal and monetary measures adopted internationally and nationally, etc. Another source of amplifying risks is political uncertainty - which may exacerbate the sources of risk previously described.

Updated coordinates of budget revenues and expenditures[5]

Compared to the parameters approved by the first budget revision for 2020, the draft of the second budget revision increases the total estimated GCB revenues by 0.92 billion lei, while total budget expenditures are supplemented by 19.42 billion lei, the budget deficit being thus increased by 18.5 billion lei. Expressed as a percentage of GDP, the forecasted level of the budget deficit is 8.6%, being 1.75 pp higher than the level estimated at the first budget revision, respectively 4.77 pp higher than the target from the initial budget.

In what concerns **budget revenues**, revisions of previous estimates occur in the following categories:

- Fiscal revenues: -5.7 billion lei, out of which:
    - *Corporate income tax:* -0.54 billion lei. The MPF estimation is subject to major uncertainties, as the revenues from this tax have the potential to decrease massively under the conditions of a large economic decline.
    - *Personal income tax*: -0.3 billion lei. Even under the conditions of the macroeconomic framework formulated by the MPF, an overvaluation of about 0.6 billion lei can be identified. Moreover, a possible cautious attitude of economic agents regarding the distribution of dividends will determine an increase in this gap.
    - *Other taxes on income, profit and capital gains*: -0.51 billion lei. The assessments from corporate income tax also apply here.
    - *VAT*: -4.3 billion lei. The reduction of the VAT revenue estimate is in line with the updated macroeconomic framework and the elimination of the additional excise duty on fuel.

[5] Data on GCB revenues, expenditures and deficit include swap compensation schemes.

  - *Excise duties*: +0.16 billion lei. FC maintains its opinion on a possible overestimation of this category by 1 billion lei taking into account that a negative deviation of fuel consumption from the dynamics of the macroeconomic base considered for the projection of this budgetary aggregate (household consumption in real terms) is very likely in the current context.

- *Social security contributions*: -1.3 billion lei. The reduction is in line with the FC's observation regarding an overvaluation of about 1.1 billion lei noted in the Opinion on the first budget revision and the assessment of the macroeconomic framework.

- *Non-fiscal revenues*: -0.52 billion lei.

- *Amounts received from the EU/other donors on account of payments made and pre-financing related to the 2014-2020 financial framework*: +8.47 billion lei.

The MPF estimates concerning fiscal revenues and social security contributions include, according to the *Substantiation Note of the GEO on the revision of the state budget for 2020, amending some normative acts and establishing certain budgetary measures*, sums in the amount of 7 billion lei which rely on the recovery of delayed fiscal obligations owed by economic agents (according to the provisions of GEO no. 29/2020), performed by NAFA until the end of 2020 (0.9 billion lei corporate income tax and income tax on micro-enterprises, 0.4 billion lei personal income tax, 2.9 billion lei VAT, 0.2 billion lei excise duties, 2.6 billion lei from social security contributions). FC considers that the *ex-ante* inclusion of these amounts, in the current context characterized by a high degree of uncertainty, tilts the risk balance towards a larger deficit.

In what concerns **budget expenditures**, revisions of previous estimates occur in the following categories:

- *Personnel expenditures*: +1.17 billion lei. The amounts are intended for the payment of staff in public health units, the granting of the risk incentive, bonuses for special dangerous conditions, overtime. The granted bonuses are financed by European funds.

- *Goods and services*: +3.64 billion lei. In its Opinion on the first budget revision, FC noted the need to supplement these amounts by 0.2-0.4% of GDP. Under the new conditions, this budgetary aggregate is projected at 55.2 billion lei, about 5% above the nominal level from 2019. In the first 6 months of 2020, this category of expenditures has already registered a growth rate of about 16% compared to the same period of the previous year. Considering the impact of the additional needs related to this category generated by the fight against the COVID-19 pandemic, it is necessary to supplement this budgetary aggregate by about 0.4-0.5% of GDP.

- *Social assistance*: -0.75 billion lei. The downward revision was carried out at the level of the social security budget, respectively, 6.8 billion lei, due to the amendment of the pension point increase beginning with September 1, 2020, from 1,265 lei to 1,442 lei. The amounts related to the *Single National Health Insurance Fund* (+0.8 billion lei) and the unemployment fund (+3 billion lei) were supplemented. The need to increase the amounts for technical unemployment was highlighted by FC in its previous opinion and we maintain the assessment that this estimate is still subject to relevant uncertainties, given the recent measures to extend benefits under GEO no. 30/2020, the settlement for a period of three months, starting with June 1, of a part of the salary for the employees who had their individual employment contracts suspended and did not benefit from the provisions of GEO no. 30/2020 and the facilities offered to employers who hire people from certain age categories.

- *Reserve funds*: -1 billion lei.
- *Capital expenditures*: +3.6 billion lei. The upward revision is explained by the increase of investment expenditures by 3.8 billion lei, compared to the same period of the previous year, and by the plan to continue their increase in the second half of the year.

Compliance with fiscal rules

Amid the negative adjustment of the macroeconomic forecast, the proposed revision envisages decreases for most categories of GCB revenues, but, as a result of a prospected increase in amounts received from the EU, the aggregate level of revenues is projected to advance by about 0.9 billion lei. On the other hand, the aggregate level of GCB expenditures is revised upwards by about 19.4 billion lei, the most important increases being recorded at the level of projects financed from non-reimbursable external funds, expenditures on goods and services, respectively capital expenditures.

In this context, a significant deepening of the budget deficit is estimated, and the revision draft supplements the ceilings of the indicators specified in the budgetary framework for 2020 (initially established by Law no. 283/2019 and then modified on the occasion of the first budget revision by GEO no. 50/2020, subsequently amended by Law No. 115/2020) as follows:

- the nominal ceiling of the GCB primary deficit is increased by 15.8 billion lei to the level of 75.3 billion lei;
- the nominal ceiling of the GCB deficit is increased by 17.6 billion lei to the level of 91 billion lei;
- the GCB deficit ceiling, expressed as a percentage of GDP, is increased by 1.8 pp to the level of 8.6%;
- the GCB personnel expenditures ceiling, expressed as a percentage of GDP, is increased by 0.5 pp to the level of 10.6%;
- the nominal ceiling of GCB personnel expenditures is increased by 2.1 billion lei to the level of 111.8 billion lei;
- the nominal ceiling of GCB total expenditures, excluding financial assistance from the EU and other donors, is increased by 10 billion lei to the level of 391.3 billion lei;
- the public debt ceiling, expressed as a percentage of GDP, is increased by 3 pp to the level of 44%.

The draft Government Ordinance on the revision of the state budget for 2020 stipulates the necessary derogations from the fiscal rules established by the FRL and redefines the ceilings of the budgetary aggregates in accordance with the levels stipulated in the revision proposal.

The opinions and recommendations formulated above by the Fiscal Council were approved by the Chairman of the Fiscal Council, according to the provisions of art. 56, para (2), letter d) of Law no. 69/2010 republished, after being approved by the Council members, through vote, on August 14, 2020.

14th August 2020

Chairman of the Fiscal Council

Professor Daniel DĂIANU