Fiscal Council's opinion on the Fiscal Strategy for 2014-2016

The Ministry of Finance sent to the Fiscal Council by letter no. 81681/21.05.2013 the Fiscal Strategy for 2014-2016 (FS 2014-2016) and the draft law approving ceilings for certain indicators specified in the budgetary framework. Under article 40, paragraph (2), letter b) of the Fiscal Responsibility Law (FRL), the Fiscal Council has the legal attribution to *"analyze and issue opinions and recommendations on the Fiscal Strategy and assess its compliance with the principles and rules specified in this law"*. Moreover, according to article 40, paragraph (2), letter a), the Fiscal Council has the legal attribution to "analyze and issue opinions and recommendations on official macroeconomic and budgetary forecasts".

Thus, given its mandate in accordance with law no.69/2010*, **the Fiscal Council issues the following opinions and recommendations on the Fiscal Strategy for 2014-2016**:*

General remarks

Earlier this year, after the installation of the new government, a revised form of the Fiscal Strategy 2013-2015 (FSr 2013-2015) was developed and approved, on which the Fiscal Council has expressed its opinion on February 5th. Given the relatively short time between that moment and the formulation of FS 2014-2016 and considering that the macroeconomic developments were broadly in line with the expectations, as it was also revealed by the insignificant differences between the European Commission forecasts (the interim European economic forecast from February 2013 and the spring forecast from May 2013), the FS 2014-2016 records minor changes compared to the parameters considered in the previous version. In fact, the revenue projection remains unchanged, while minor changes occur at the level of some expenditure chapters in 2014 and 2015;in addition the deficit target for 2015 is revised downwards (-0.2 pp. of GDP).

Compliance with the rules from the Fiscal Responsibility Law

Under article 6, letter d), of the Fiscal Responsibility Law "*until the consolidated general budget balance is in surplus in the previous year, the annual rate of growth in the forecasted consolidated general budget expenditures will be maintained below the annual rate of growth of the forecasted nominal GDP for the three-year period of the fiscal strategy*". The FS 2014-2016 respects this rule, considering that the total expenditure of the general government in amount of 35.72% of GDP in 2014, 35.50% of GDP in 2015 and 35.47% of GDP in 2016 are on a downward path and given that the budget for the current year sets total expenditures at 35.73% of GDP. Moreover, if total expenditure are adjusted by eliminating the financial assistance from the EU (post-accession grants) and other donors, the growth rate of the budget expenditures is maintained below the one of nominal GDP and its downward trajectory is even more obvious: 33.5% of GDP in 2014, 33.0% of GDP in 2015 and 32.9% of GDP in 2016, compared to a planned level of 33.8% of GDP in 2013.The Fiscal Council reiterates its recommendation to amend the rule described in article 6 letter d) of the Fiscal Responsibility Law, so that it should not refer to *"total expenditure of the general government"*, but to*"the total budget expenditures minus* *financial assistance from the European Union and other donors"*; a revised formulation has the advantage of being consistent with the definition used in the rule stated at art. 6 letter c),while the Government will not be penalized for a possible better performance in terms of EU funds absorption by imposing a constraint to operate cuts in other chapters of expenditure.

Under article 18, paragraph (3) of the Fiscal Responsibility Law, *"the ceiling for the total balance and personnel spending of the general consolidated budget specified in article 20 paragraph (1) sub-paragraphs (a)-(b) shall be approved by the Parliament and it shall be binding for the next two budget years"*. Following the elaboration of the revised Fiscal Strategy 2013-2015, the Parliament passed the Law no. 4/2013 for approving ceilings for certain indicators specified in the budgetary framework. Under article 20, paragraph (1), letter a) and b) of the FRL, it sets mandatory ceilings for the budget deficit at 2.1% of GDP in 2013 and 1.8% of GDP in 2014, respectively 7.4% of GDP for personal expenditures in both years. For the first year covered by the FS 2014-2016, the budgetary parameters namely the budget deficit of 1.8% of GDP and personal expenses of 7.4% of GDP comply with the provision of FRL, respecting the limits stipulated by Law no. 4/2013.

Assessment of the macroeconomic framework underlying the FS for 2013-2015

The economic growth assumption underlying the 2014-2016 FS is almost unchanged compared to the one used in the updated FS 2013-2015 (increases of 1.6%, 2.2% and 2.8% in 2013, 2014 and respectively in 2015), only one change occurring in 2015 where the current projection of real GDP growth (2.4%) records a downward revision compared to the previous one of 2.8%, without specifying the reasons for this update (especially given that the projections for 2014 and 2016 remain unchanged). However, at the level of GDP deflator a symmetrically opposite revision was operated so there is no change in the considered path of nominal GDP. Both in 2014 and 2015, minor changes in the expenditure components of GDP are operated in the FS 2014-2016 compared to the previous version (see Table 1), without influencing the nominal GDP for 2014 or the trajectory for budget revenues in any of these years, which is likely to suggest symmetrical and opposite revisions of the correspondent deflators. In this context, the downward revision of the economic growth forecast for 2015 seems to be motivated by the cumulative impact of lower private consumption dynamics (-0.4 pp. lower growth rate) and faster advance in imports (+0.2% of GDP).

Table 1: Assumptions regarding the dynamic of total GDP and demand components

	Δ (%) real GDP		Δ (%) nominal GDP		Δ (%) real private consumption		Δ (%) real government consumption		Δ (%) real GFCF		Δ (%) real exports		Δ (%) real imports	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
- FS 2013-2015 (1)	2.2	2.8	6.0	5.4	1.7	2.1	1.4	1.3	5.6	6.7	3.2	5.1	4.3	5.7
- FS 2014-2016 (2)	2.2	2.4	6.0	5.4	2.0	1.7	1.4	1.3	6.0	6.7	3.4	5.1	5.1	5.9
- Differences (2)-(1)	0.0	-0.4	0.0	0.0	0.3	-0.4	0.0	0.0	0.4	0.0	0.2	0.0	0.8	0.2

The Fiscal Council has no major objections regarding the macroeconomic framework used in FS 2014-2016 (identical with the one from the Convergence Programme 2013-2016 submitted to the European Commission at the beginning of May), which we appreciate as realistic considering the information available at this moment. Nevertheless, the Fiscal Council notes that the upward trend of economic growth is dependent over the medium and long term by a better performance of EU funds absorption (as reflected in the budget projection) and by further implementation of structural reforms in the economy. Also, the Fiscal Council assesses the balance of risks to be relatively neutral, even with a slight tilt in the sense of a higher economic growth than the one forecasted for the current year, taking into account the unexpected GDP advance recorded in the first quarter of 2013 (the interim estimation of NIS indicates that the annual real GDP recorded an increase of 2.1% for the unadjusted series and of 1.4% for the seasonally adjusted series), the upward revision of the real GDP growth rate in 2012 (+0.7% compared with an initial estimate of 0.3%) and the possible positive influence in the coming quarters of an agricultural production superior to initial expectations. Also, the GDP dynamics in the first quarter is difficult to be interpreted as the beginning of a long term recovery of the economic growth, given that the short-term indicators are still offering contradictory signals: the contraction of imports in the conditions of a real exchange rate appreciation indicates a weak aggregate demand dynamics, bank lending growth is still negative, while the quarterly acceleration growth of retail sales in the first quarter occurred in the conditions of a monthly trajectory that suggests a deceleration in the next quarter (negative carry-over). In addition, the GDP dynamics excluding the agriculture sector (a less volatile measure of the economic activity) indicate an economic slowdown in the first quarter of 2013, as the growth rate of this aggregate was the lowest in the last five quarters. Also, the structural problems of Romania's main trading partner - the Euro Zone - are still far from being solved and this generates an important source of uncertainty throughout the forecast horizon.

Assessment of the fiscal framework in the 2014-2016 period

For the first year covered, the FS 2014-2016 does not change the budget deficit target (1.8% of GDP), but compared to the previous version of the document which stipulates the same deficit for the next year, the new strategy plans a further reduction of the budgetary imbalance by 0.2 pp. of GDP for 2015 (to 1.6% of GDP), the target for 2016 being also set at this level. The budget deficit according to ESA95 methodology is planned to decline from 2.4% of GDP in the current year to 2% in the next year and to 1.8% in 2015 and 2016. The trajectory of the budgetary deficit is chosen in order to ensure compliance with the conditions imposed by the Fiscal Compact (ratified by Romania in June 2012) regarding the maximum level of the structural deficit.

The medium-term objective in terms of the structural deficit that Romania needs to align to as a result of its status as an EU member is determined starting from the deficit that stabilizes the share of GDP of the public debt stock plus an adjustment due to the incorporation of a portion of the long-term costs of aging. The MTO was revised upwards by the European Commission at 1.25% of GDP (from 0.7% of GDP) as a result of the favorable impact of structural reforms on pensions, assessed in the context of the *Ageing Report 2012* developed by the European Commission. However, given that the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the Fiscal Compact), ratified by Romania, sets a maximum limit of the structural deficit at 1% of GDP for countries with a low public debt (significantly below 60% of GDP), the operational medium-term objective for Romania is set at this latter level.

If the expected substantial improvement in EU funds absorption is eliminated, the decrease by 0.5 pp. of the budget deficit during 2014-2016 is attributable entirely to cuts in total expenditure, whose share in GDP is expected to decrease by 0.9 pp., compensating the reduction of revenues by 0.4 pp. of GDP in the same period as a result of the expiration in 2015 of some additional taxes for the energy and natural resource exploitation sectors.

Given the assumptions regarding the potential GDP included in the Convergence Programme - which are in fact very close to those of the European Commission (a growth rate of 2.1% percent in 2013, followed by an acceleration to 2.6% in the next year), the projected trajectory for the real GDP growth implies a continuous widening of the output gap up to 2015 (to a level of 3.1% of potential GDP), followed by a relative stabilization in 2016. Under these conditions, the size of negative cyclical component of the budget balance is expected to increase compared to the starting point, which implies that the adjustment of the structural deficit will be higher than the one of the actual budget deficit. Thus, if in ESA95 terms, the deficit is expected to decline from 2.4% of GDP in 2013 to 1.8% of GDP in 2015 and 2016 (-0.6 pp. of GDP), the structural deficit would decline from 1.6% of GDP to 1% of GDP in 2014 (a level that ensures the fulfillment of the MTO - structural deficit of 1% of GDP), and in addition to a level of 0.8% of GDP in 2015 and 2016 (a cumulative structural adjustment of 0.8 pp. of GDP).

The Fiscal Council considers as prudent the additional structural adjustment introduced by the FS 2014-2016 for 2015, even though strictly speaking, maintaining the structural deficit of 1% of GDP, expected to be reached in 2014 would have been sufficient for compliance with the conditions imposed by the Fiscal Compact. The reasons underlying the new deficit target are related to the inherent uncertainty associated to the estimation of unobserved variables such as the potential GDP and also the significant differences between the results of the alternative methodologies used in the estimation of the output gap; thus, it appears adequate to choose a level of the headline budget deficit that would ensure reaching the MTO, regardless of any further revision of the economy’s cyclical position. The compliance with the medium-term objective in 2014 is assured only if the subsequent assessments of the potential GDP growth will continue to show the same path as today. There are significant differences in the results generated by alternative methodologies used by the European Commission[1]: in the case of the production function method, the potential GDP growth path shows a rapid acceleration (from a growth rate of 1.8% in 2012, to 2.1% in 2013 and 2.6% in 2014), which implies a widening output gap from 2.1% in 2012 to 3% of potential GDP in 2014, while the univariate filters are

[1]https://circabc.europa.eu/sd/d/0417d489-a9c7-4521-876c-abda2aae61cd/OG_2013_Spring_Final%20MSs_tables.xlsx

suggesting a more "smooth" dynamic (potential GDP growth rate of 1.9 to 2% in the period 2012-2014) and in the Fiscal Council's opinion also a more plausible one, with the negative output gap reaching a maximum of 2.8% in 2013 and later entering on a downward trend[2] (to a level of 2.5% of potential GDP in 2014). If the first method is used, the cyclical component of the budget deficit in 2014 would be about 1% of GDP, which would ensure that the medium-term objective of 1% structural deficit is consistent with a 2% of GDP level in 2014 for the headline budget deficit (ESA 95). If univariate filters are used, the cyclical component would be only 0.8% of GDP, implying the existence of a structural fiscal consolidation gap to the MTO (0.2 pp. of GDP), a gap that can only widen given the trajectory of the output gap in the coming years according to the said method of estimating the potential GDP.

Budgetary revenues and expenditures

The FS 2014-2016 maintains the revenue trajectory as in the previous version of the strategy (the revised Fiscal Strategy for 2013-2015), on which the Fiscal Council expressed an opinion in early February 2013. Given the set of available information and the relatively unchanged macroeconomic coordinates considered, the Fiscal Council reaffirms its view that the projected medium-term revenues trajectory is realistic. In addition, based on the information received regarding the implementation of new compensations schemes in the years 2014-2016 (swap schemes) designed to clear outstanding obligations to the budget with a favorable impact on revenue from VAT (but neutral on the budget deficit), the Fiscal Council is no longer querying the projected evolution of this category of revenue as the institution raised doubts in its opinion on the revised Fiscal Strategy for 2013-2015.

The FS 2014-2016 mentions as future directions for modifying the tax system a gradual reduction in the level of employer social contributions and in the VAT rate. However, the 2013-2016 Convergence Programme submitted to the European Commission (in which the revenue projection is the correspondent in the ESA95 methodology of the forecast in cash terms from the FS 2014-2016) explicitly acknowledges (see Annex 2b thereof[3]) that the current projection is drawn on a scenario of no policy change, respectively assuming that the current system of taxes is maintained. Moreover, the FS 2014-2016 states that changes in the tax system are dependent on an increased revenue collection in the future, suggesting that reducing taxes is rather an objective than a definite decision. However, the Fiscal Council reiterates that caution is needed, also considering the principle of fiscal responsibility stated in the FRL, and insists that the assessment of tax collection efficiency improvements should be made strictly ex post, i.e. after year-end revenues will exceed the original estimates (which, ceteris paribus, would result in a budget deficit below the proposed target) and their trajectory is not attributable to a more

[2]A similar trajectory is suggested by the most recent assessment of the NBR (Inflation Report May 2013) on the cyclical position of the economy

[3]http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2013/01_programme/ro_2013-04-30_cp_en.pdf

favorable than expected development of the relevant macroeconomic bases. This latter aspect is particularly relevant given that the nominal deficit target is set based on the structural deficit, which means that a more favorable macroeconomic evolution (a higher economic growth) will often lead to an improvement in the cyclical position of the economy –a reduced negative cyclical component of the budget deficit when there is a negative output gap, i.e. a higher positive cyclical component in the case of a positive output gap. The higher revenues in such a situation would lead to a lower actual deficit, but that would not translate into an equivalent adjustment of the structural budgetary position.

In addition, the Fiscal Council reiterates that the materialization of the government's intention to reduce tax rates is possible, under Article 13 of the FRL, only if the proposed regulations respect at least one of the following conditions:

(a) To have the endorsement of the Ministry of Public Finance and the Fiscal Council, confirming that the financial impact was taken into account in the budgetary revenue forecast and that it does not affect the annual budget targets and the medium term targets.

(b) To be accompanied by proposals for measures to compensate the financial impact, by increasing other budgetary revenues.

From the perspective of the necessary assessments above mentioned, the Fiscal Council considers as absolutely necessary the materialization of its repeated recommendations related to the inclusion in the Fiscal Strategy of an explicit and detailed presentation of the macroeconomic bases and elasticities for each revenue category, and also of the budgetary impact divided by years of considered discretionary measures that affect the trajectory of revenues; the disclosure of these information is also an imperative given the principle of transparency stated in article 4 of Law no. 69/2010.

Under Article 20 paragraph (2) of Law 69/2010, the Fiscal Strategy should include a sensitivity analysis of the changes in fiscal targets in response to changes in the macroeconomic indicators. However, the Fiscal Council notes again the lack of this analysis, which is absolutely necessary especially in the current context characterized by an economic environment still difficult to predict, both in the European economy and, consequently, in the Romanian economy.

Regarding budgetary expenditures, the FS 2014-2016 provides some reallocation between chapters compared with the revised FS 2013-2015, along with a decrease in the amount of total expenditure of the general government in 2015, while the majority of expenditure chapters remain unchanged. In the first year covered by the new strategy compared to the levels from the previous version of the document, we can observe a reduction in the chapters "other transfers" (-501.8 million) and capital expenditure (-8.3 million), a decrease which is fully offset by the rise of the allocations for procurement of goods and services (510.1 mil), leaving total spending unchanged. The reduction by 0.2 pp. of GDP of the deficit target for 2015 (from 1.8% of GDP in the revised FS 2013-2015 to 1.6% of GDP in the current version) is achieved due to lower total expenditure(-1392.5 million lei), explained by reduced allocations under "other transfers" (-1,001.7 million) and of projects from EU funds (-964.3 million), accompanied by an increase in spending on goods and services by 573.5 million. In the year 2016, which is beyond the scope covered by the previous version of the Fiscal Strategy, but it is covered in the Report on the macroeconomic situation in 2013 and the projections for 2014-2016 released alongside with the 2013 budget draft, the reduction of the budget deficit target is propagated (-0.2 pp. of GDP, from an initial level of 1.8% to 1.6% of GDP), and it is also due to lower allocations for other transfers (in the same amount as in the previous year, respectively -1,001.7 million) and for projects funded by external grants (-1,207.6 million), while supplementing spending on goods and services by 739.8 million.

The Fiscal Strategy does not describe the specific measures underpinning the substantial reductions in the planned budgetary allocations for the chapters mentioned above. Also, the inflows from post-accession funds and spending for projects financed through reimbursable post-accession funds condition each other: while the estimate of EU funds absorption is not changed, it is difficult to explain to what extent it is possible to reduce expenditure for the projects implemented with EU funds related to the national contribution or considered as ineligible, without seriously affecting the implementation of these projects and thus the materialization of revenues. In this regard, the Fiscal Council considers as absolutely necessary to include in the text of the strategy the concrete measures underlying the planned spending cuts.

The Fiscal Council notes that despite its previous recommendations, an explicit presentation of the assumptions regarding the variation of average earnings and the number of employees in the public sector is still missing, while these information are underlying the trajectory for personnel expenditure for the period covered by the FS 2014-2016 and also the assumptions on the average remuneration per employee and number of employees in the economy. The personnel costs in the public sector, which include for the period 2014-2016 the amounts related to the obligations of the State to certain categories of employees in the public sector as a result of final court rulings[4], remain unchanged compared to the previous version of the strategy. Eliminating the influence of these amounts, the wage bill is expected to increase by 2.76% in 2014, 2.63% in 2015 and only 0.5% in 2016 (an election year). These growth rates involve that in the absence of significant reductions in the number of public sector employees in the coming years, the annual rise of the average wage in the public sector will be below the average forecasted inflation taken into account in the budget construction (3.3% in 2014, 2.8% in 2015 and 2.5% in 2016) and substantially lower than those projected for the private sector[5],

[4]The budgeted amounts are 900 million in 2013, about 2.2 billion lei in 2014 and 2015, respectively about 3 billion lei in 2016.

[5]The 2013-2016 Convergence Programme takes into account annual increases in the average remuneration per employee in the economy of 4.8% in 2014, and 4.4% in 2015 and 2016.

which do not appear to be plausible. Given the above, the Fiscal Council maintains its view that the personnel costs during the 2014-2016 periods appear as undervalued.

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of Fiscal Council, according to article 43, paragraph (2), letter d) of Law no. 69/2010, after being approved by the Council members through vote, on May 28th, 2013.

May 28th, 2013 Chairman of the Fiscal Council

IONUȚ DUMITRU