

BUDGET REPORT

3 February 2014

Budget deficit shrank to 2.3% in Q3 (4Q rolling)

- The ESA budget deficit witnessed significant decrease of 2pp to 2.3% in GDP as of Q3 2013, on 4Q rolling basis, compared to one year ago; this result was possible mainly by reducing investments, which fell from 5.6% in GDP in Q3 2012 to 3.7% in Q3 2013;
- Current revenues fell by 1pp in GDP to 32.2% (in the last 4 quarters) as the GDP growth witnessed in 2013 was not tax rich and tax collection has suffered following the reorganization of ANAF;
- Current expenditures dropped by only 0.4 pp (in the last 4 quarters);
- EU funds absorption was low as most operational programs were blocked in Q4 2012 and H1 2013;
- Social contributions revenue in GDP rose only from 8.9% to 9% after we witnessed the increase of public wages and the minimum wage;
- In 2014, we expect a 2.5% ESA deficit provided that our base macro scenario comes through: higher households' consumption (2% YoY versus 0.8% YoY in 2013). We also assume faster pace of non-farm output which is more favourable for tax purposes. Additionally, our scenario takes partially into consideration the new fiscal measures ought to bring 0.6% of GDP in revenues. If the social contributions of the employer are lowered by 5 pp in H2 2014, there is a risk to enter EDP again.

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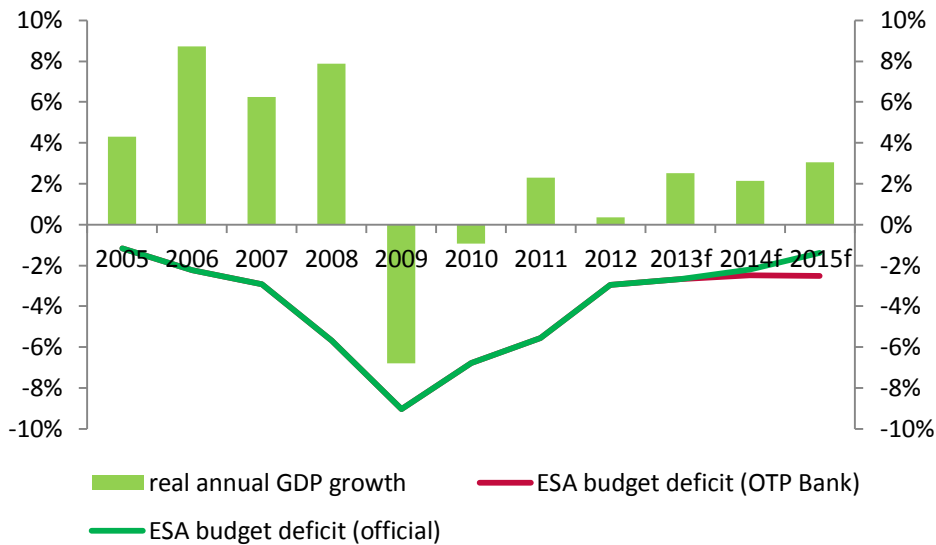
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Fiscal consolidation to slow down in 2014



Source: Eurostat, OTP Research, The Ministry of Finance
F= forecast

The ESA budget deficit witnessed significant decrease of 2pp to 2.3% in GDP as of Q3 2013, on 4Q rolling basis, compared to one year ago (please see Table 1). **This result was possible mainly by reducing investments** which fell from 5.6% in GDP in Q3 2012 to 3.7% in Q3 2013. Otherwise, the current revenues fell by 1pp of GDP to 32.2% while during the same period current expenditures dropped by only 0.4 pp. However, in support of these figures which point to lower revenue collection, we mention that **the GDP growth witnessed in 2013 was not tax rich**: for example, the first 9M data shows that agriculture contributed by 1pp to the 2.7% YoY growth, if we take the production side approach. Also, if we look at the expenditure side, we see that growth is explained by the advance of net exports while **households consumption has in fact stagnated during the first 9M**. What is also affecting our final numbers as percentage in GDP are revenues and expenditures related to **EU funds absorption which have influenced mainly 3 out of 4 quarters of data as most operational programs were blocked in Q4 2012 and H1 2013**. Finally, as far as 2013 is concerned, we believe that ESA deficit will fall close to the yearly target of 2.6%, but the weaknesses that exist in terms of tax collection and the efficiency of the fiscal decisions taken in 2013 will have to be addressed further on.

With reference to the fiscal measures proposed in 2013 (please see Table 2), **certain income categories that should have been supported have in fact dropped as a % in GDP**. For example, **direct taxes on income dropped from 6.4% to 5.6% even if there were several fiscal measures addressing them directly** such as the introduction of 3% tax on turnover for microenterprises with annual revenues of max. EUR 65 000 or the widening of tax base by including a additional income for agricultural activities, to name just a few. Additional to these measures, the increase of public employees wages by 15% as of December 2012 and the hike of the minimum wage should have also contributed positively to the evolution of this tax category. **The component that has suffered is most likely the corporate income tax**, especially due to recorded results of commercial banks and the Central Bank as well. The Central Bank's net result has deteriorated after passing from net creditor position to net debtor in Q3 2013, among others; according to its statute, it redirects 80% of its net income to the state budget. Additionally, **tax collection has suffered following the reorganization of ANAF** in 2013.

Another category for which there was fiscal stimulus were indirect taxes on production and imports which saw hikes of excises for beer, diesel and cigarettes. However, the **weak consumption figures dragged on VAT**



and on excise revenues. Moreover, there was also a decrease in VAT for bread and other bakery goods from 24% to 9% as of September.

Social contributions revenue in GDP rose from 8.9% to only 9% after we witnessed the increase of public wages and the minimum wage. The move was concomitant with a negative effect from the supplementary transfer to the second pension pillar of 0.5 pp.

Moving to the expenditure' side, compensation of employees share in GDP rose from 7.7% in Q3 2012 to 8.2% one year later. This was expected given the operated hikes of public staff wages. Additionally, we notice that compared to December 2012, the number of public employees was lower by 7000 and by 3000 below the target assumed by the government for December 2013, which was 1187 thousand.

The effort for fiscal consolidation was visible from the evolution of intermediate consumption line which decreased from 6.2% to 5.4%.

Last, investments and net acquisitions were drastically reduced, from 5.6% in Q3 2012 to 3.7% in Q3 2013.

What to expect in 2014

Starting from the macro scenario, **we expect a boost in households' consumption of 2% YoY as opposed to only 0.8% YoY in 2013.** Also, the **unemployment rate already showed signs of easing**, dropping in the final month of 2013 to 7.1% after 5M of stagnation at 7.3%, so we are past an inflexion point and look forward to further adjustment. Also, the base scenario counts on a **faster pace of non farm output** which is more favorable for tax purposes. Along with an improved macro picture, **ANAF reorganization has moved pass a critical point** which was witnessed in 2013.

Moving forward to the fiscal aspects, **we ought to consider that an exceptional revenue** that supported the budget in 2013 (the **RON 2.1 bn** paid by telecom operators for renting the frequency bands) **is not applicable anymore.** Instead, **the government has come with a RON 4.3 bn package (0.6% of GDP, Table 2) which cannot be considered at face value:**

- First, the additional income of RON 2.4 bn (or 0.3% of GDP) does not stand as the excise hike has been delayed by one quarter, although its full effect has been accounted in the budget
- Second, the other measure that is supposed to bring roughly 0.1% of GDP comes from increasing the tax base with additional taxes on special structures (pools, pipelines etc.); however the magnitude of these revenues is not easily predictable.

Additionally, another 0.5 pp from employees social contributions will be derived to the second pension pillar. **Government officials also announced the intention to decrease social contributions of the employer by 5 pp** in the second part of the year. However, **this measure does not seem to be comprised in the budget** and according to our calculations, **it creates a 0.4% gap and could potentially threaten the 3% budget deficit level** that should be monitored in order not to enter the excessive deficit procedure again. However if this measure does not apply, we expect a 2.5% deficit in 2014 (which incorporates only half of the fiscal package assumption). The risk to our forecast comes from a lower than expected economic growth and households consumption especially.

Table 1: Main aggregates of the government sector (mn RON and as % of GDP)

mn RON	2011	Q1 2012 4Q rolling	Q2 2012 4Q rolling	Q3 2012 4Q rolling	2012	Q1 2013 4Q rolling	Q2 2013 4Q rolling	Q3 2013 4Q rolling
Deficit (-) or surplus (+)	-30.901	-29.670	-28.389	-24.755	-17.424	-19.769	-17.538	-14.025
Total government revenue	188.805	191.382	194.383	196.439	197.689	194.577	195.419	200.845
Total government expenditure	219.707	221.052	222.772	221.194	215.113	214.346	212.957	214.869
Primary deficit or surplus	-21.513	-19.466	-16.749	-14.695	-7.008	-9.916	-8.563	-3.529
Total current revenue	185.166	187.492	190.825	192.943	192.860	191.393	192.582	198.375
Direct taxes (on income, wealth etc)	34.391	35.059	35.677	37.086	35.865	31.979	32.656	34.756
Indirect taxes (on production and on imports)	72.662	73.206	74.880	76.910	77.324	78.789	79.975	80.065
Social contributions	50.808	51.564	51.894	51.639	52.585	53.259	54.144	55.324
Other	27.305	27.663	28.375	27.308	27.085	27.366	25.807	28.230
Total current expenditure	175.404	176.592	178.634	177.284	181.197	183.029	183.029	185.138
Current transfers	88.120	87.818	87.780	86.619	90.056	90.955	91.472	90.956
Interest payable	9.388	10.205	11.640	10.061	10.415	9.853	8.975	10.495
Compensation of employees	44.057	44.147	44.024	44.746	46.000	47.202	48.770	50.181
Intermediate consumption	33.839	34.423	35.191	35.859	34.726	35.018	33.812	33.505
Gross saving	9.762	10.900	12.191	15.660	11.663	8.364	9.553	13.237
Total capital revenue	3.640	3.890	3.558	3.495	4.830	3.185	2.838	2.470
Total capital expenditure	44.302	44.460	44.138	43.910	33.916	31.318	29.928	29.732
Investment & net acquisitions	30.601	31.627	30.772	32.461	25.311	23.679	23.789	22.529
Capital Transfers payable	13.701	12.833	13.366	11.449	8.606	7.639	6.139	7.203
Nominal GDP	556.708	561.311	569.950	580.599	587.499	595.576	604.693	615.292
% GDP	2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013
Deficit (-) or surplus (+)	-5,6%	-5,3%	-5,0%	-4,3%	-3,0%	-3,3%	-2,9%	-2,3%
Total government revenue	33,9%	34,1%	34,1%	33,8%	33,6%	32,7%	32,3%	32,6%
Total government expenditure	39,5%	39,4%	39,1%	38,1%	36,6%	36,0%	35,2%	34,9%
Primary deficit or surplus	-3,9%	-3,5%	-2,9%	-2,5%	-1,2%	-1,7%	-1,4%	-0,6%
Total current revenue	33,3%	33,4%	33,5%	33,2%	32,8%	32,1%	31,8%	32,2%
Direct taxes (on income, wealth etc)	6,2%	6,2%	6,3%	6,4%	6,1%	5,4%	5,4%	5,6%
Indirect taxes (on production and on imports)	13,1%	13,0%	13,1%	13,2%	13,2%	13,2%	13,2%	13,0%
Social contributions	9,1%	9,2%	9,1%	8,9%	9,0%	8,9%	9,0%	9,0%
Other	4,9%	4,9%	5,0%	4,7%	4,6%	4,6%	4,3%	4,6%
Total current expenditure	31,5%	31,5%	31,3%	30,5%	30,8%	30,7%	30,3%	30,1%
Current transfers	15,8%	15,6%	15,4%	14,9%	15,3%	15,3%	15,1%	14,8%
Interest payable	1,7%	1,8%	2,0%	1,7%	1,8%	1,7%	1,5%	1,7%
Compensation of employees	7,9%	7,9%	7,7%	7,7%	7,8%	7,9%	8,1%	8,2%
Intermediate consumption	6,1%	6,1%	6,2%	6,2%	5,9%	5,9%	5,6%	5,4%
Gross saving	1,8%	1,9%	2,1%	2,7%	2,0%	1,4%	1,6%	2,2%
Total capital revenue	0,7%	0,7%	0,6%	0,6%	0,8%	0,5%	0,5%	0,4%
Total capital expenditure	8,0%	7,9%	7,7%	7,6%	5,8%	5,3%	4,9%	4,8%
Investment & net acquisitions	5,5%	5,6%	5,4%	5,6%	4,3%	4,0%	3,9%	3,7%
Capital Transfers payable	2,5%	2,3%	2,3%	2,0%	1,5%	1,3%	1,0%	1,2%

Source: Eurostat

Table 2: The fiscal measures proposed by the government in 2013 and 2014

2013 fiscal measures	Amount (RON mn)	Impact as of % GDP	2014 fiscal measures	Amount (RON mn)	Impact as of % GDP
Monthly ceiling of RON 18,000 for deductibility of depreciation expenses incurred for vehicles	169	0,03%	Modification of the formula for indexing the excises with the inflation rate (4,75%)	1107	0,17%
Solidarity tax for increasing the price of gas	335	0,05%	Increase of fuel excise 7 eurocents /liter	2280	0,35%
Gradual liberalization of gas and electricity prices	297	0,05%	Increase of tax base with additional tax on property, for special structures)	488	0,07%
Special fee for exploitation of mineral resources (other than natural gas)	107	0,02%	The increase of royalties for mineral resources, other than oil and gas, by 25%	50	0,01%
Fee for transportation of gas and electricity	205	0,03%	The increase of minimum wage by 50RON to 850 RON as of 1st January and to 900 RON as of 1st July	344	0,05%
Establishing the standard notional income for income from agricultural activities	413	0,07%	TOTAL	4269	0,6%
The inclusion in the tax base of allowances	30	0,00%			
Increased excise on cigarettes	312	0,05%			
Increased excise on diesel	403	0,06%			
Increased excise on beer	80	0,01%			
The increase of minimum gross salary	328	0,05%			
Environmental tax for registration of vehicles	100	0,02%			
The increase of deduction ceiling for research and development expenditure	-5	0,00%			
Property tax increase for local authorities with arrears	285	0,05%			
The introduction of the 3% tax on turnover for micro-enterprises with annual revenues of maximum EUR 65,000	457	0,07%			
Supplementary transfer to the second pension pillar (+0.5 pp. of pension contribution paid by employee)	-500	-0,08%			
Reimbursement to retirees of health contributions collected during the period 1 January 2011 - 30 April 2012 under a provision declared unconstitutional	-796	-0,13%			
The increase of natural gas royalties	62	0,01%			
TOTAL	2280	0,4%			
Exceptional revenues					
Temporary mechanism to decrease arrears	1000	0,16%			
Tax for renting the frequency bands by mobile operators	2159	0,35%			
TOTAL	3159	0,5%			

Source: The Finance Ministry, The Fiscal Council

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