ROMANIA
Macroeconomic outlook and fiscal policy issues

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President of the Fiscal Council

8 March 2011,

AmCham Business Breakfast

AGENDA

1. Recent economic developments and medium term outlook

2. Structural reforms – the key for long-term soustainable growth

3. Fiscal issues – reversing the pre-crisis unsoustainable fiscal policy is painful

4. Conclusions

1. Recent economic developments and medium term outlook

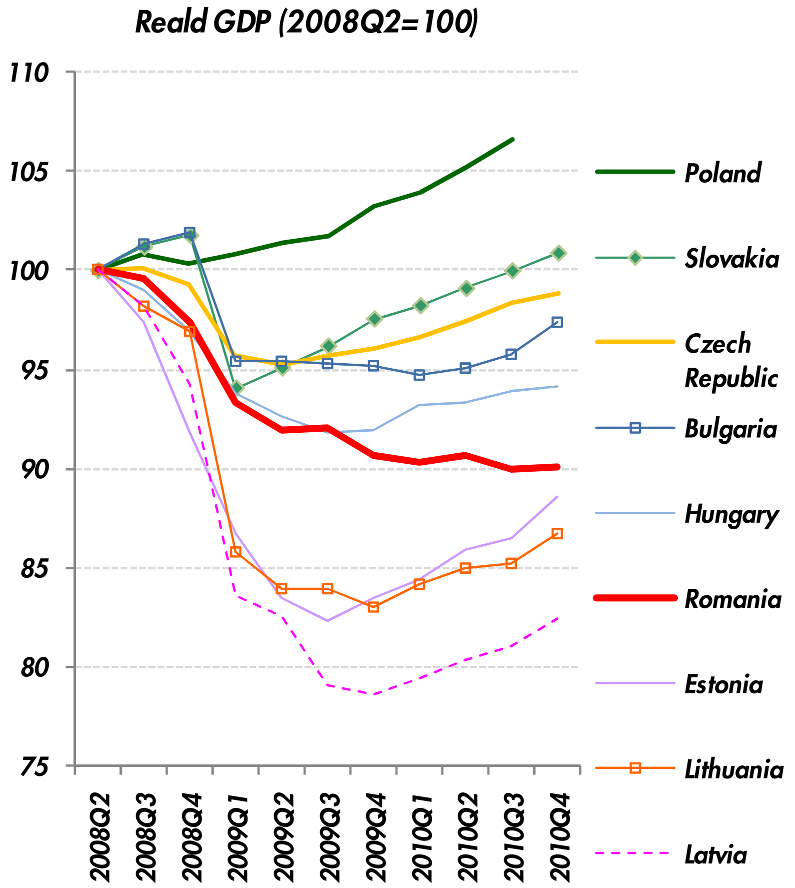
Ongoing economic recovery on the external markets
Delayed economic recovery in Romania

Economic activity is expanding already for several quarters both in developed and emerging economies

Quarterly GDP changes (% qoq)

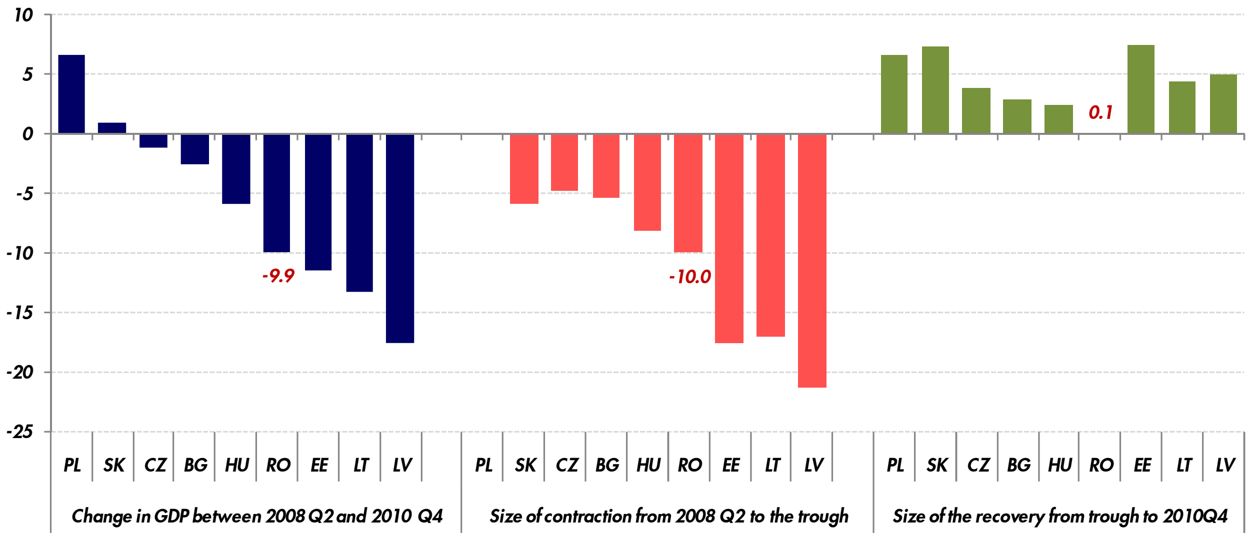
	10 Q1	10 Q2	10 Q3	10 Q4
US	0.9	0.4	0.6	0.8
Japan	1.6	0.4	0.9	-0.3
Canada	1.5	0.5	0.4	
Euro area	0.4	1.0	0.3	0.3
Germany	0.6	2.2	0.7	0.4
France	0.3	0.6	0.3	0.3
Italy	0.4	0.5	0.3	0.1
Spain	0.1	0.3	0.0	0.2
UK	0.3	1.1	0.8	-0.3
Slovakia	0.7	0.9	0.9	0.9
Czech Rep.	0.7	0.8	0.9	0.5
Hungary	1.4	0.2	0.6	0.2
Poland	0.7	1.2	1.3	
Romania	-0.3	0.3	-0.7	0.1
Bulgaria	-0.5	0.5	0.7	1.7
Estonia	1.0	1.9	0.7	2.3
Latvia	1.2	0.3	0.9	1.7
Lithuania	1.4	1.0	0.3	1.7

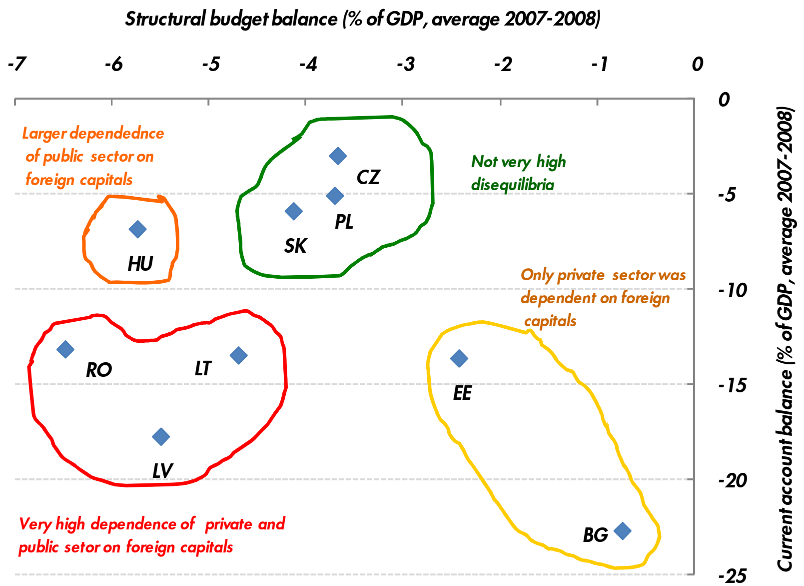
Real GDP is on an upward trend in all new EU member countries except Romania



Source: Eurostat

Large macroeconomic imbalances at the beginning of crisis explain the large contraction and delayed recovery in Romania



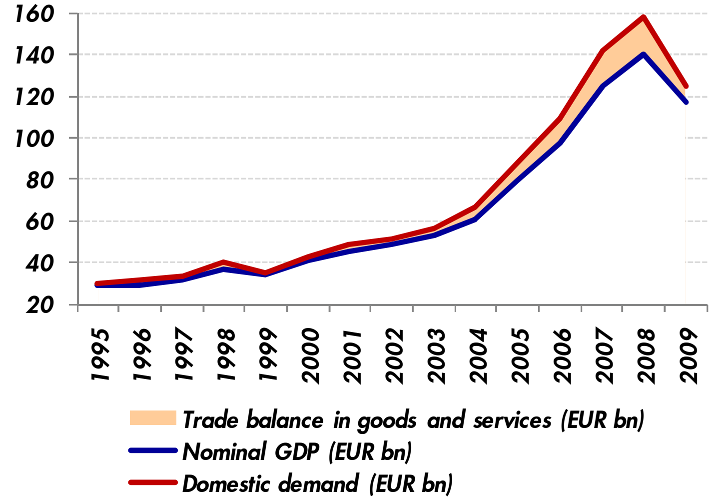


- Economic contraction was deeper in countries with the largest macroeconomic disequilibria
- Strong recovery in the last quarters in all countries except Romania
- Romania had the largest disequilibria when small countries (LV, LT, EE) are excluded
- Recession was less profound in Romania compared with the Baltic countries, but it was larger than in the other CEE countries
- Difficult and delayed economic recovery in Romania
  - Large country with large disequilibria
  - Key austerity measures were enforced only in 2010 Q2

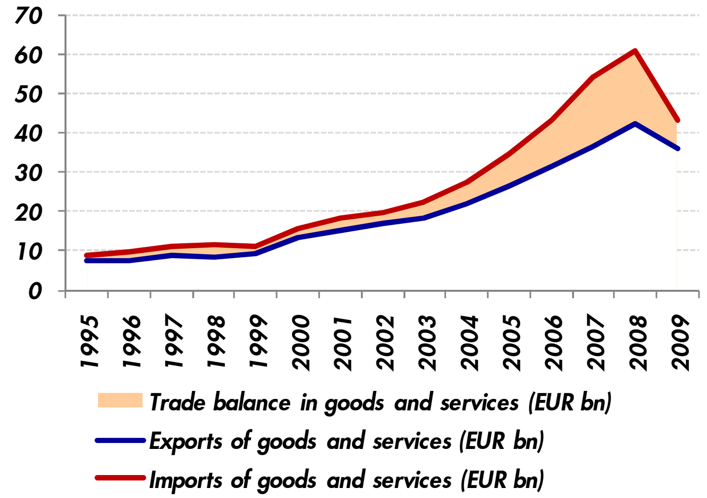
Source: Eurostat, European Commission

Rapid increase in domestic demand was financed by foreign capitals

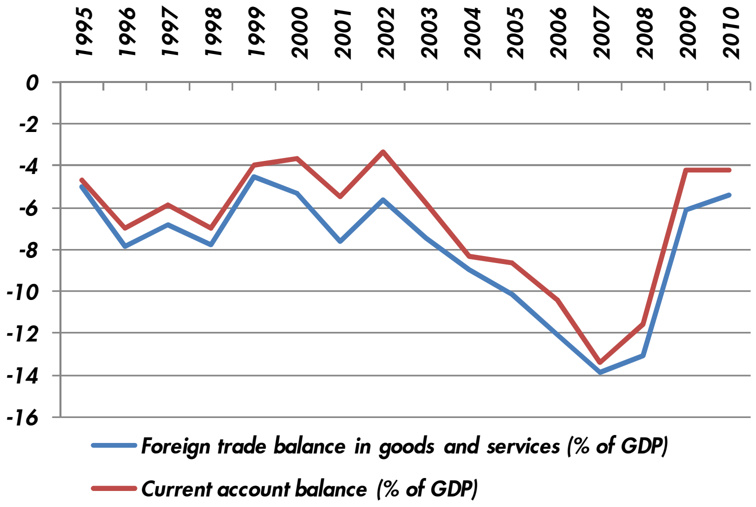
Romania spends more than produces



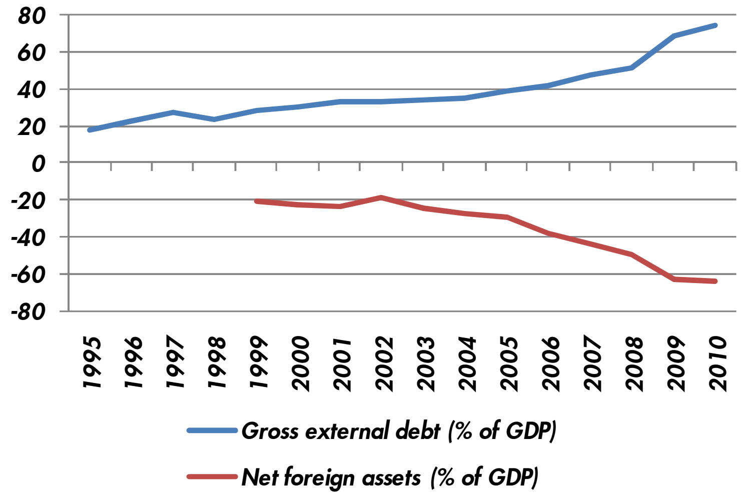
Imports are higher than exports



Large current account deficit



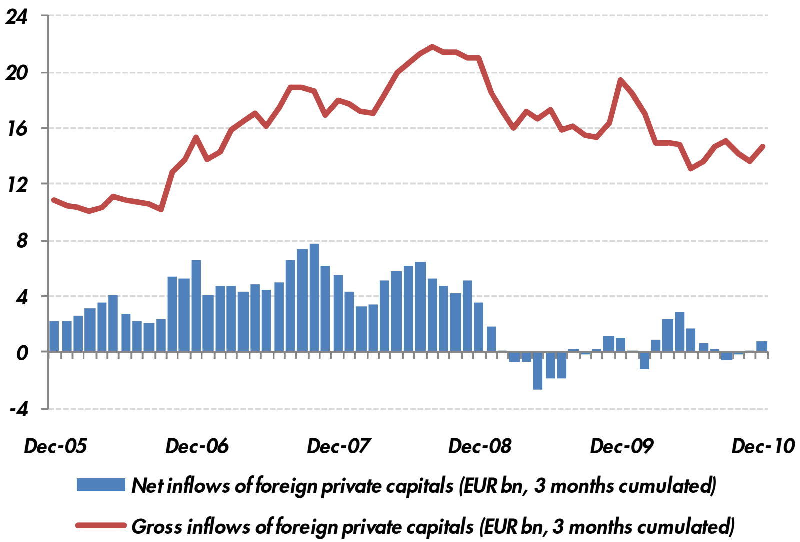
Rapid increase in external debt



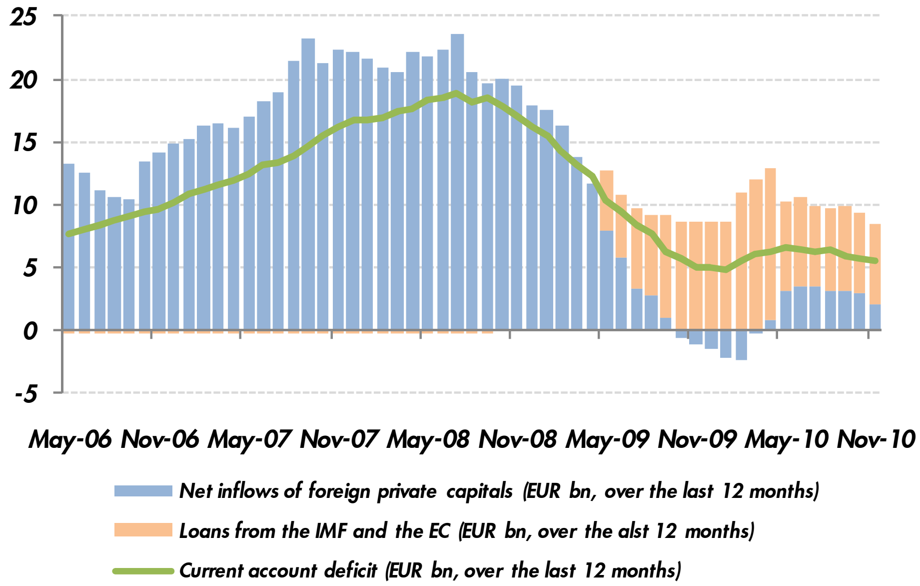
Source: Eurostat, NBR, National Institute of Statistics

Decrease in inflows of foreign capitals driven by high risk aversion worldwide

Net inflows of private foreign capitals became negative



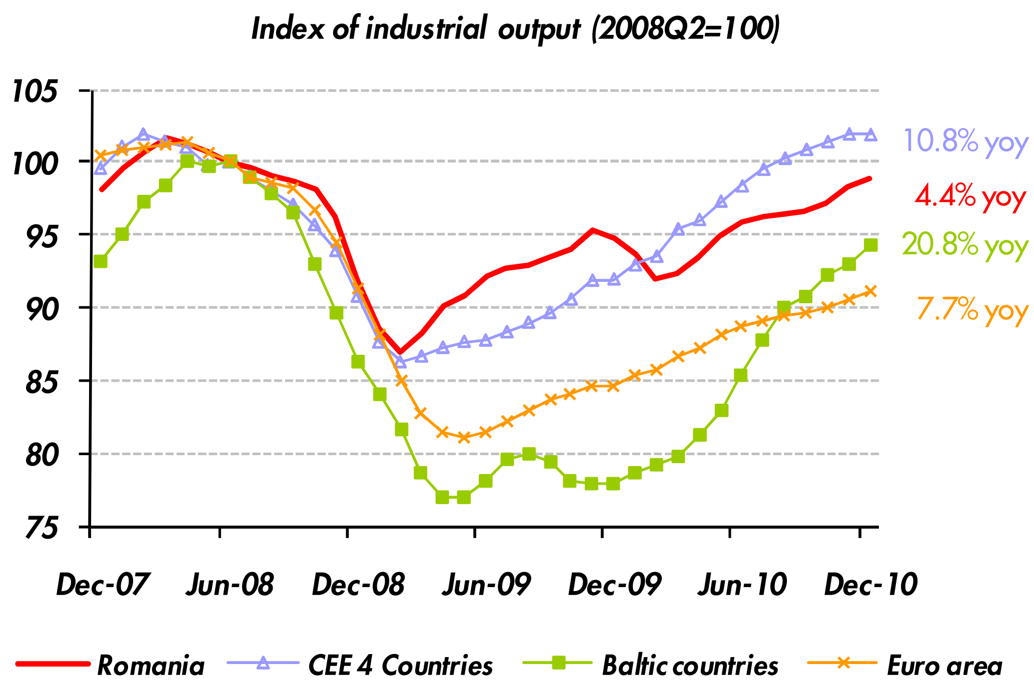
Lower inflows of foreign capitals than C/A deficit

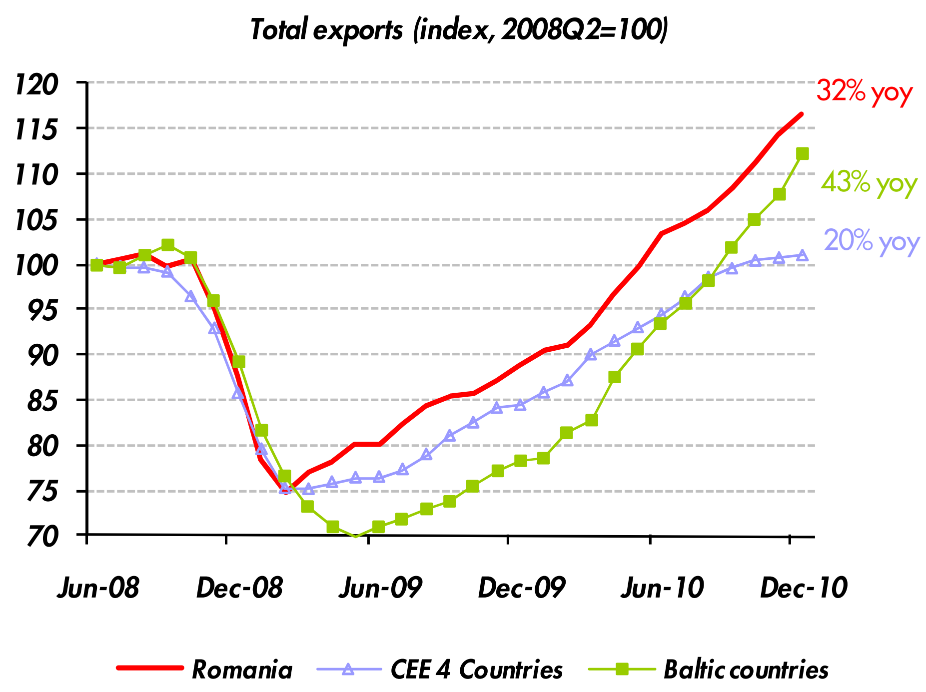


- Romanian authorities had to borrow money from the IMF and the EC in order to cover the external financing gap
- Romania borrowed around EUR 15.3 bn from the IMF and the EC since 2009, which allowed it:
  - To cover the external financing gap
  - To limit the size of economic contraction
  - To limit the amplitude of leu depreciation

Source: NBR

Strong recovery of industry driven by exports …

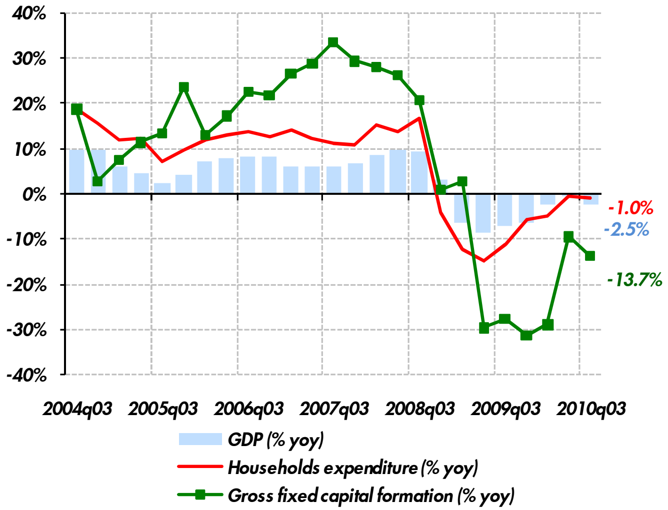




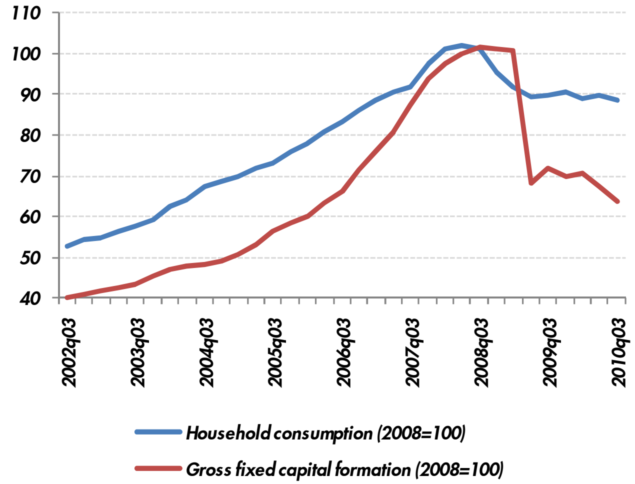
Source: Eurostat, National Institute of Statistics

… was not enough to offset the sharp adjustment in domestic demand

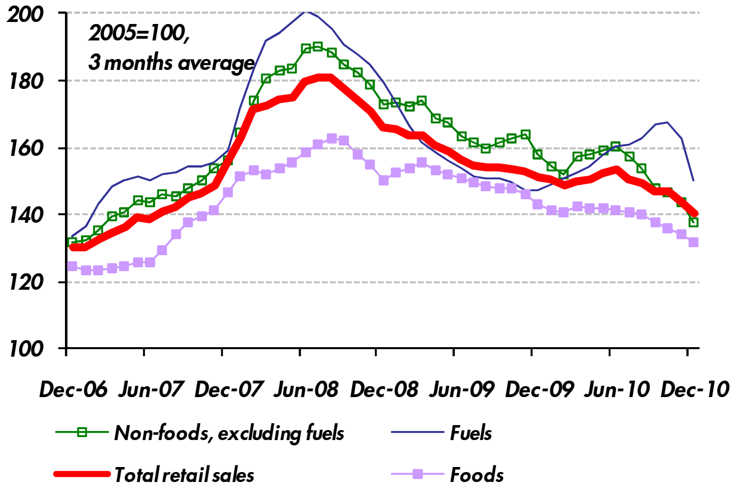
Both consumption and investment plunged rapidly



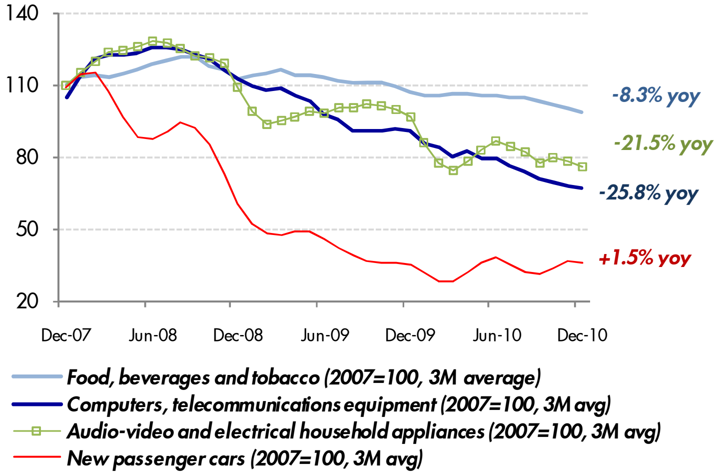
Consumption and investments returned to their levels from 2007 (respectively 2006)



Clear downward trend in retail sales in 2009-2010



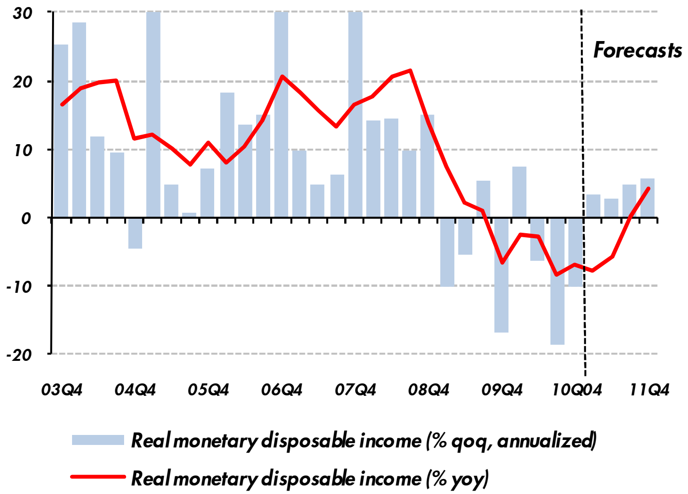
Sales of durable consumer goods were the most affected as purchases depends on lending and economic perspectives



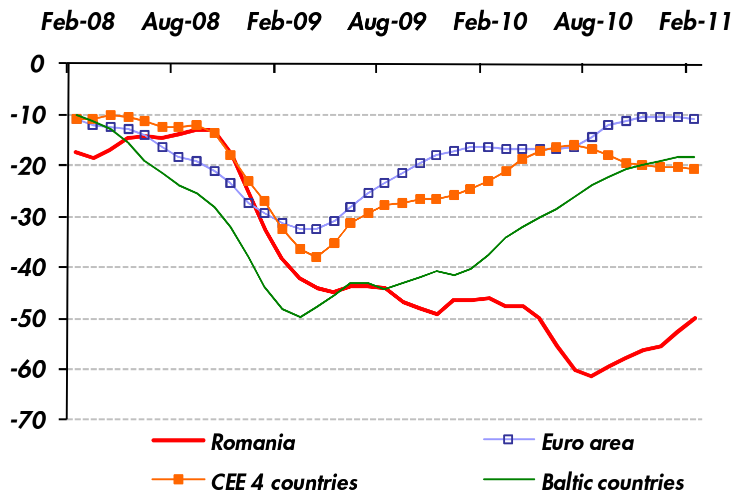
Source: Eurostat, National Institute of Statistics

Sharp fall in disposable income and weak economic perspectives forced households to cut spending and to refrain from borrowing

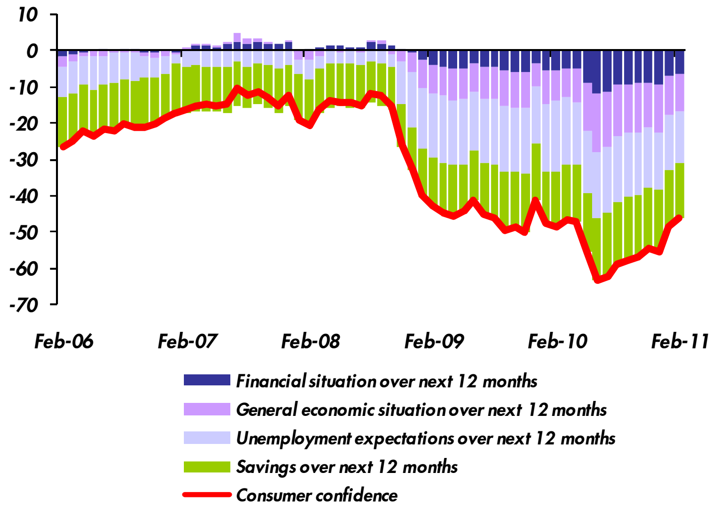
Real monetary disposable income fell



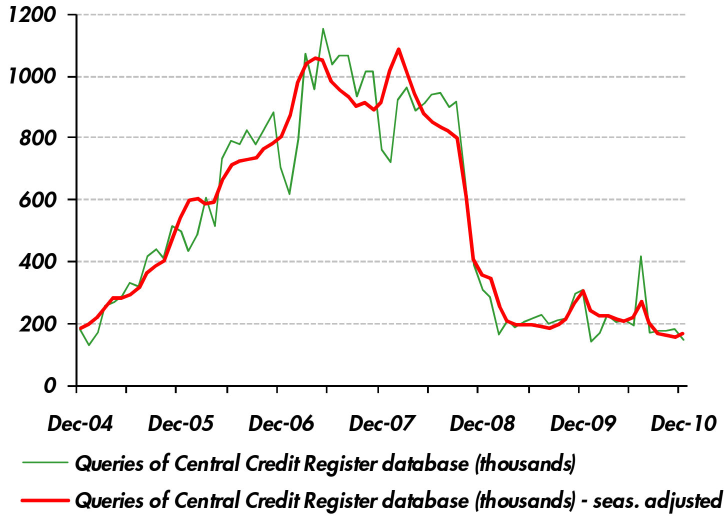
Households' sentiment deteriorated a lot



Low morale at the households level due to weak perspectives

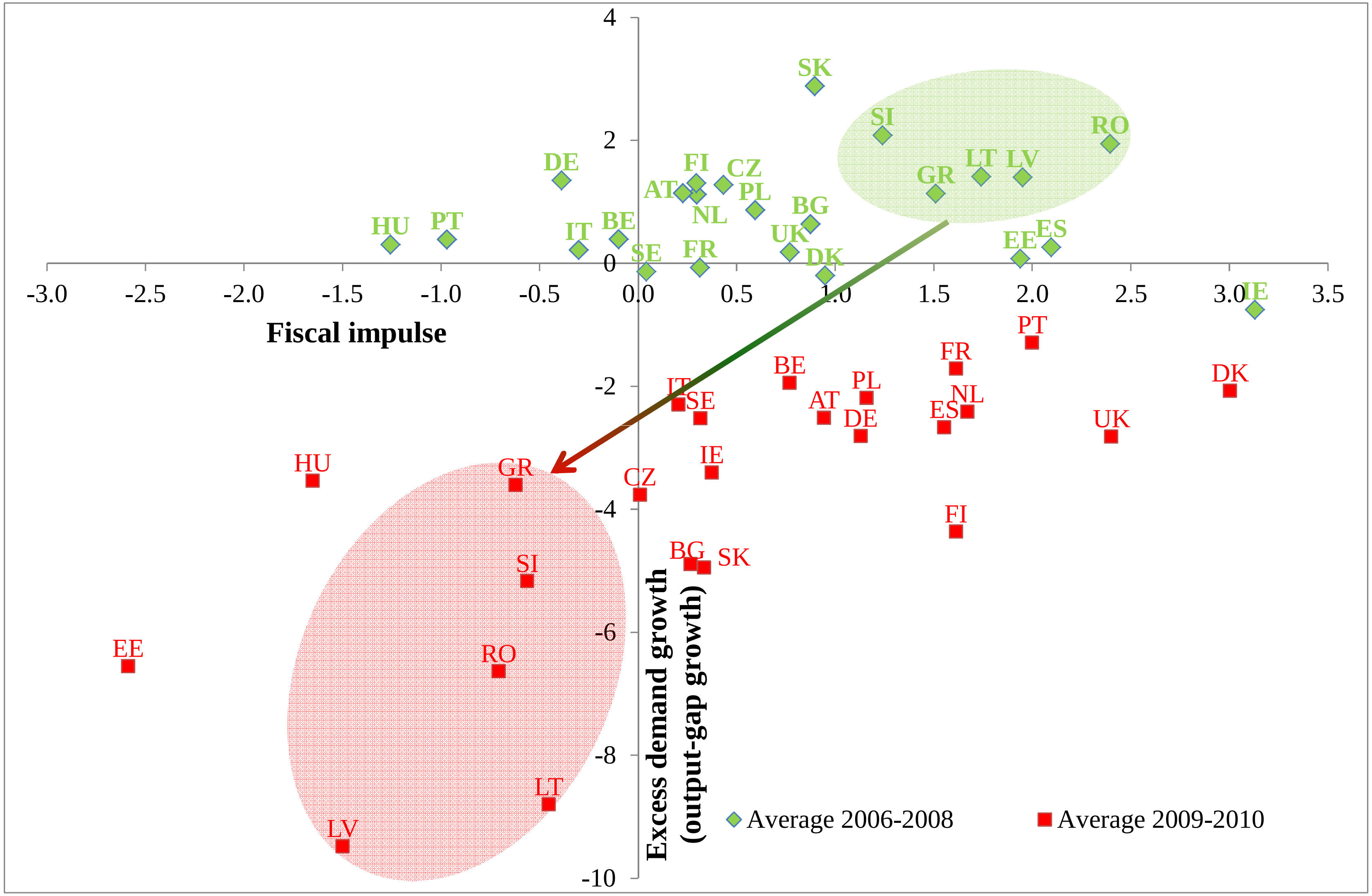


Low demand for loans and weak lending activity



Source: European Commission, NBR, National Institute of Statistics

Hard to escape from pro-cyclical fiscal policy

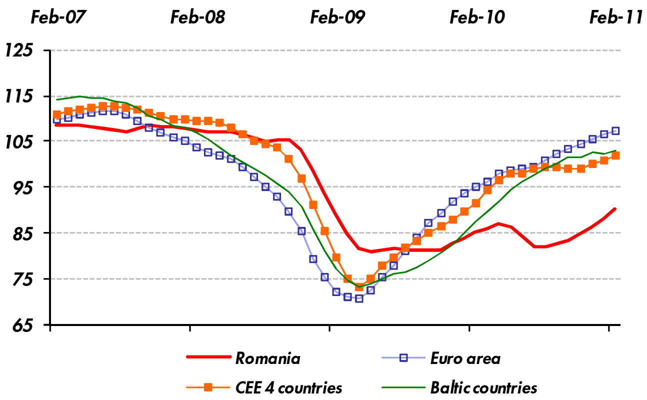


Note: Fiscal impulse = growth of structural budget deficit

Source: EUROSTAT, Fiscal Council

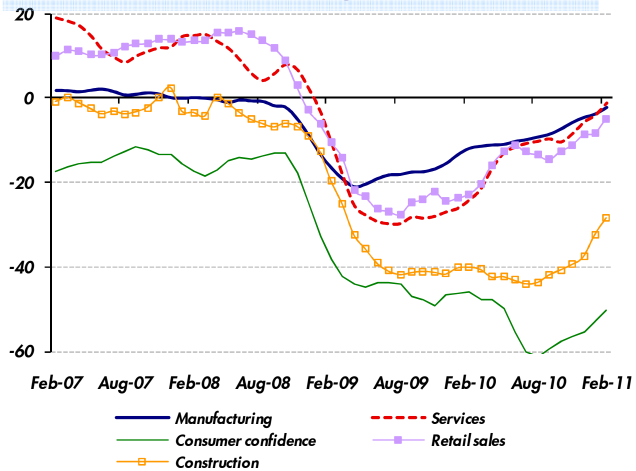
Economic activity most likely bottomed out
Slow recovery expected in the coming quarters

Economic Sentiment Index is improving



Note: 3-months moving average

Confidence is improving in all sectors



Only moderate recovery in short term (next 2 quarters)

- External demand is growing and this should help exports and industry
- Investments have room to increase after they plunged in the last 2 years
- Households expenditures are likely to remain weak as their confidence is still weak
- Government should keep a tight control over expenditures in order to reduce the budget deficit

Better prospect in medium and long-term

- Business sentiment and household morale would improve more towards the end of the year
- Households would start to spend slightly more

Key risks

- Political turmoil
- Fiscal consolidation process fails
- Turbulences on the external markets

Source: European Commission

2. Structural reforms – the key for long-term soustainable growth

The contribution of production factors to the economic growth – lower post-crisis growth potential

Contribution to GDP Growth

	Real GDP growth (%)	Growth contributions (pps.) Capital stock	Labor	TFP
Average 1993 – 99	0.6	2.3	-1.2	-0.5
Average 2000 – 04	5.5	2.5	0.2	3.2
Average 2005 – 08	6.4	6.1	0.4	-0.3
2009	-7.1	2.9	-0.9	-9.5
Average 2010 – 15	*2.9*	*3.4*	*-0.1*	*-0.4*

Source: IMF staff estimates. Figures in italics refer to potential growth.

- More difficult access to financing due to higher risk aversion
- Negative effect on economic growth from deleveraging
- Lower growth expected for euro zone
- Structural reforms are needed to increase the attractiveness for investments in the absence of fiscal space

Some structural characteristics of EU-10 countries

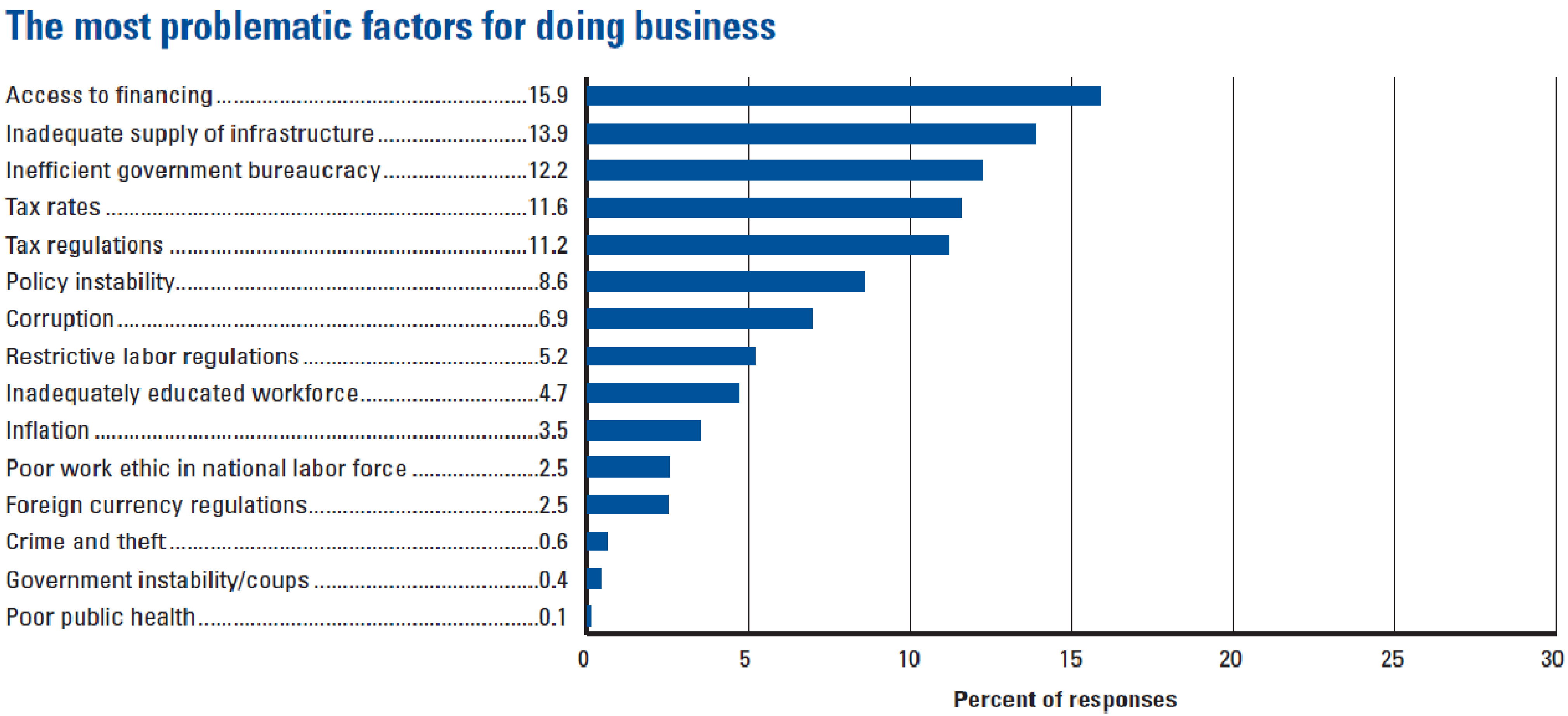
	Quality of institutions, 2010*	Corruption perception, 2010*	Ease of doing business, 2010**	Infrastructure, 2010*	Markets, 2010*	Labor market efficiency, 2010*	Employment rate, %, 2009	Education, 2010*	Energy intensity of the economy, 2008***
Bulgaria	3.29	3.6	51	3.57	4.00	4.51	62.6	4.14	944.2
Czech Rep.	3.86	4.6	63	4.78	4.58	4.75	65.4	4.66	525.3
Estonia	4.91	6.5	17	4.94	4.71	4.91	63.5	5.17	570.5
Hungary	3.76	4.7	46	4.36	4.16	4.46	55.4	4.81	401.4
Latvia	3.79	4.3	24	4.26	4.13	4.58	60.9	4.81	308.7
Lithuania	3.99	5.0	23	4.56	4.12	4.51	60.1	5.07	417.5
Poland	4.18	5.3	70	3.76	4.38	4.58	59.3	5.00	383.5
Romania	**3.74**	**3.7**	**56**	**3.44**	**4.08**	**4.32**	**58.6**	**4.47**	**614.6**
Slovakia	3.60	4.3	41	4.19	4.34	4.66	67.5	4.49	519.7
Slovenia	4.37	6.4	42	4.83	4.52	4.26	60.2	5.27	257.5
Eurozone							64.7		160.5
USA	4.67	7.1	5	5.65	4.81	5.63		5.64	180.6

* Index – a higher value means a better score;
** Rank (out of 183 countries)
***Energy consumption (Kg of oil equivalent) for producing 1000 euro GDP (constant prices 1995).
Source: World Economic Forum – Global Competitiveness Report, Transparency International, Eurostat, World Bank

Ease of doing business in Romania

	DB 2011 Rank	DB 2010 Rank	Change in Rank
Doing Business Rank	**56/183**	**54/183**	**-2**
Topic Rankings			
Starting a Business	44	41	-3
Dealing with Construction Permits	84	93	9
Registering Property	92	92	No change
Getting Credit	15	14	-1
Protecting Investors	44	41	-3
Paying Taxes	151	147	-4
Trading Across Borders	47	48	1
Enforcing Contracts	54	53	-1
Closing a Business	102	92	-10

Source: World Bank – Doing Business 2011.



Source: World Economic Forum – Global Competitiveness Report 2010-2011

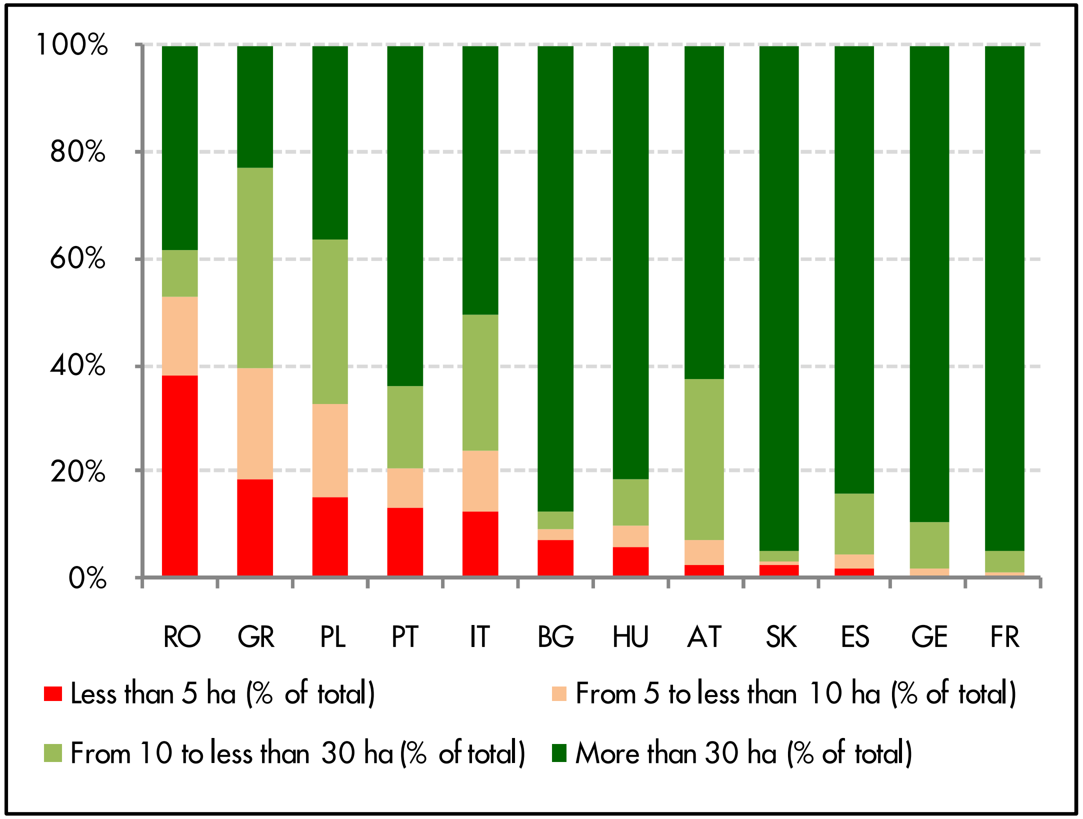
Solutions to improve the quality of infrastructure

- **Improve substantially the EU funds absorption**
- **Public-private partnerships**
- **Decrease of the social expenditures in the public budget to increase the space for public investments**
- **Multiannual budgeting and investments prioritization are essential**

Huge potential in agriculture – efficiency should be increased

- Create and support the market for agricultural products
- Tax evasion for trade with cereals should be reduced substantially
- Policies aimed at increasing the size of exploitations
- Reduce weather dependence

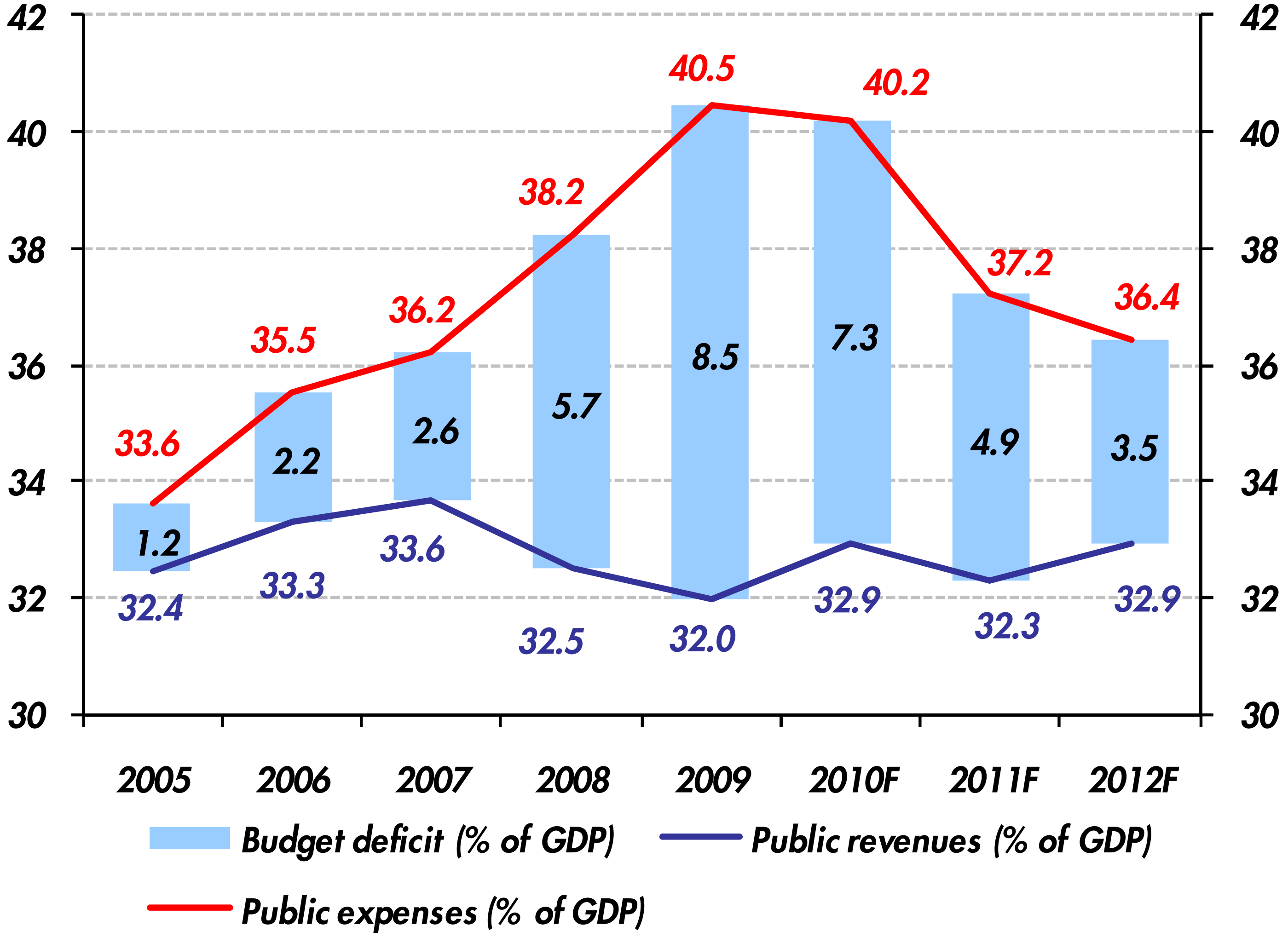
Distribution of land by the size of exploitations



Source: EUROSTAT

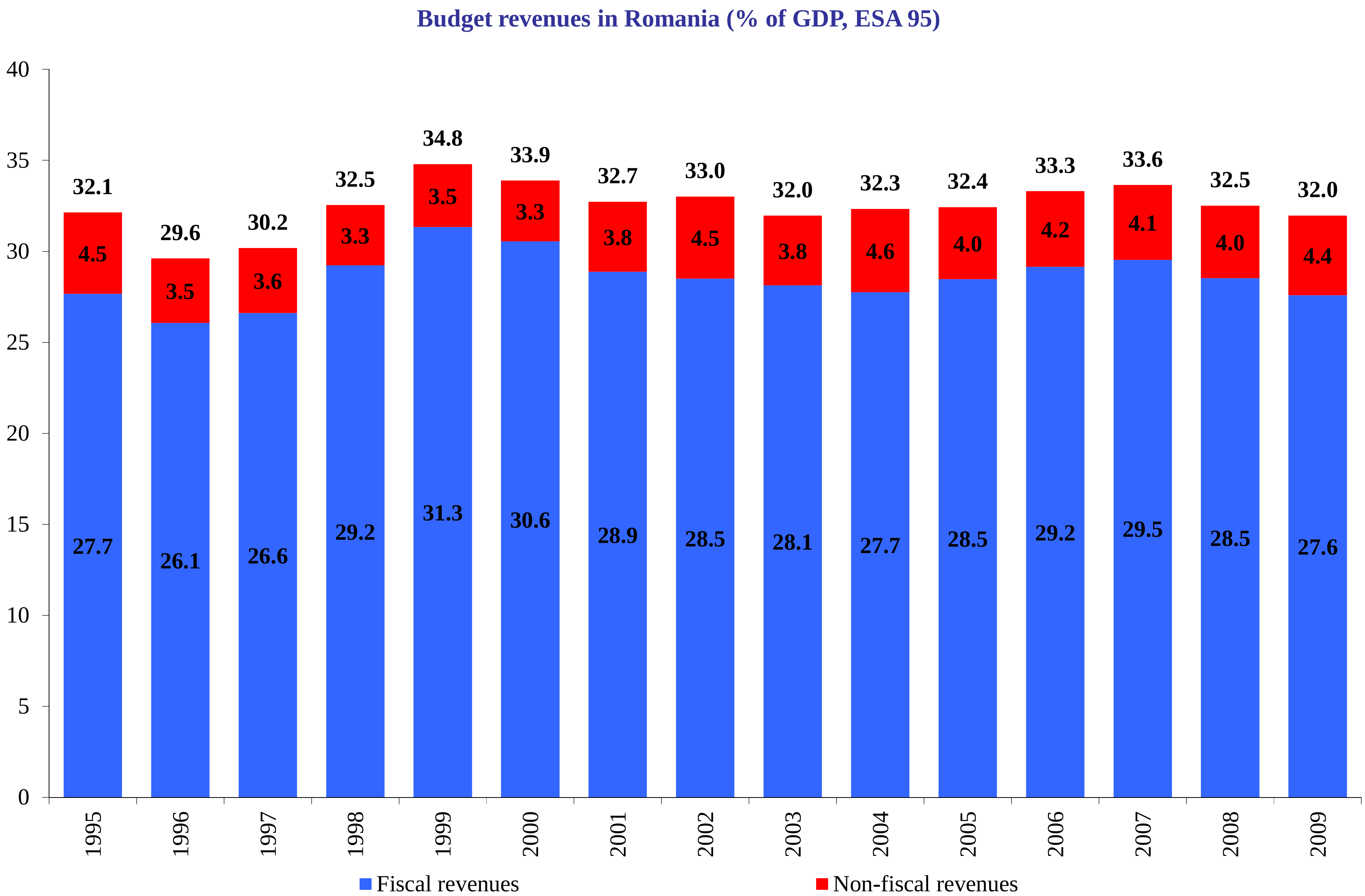
3. Fiscal issues – reversing the pre-crisis unsoustainable fiscal policy is painful

Exuberant behavior of fiscal policy before the crisis – skyrocketing increase in expenditures



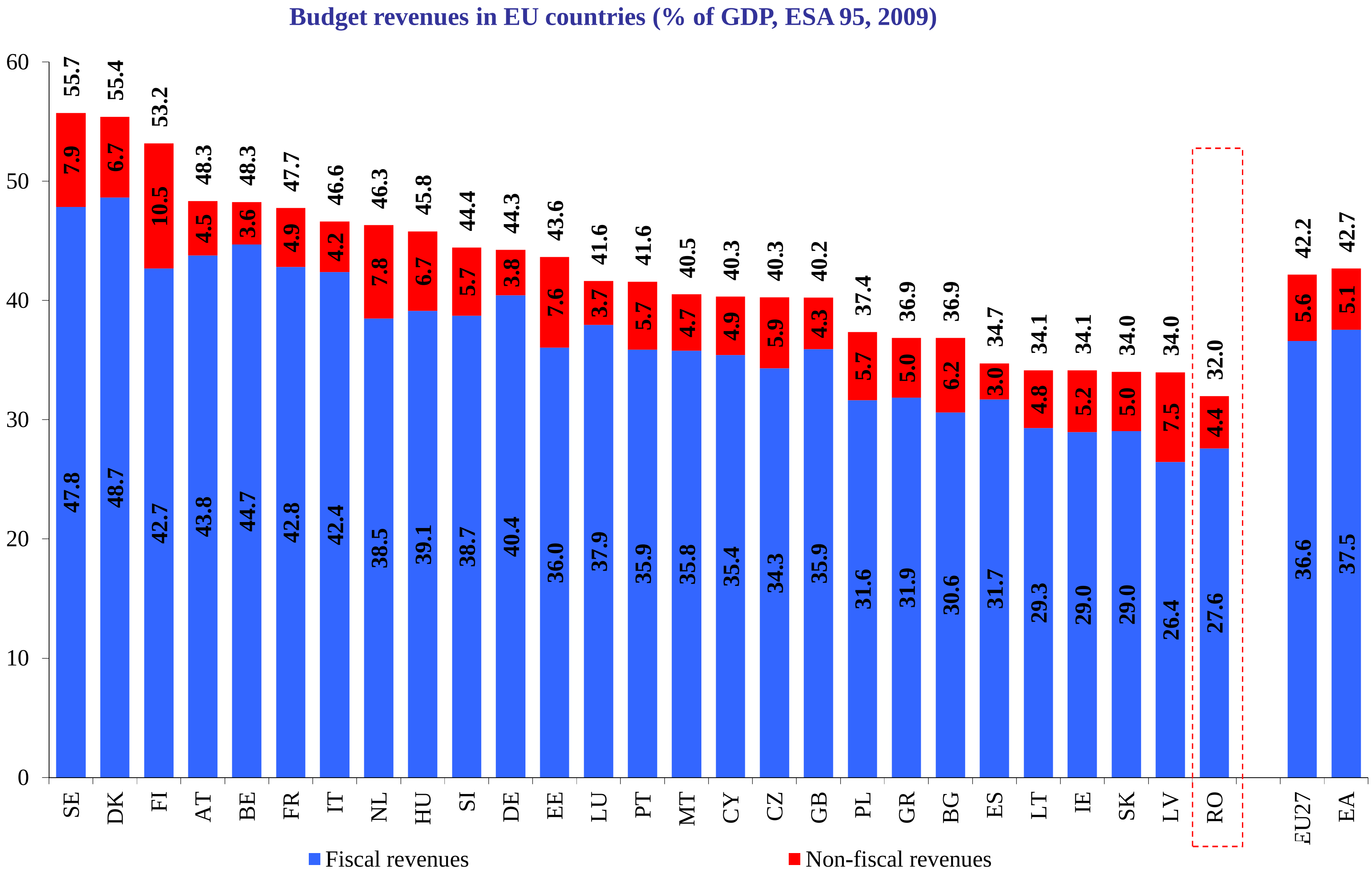
Note: Figures are in ESA 95
Source: European Commission (forecasts from Autumn 2010)

Stable budget revenues …



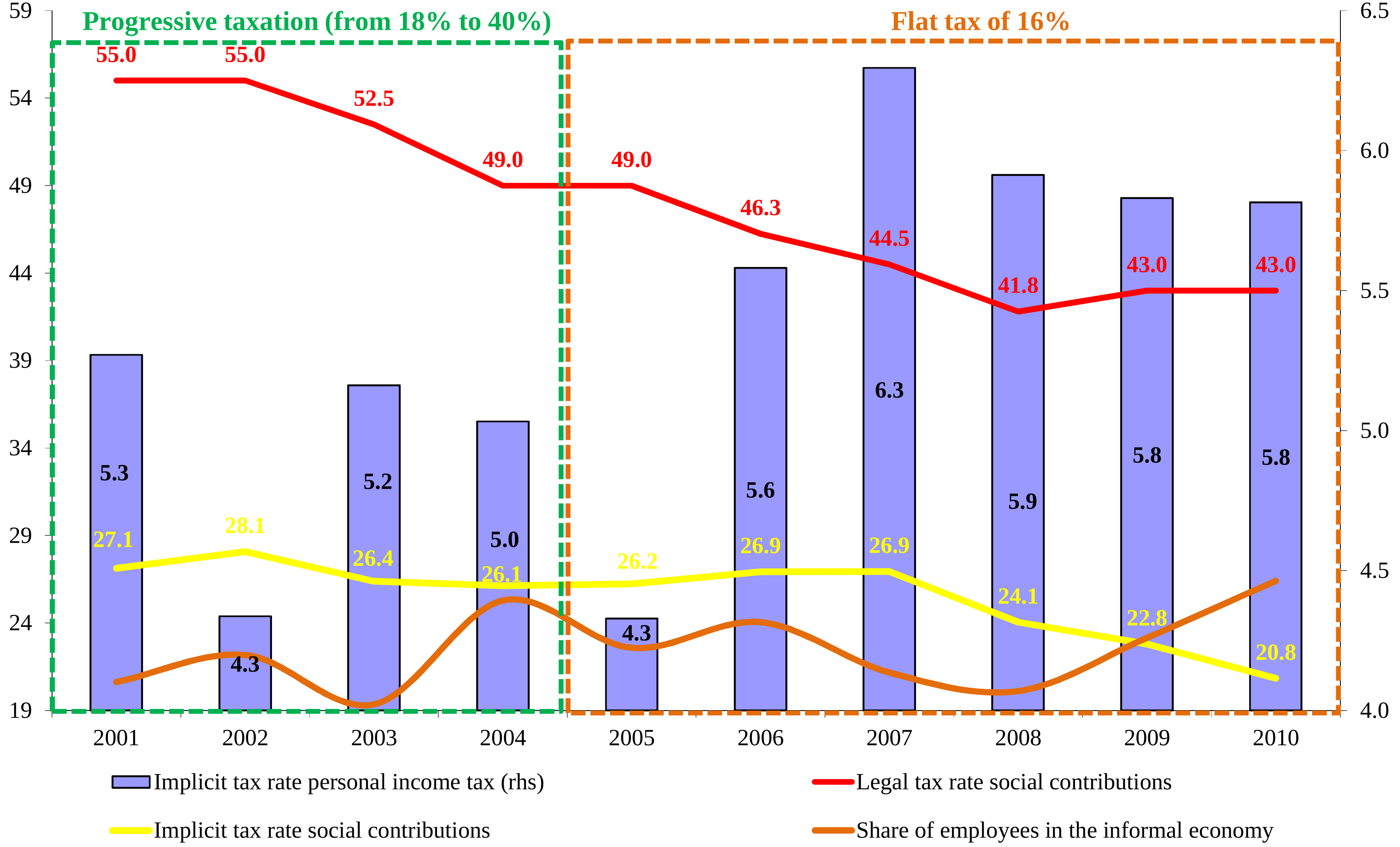
Source: Eurostat, Ministry of Finance

… but the lowest budget revenues in EU27



Source: Eurostat, Fiscal Council

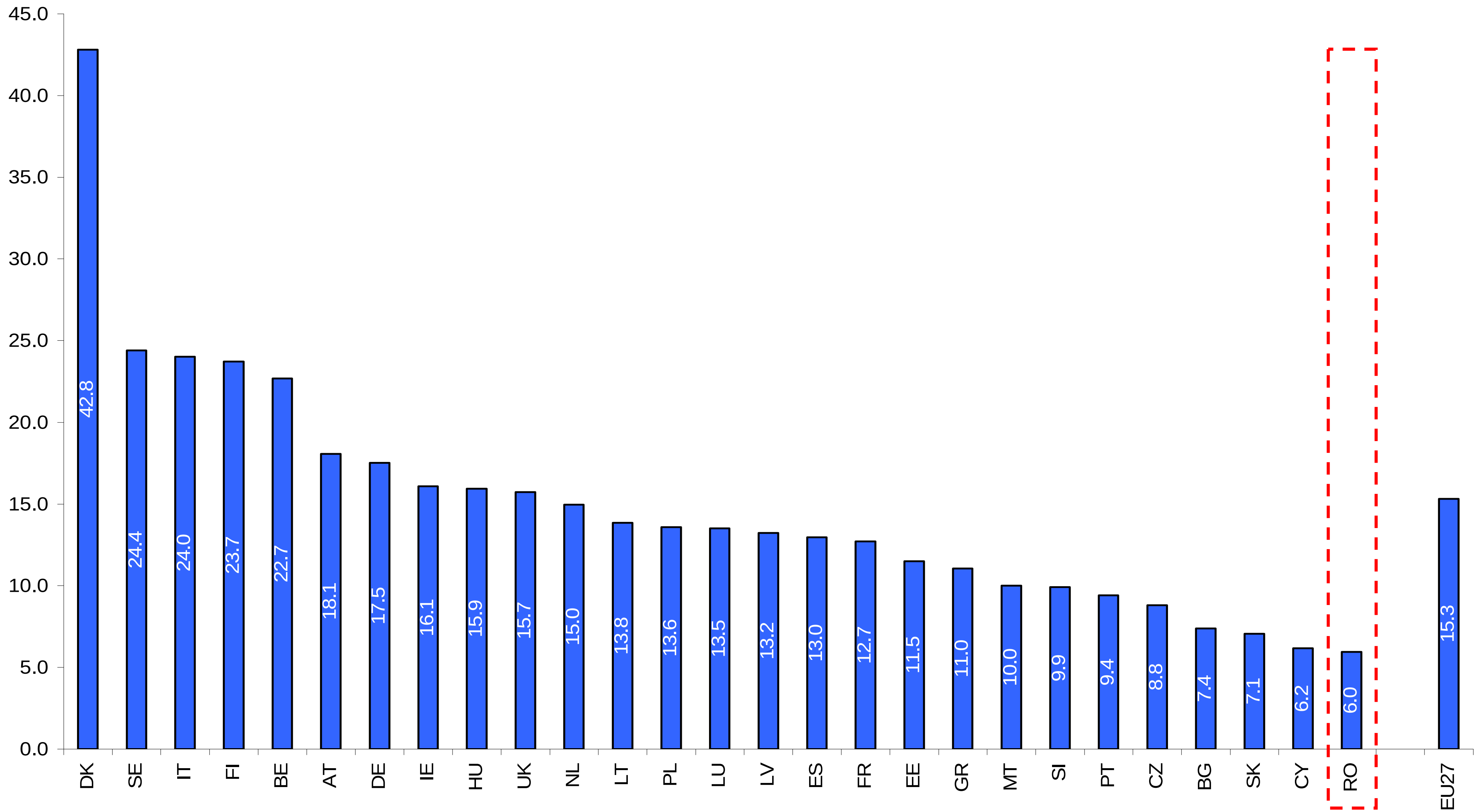
Voluntary tax compliance – personal income tax and social contributions



Implicit tax rates are computed as the ratio between the budget revenues and compensation of employees from the national accounts (including the unobserved economy). For 2009-2010 compensation of employees is estimated.
The number of employees in the informal economy is computed as the difference between the number of employees from the Labor Force Survey and the number of employees reported officially by the employers (from Labor Force Balance).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

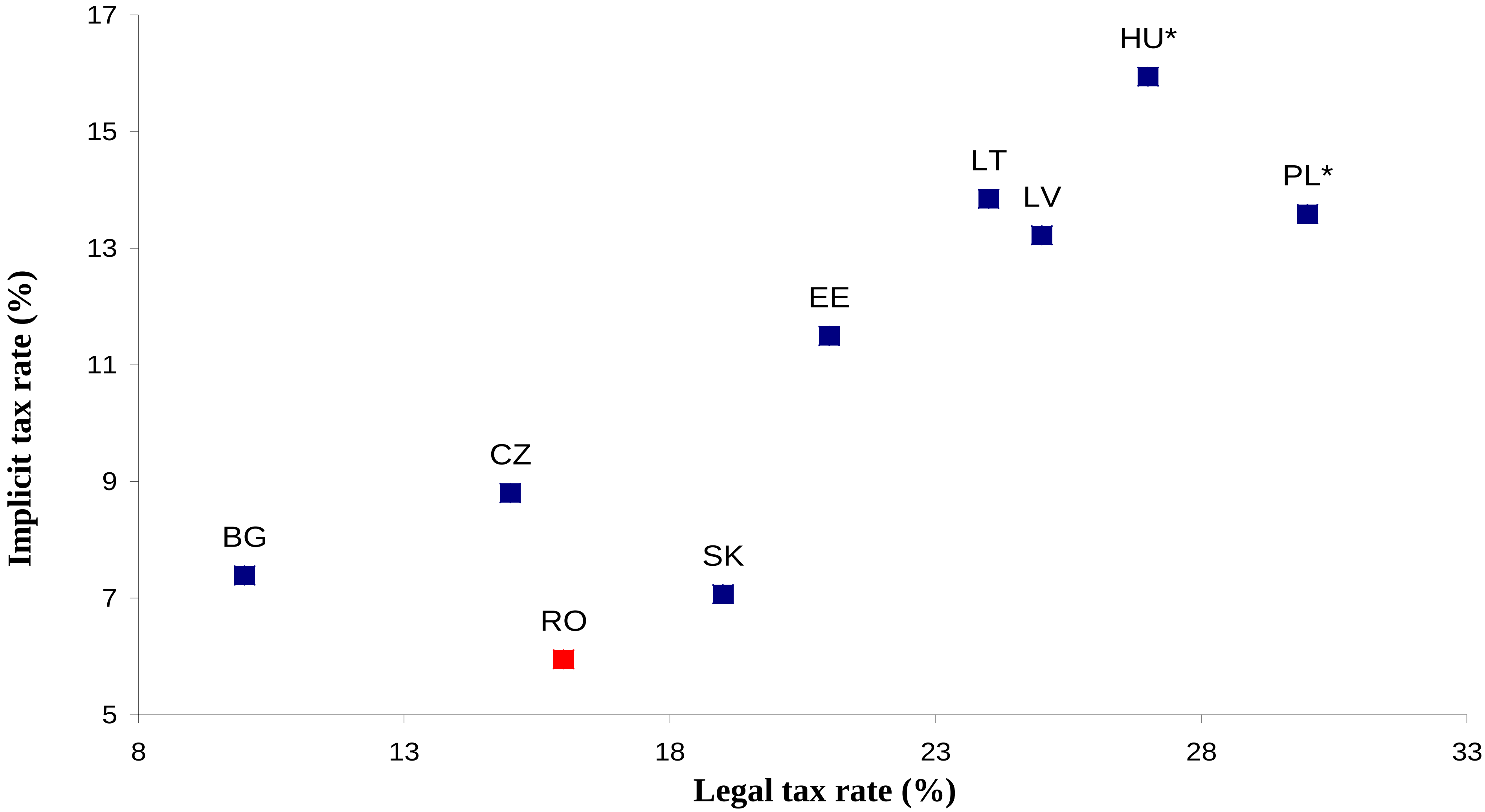
Implicit tax rate for personal income tax, 2008



Implicit tax rate is computed as the ratio between the budget revenues from personal income tax and compensation of employees from the national accounts (including the unobserved economy).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

Legal tax rates vs. implicit tax rates for personal income tax in 2008

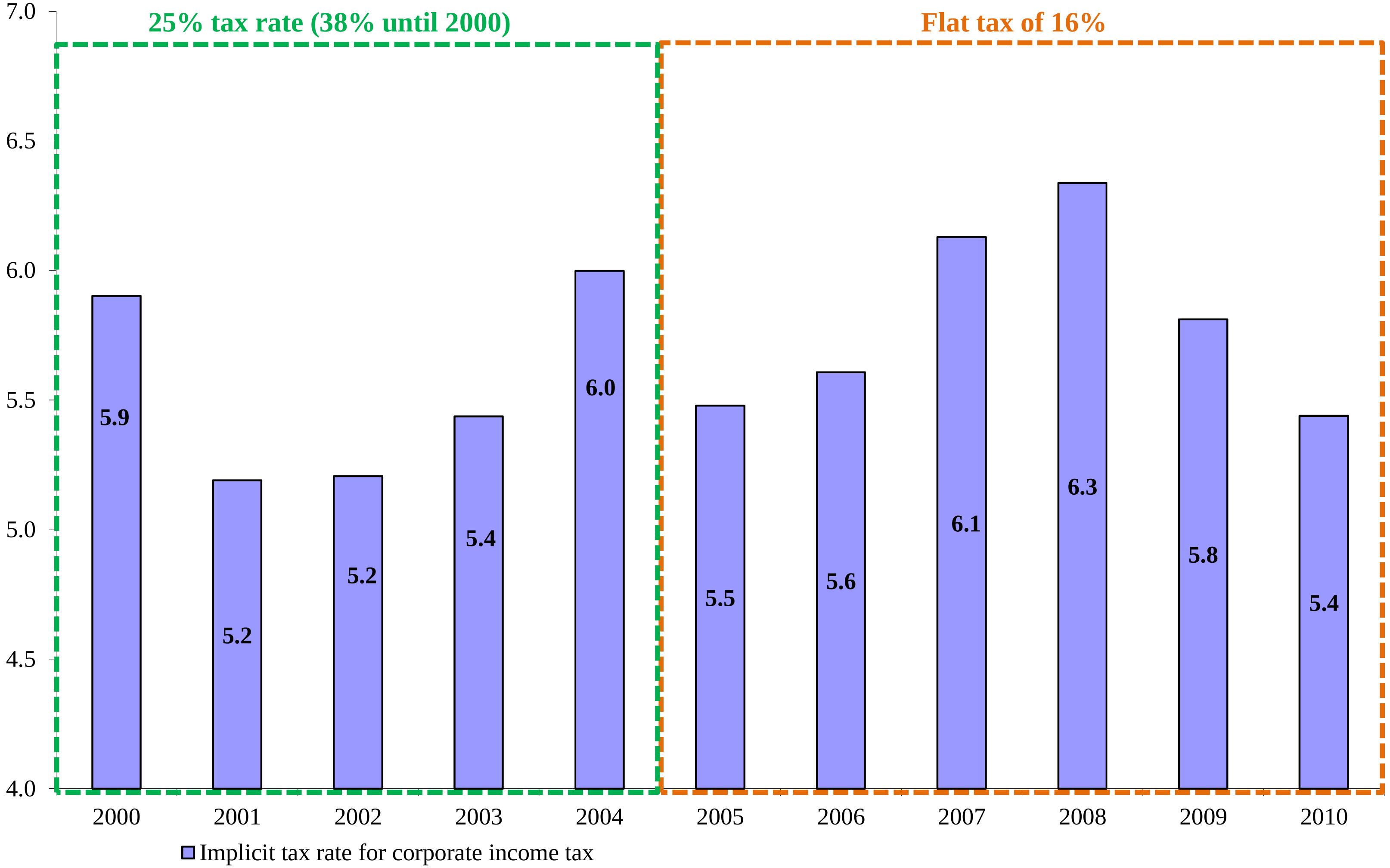


* HU and PL had progressive taxation in 2008 (two brackets in HU - 18% and 36%, and 3 brackets in PL - 19%, 30% and 40%)

Implicit tax rate is computed as the ratio between the budget revenues from personal income tax and compensation of employees from the national accounts (including the unobserved economy).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

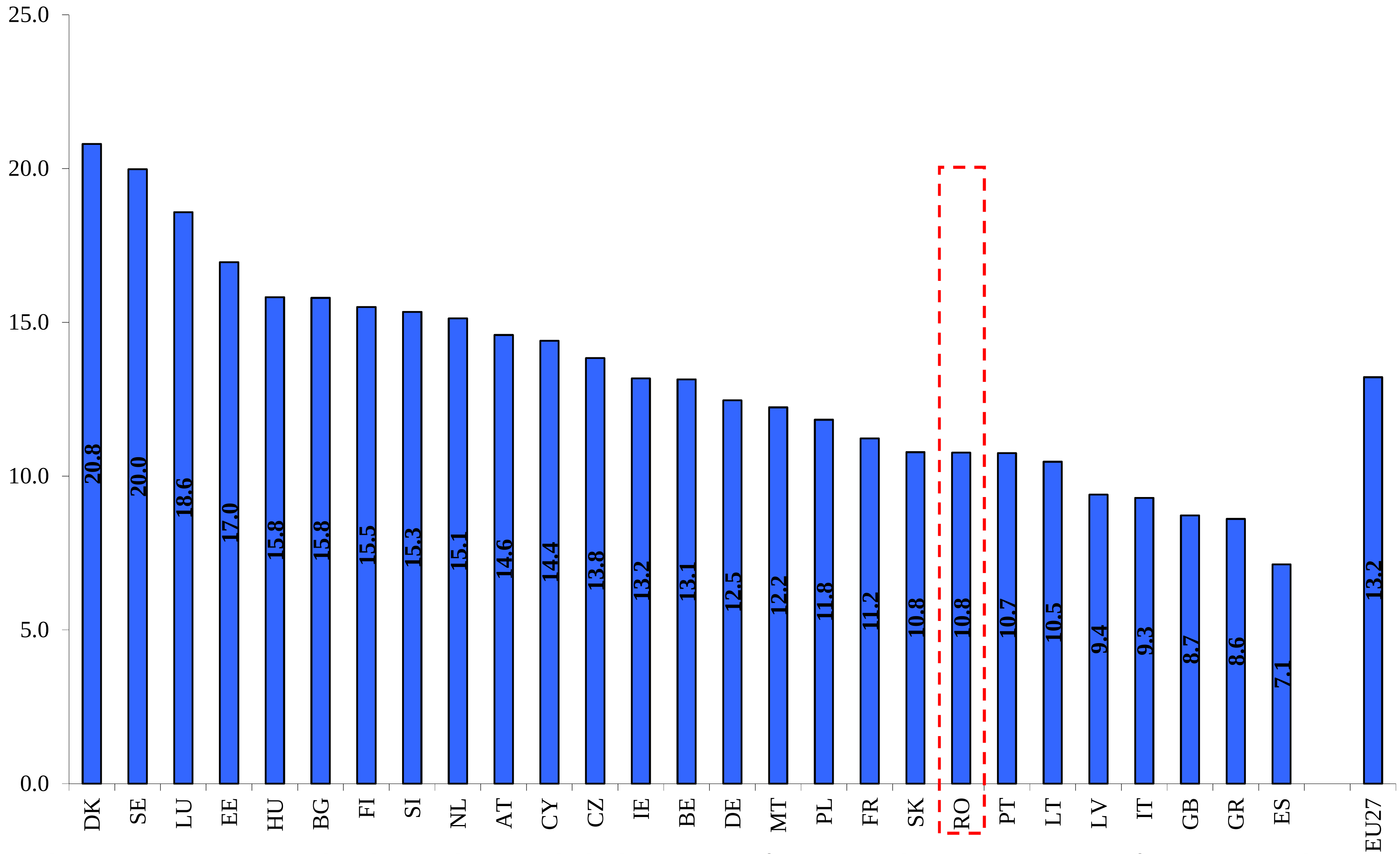
Implicit tax rate – corporate tax



Implicit tax rates are computed as the ratio between the budget revenues and gross operating surplus and mixed income from the national accounts (including the unobserved economy). For 2009-2010 gross operating surplus and mixed income is estimated.

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

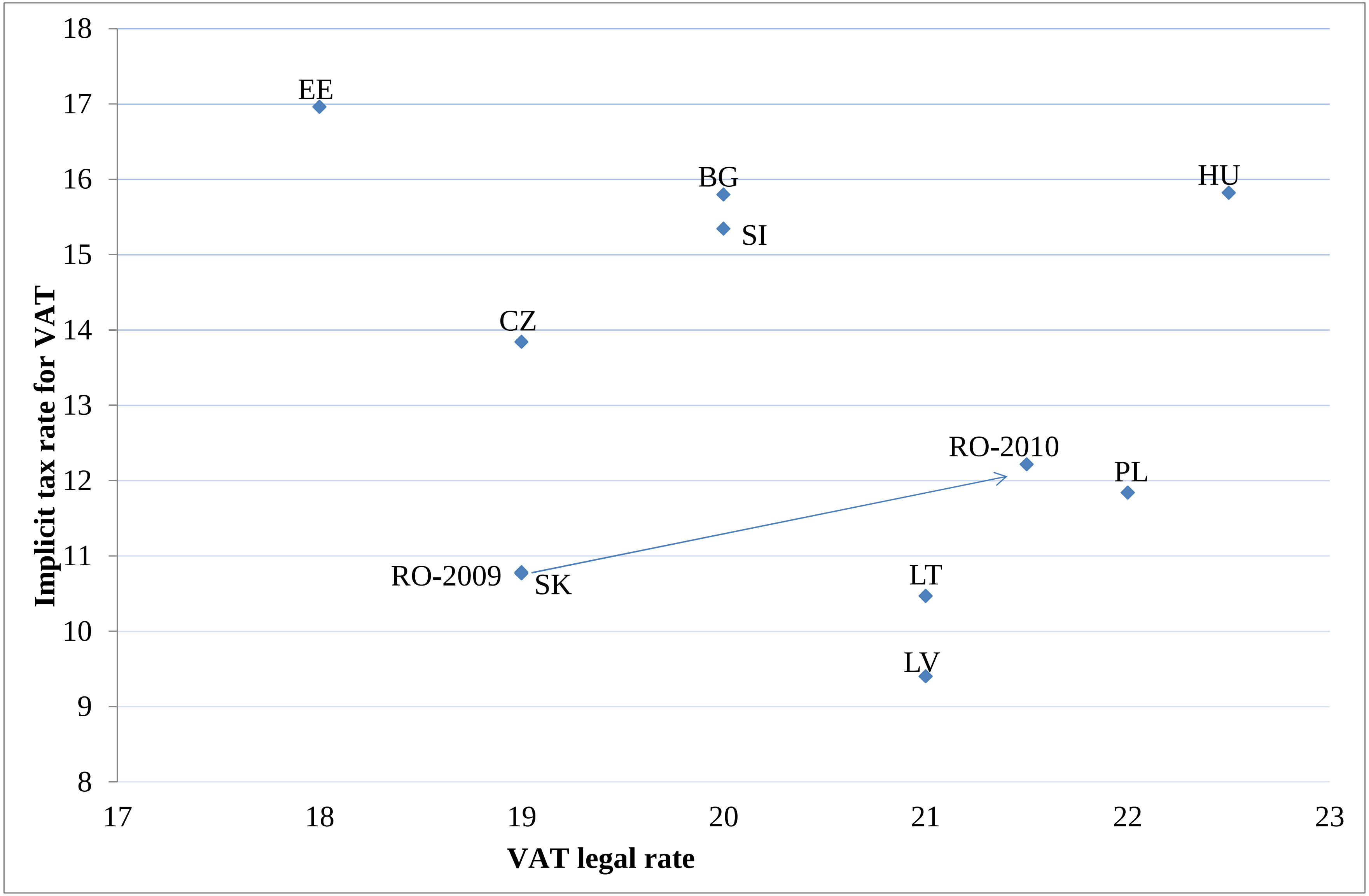
Implicit tax rate for VAT, 2009



Implicit tax rates are computed as the ratio between the budget revenues from VAT and private consumption from the national accounts (including the unobserved economy).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

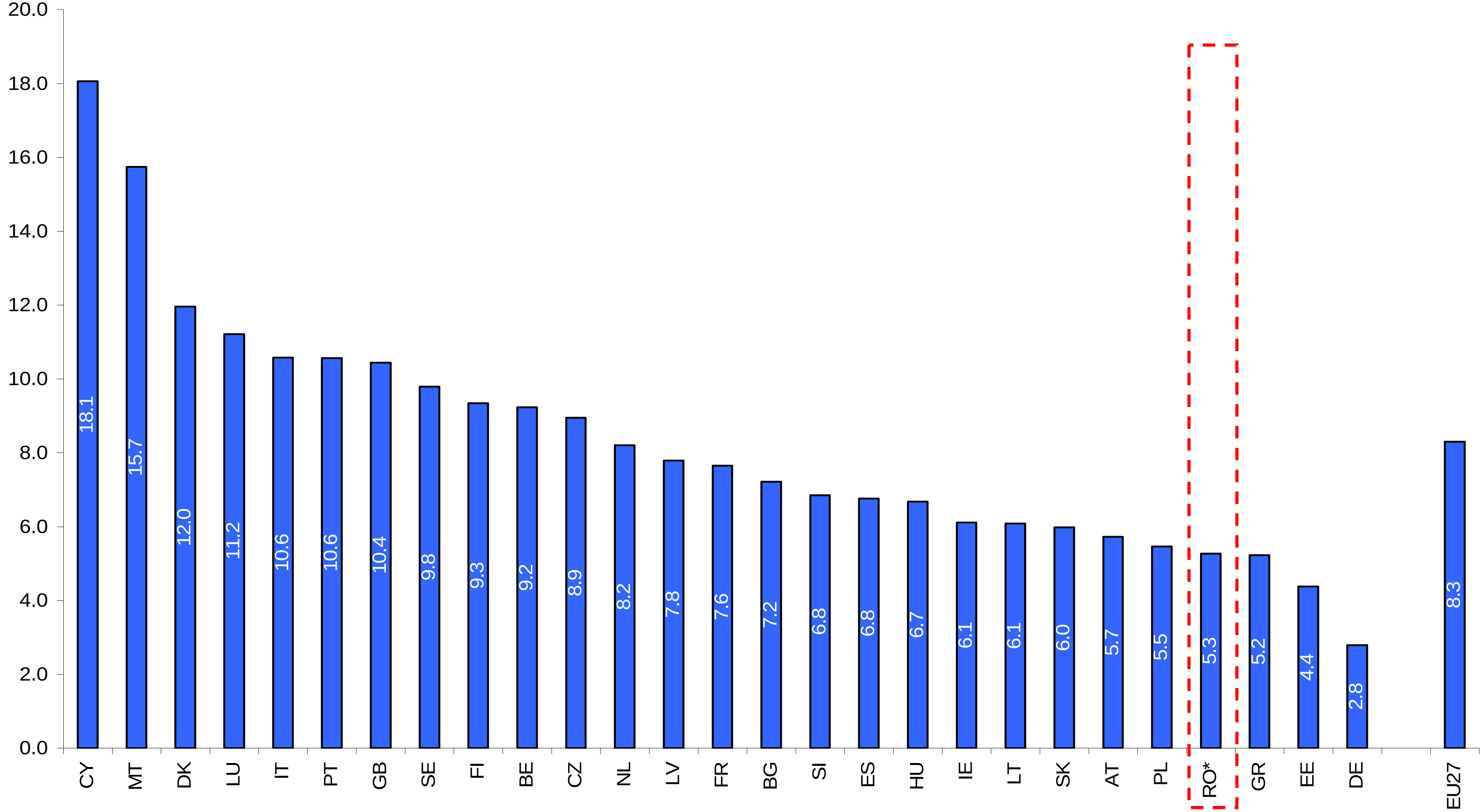
Legal tax rates vs. implicit tax rates for VAT in 2009



Implicit tax rates are computed as the ratio between the budget revenues from VAT and private consumption from the national accounts (including the unobserved economy).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

Implicit tax rate for corporate income tax, 2008



Implicit tax rates are computed as the ratio between the budget revenues and gross operating surplus and mixed income from the national accounts (including the unobserved economy).

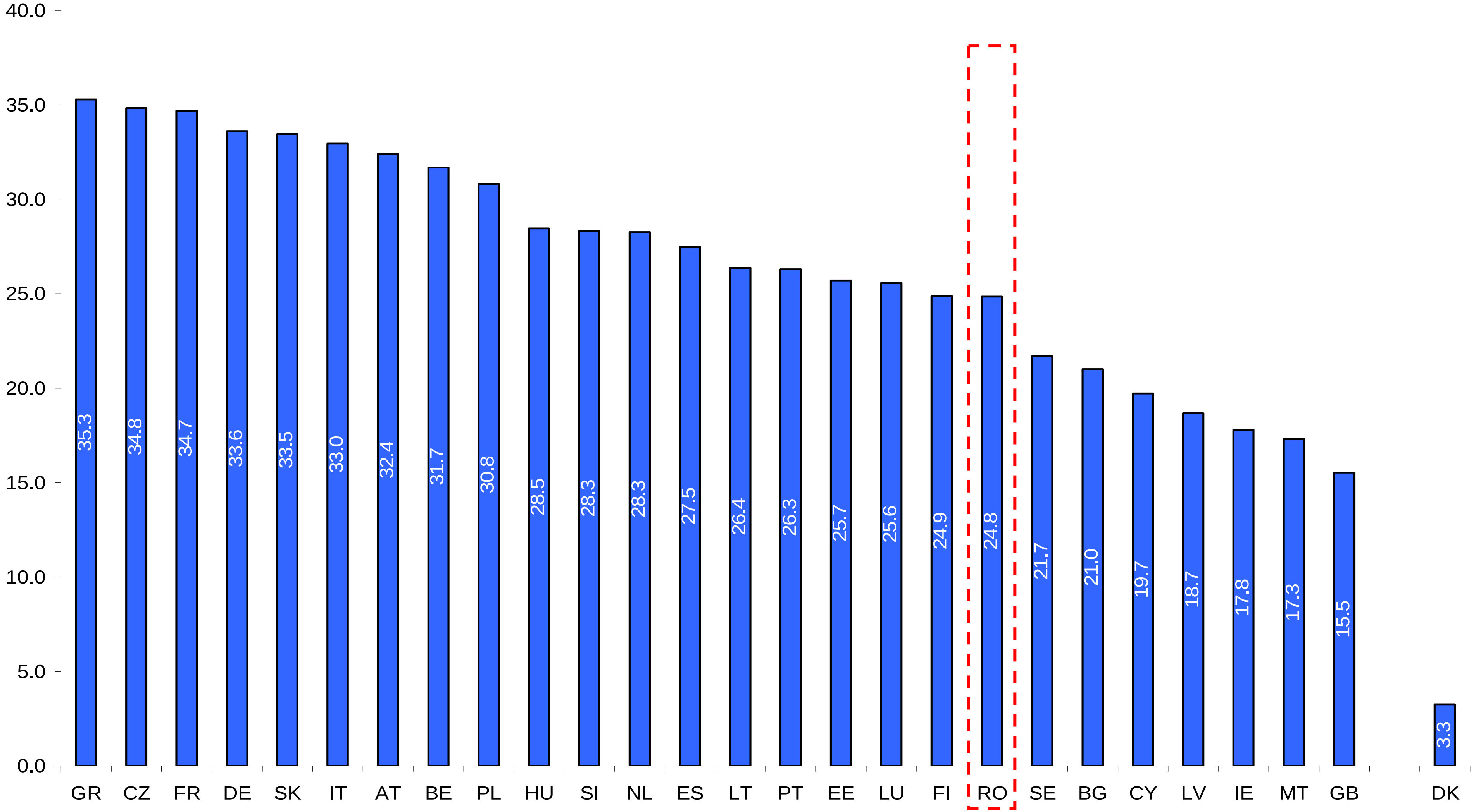
Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

Legal tax rates vs. implicit tax rates for corporate tax in 2008

Implicit tax rates are computed as the ratio between the budget revenues and gross operating surplus and mixed income from the national accounts (including the unobserved economy).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

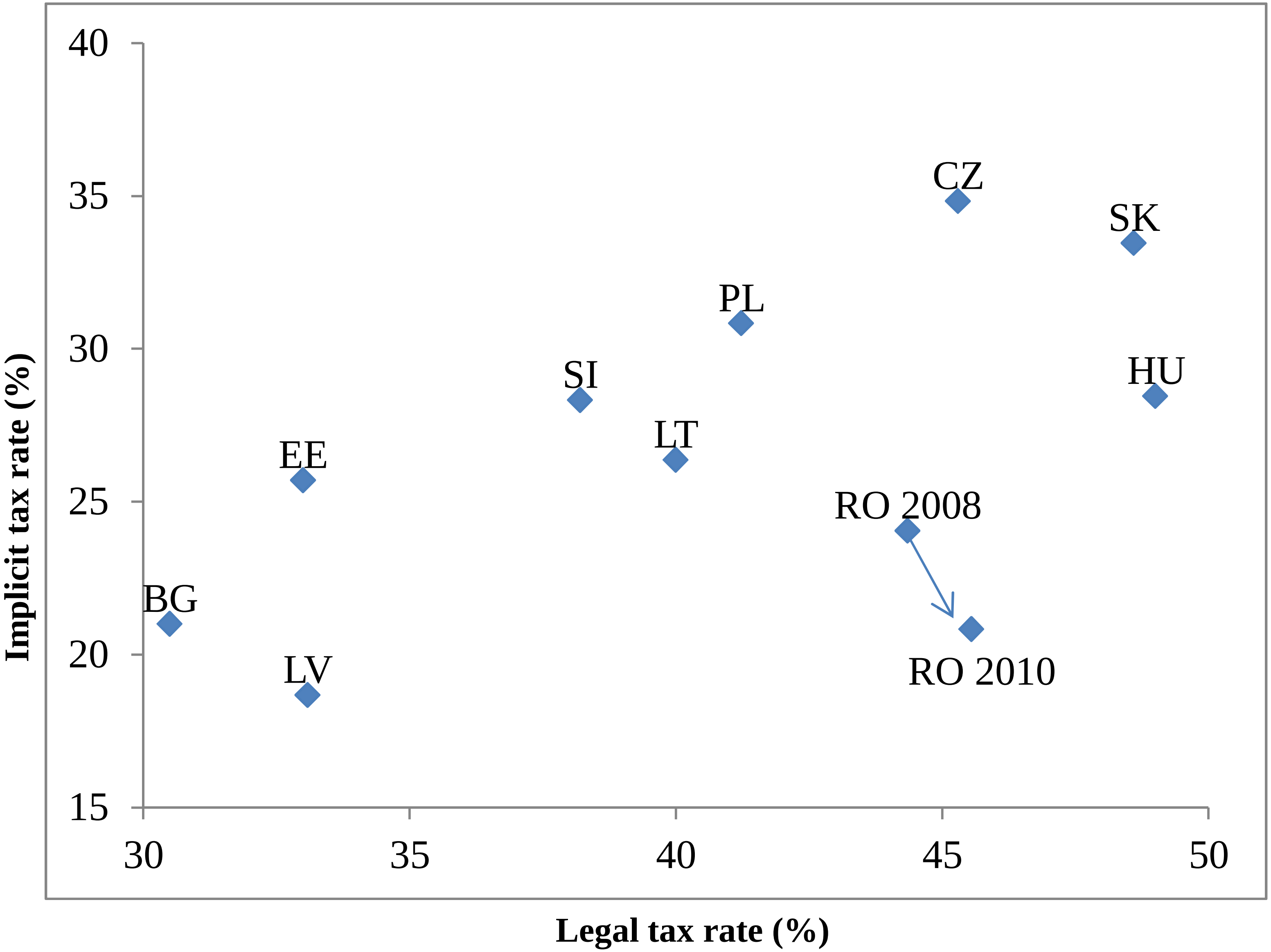
Implicit tax rate for social contributions, 2008



Implicit tax rate is computed as the ratio between the budget revenues from personal income tax and compensation of employees from the national accounts (including the unobserved economy).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

Legal tax rates vs. implicit tax rates for social contributions in 2008



Implicit tax rate is computed as the ratio between the budget revenues from personal income tax and compensation of employees from the national accounts (including the unobserved economy).

Source: Eurostat, NIS, Ministry of Finance, Fiscal Council

Social security contributions in NMS10 in 2010, %

Social Contributions		SK	HU	CZ	RO	PL	LT	SI	LV	EE	BG
Old-age pensions	Employer	14.0	24.0	21.5	20.8	9.8	23.3	8.9	-	-	8.9
	Employee	4.0	9.5	6.5	10.5	9.8	3.0	15.5	-	-	7.1
	Total	**18.0**	**33.5**	**28.0**	**31.3**	**19.5**	**26.3**	**24.4**	**-**	**-**	**16.0**
Unemployment insurance	Employer	1.0	-	1.2	0.5	-	1.1	0.1	-	-	0.4
	Employee	1.0	-	0.0	0.5	-	-	0.1	-	-	0.6
	Total	**2.0**	**-**	**1.2**	**1.0**	**-**	**1.1**	**0.2**	**-**	**-**	**1.0**
Health insurance	Employer	10.0	2.0	9.0	5.2	0.0	3.0	7.1	-	-	0.0
	Employee	4.0	6.0	4.5	5.5	9.0	6.0	6.4	-	-	8.0
	Total	**14.0**	**8.0**	**13.5**	**10.7**	**9.0**	**9.0**	**13.5**	**-**	**-**	**8.0**
Other	Employer	10.2	4.0	2.6	1.4	4.9	3.7	0.1	-	-	1.8
	Employee	4.4	3.0	0.0	-	4.0	-	0.1	-	-	2.1
	Total	**14.6**	**7.0**	**2.6**	**-**	**8.9**	**3.7**	**0.2**	**-**	**-**	**3.9**
Total	Employer	35.2	30.0	34.3	27.9	14.7	31.1	16.1	24.1	33.0	11.1
	Employee	13.4	18.5	11.0	16.5	22.7	9.0	22.1	9.0	0.0	17.8
	Total	**48.6**	**48.5**	**45.3**	**44.4**	**41.2**	**40.1**	**38.2**	**33.1**	**33.0**	**30.5**

Source: European Comission

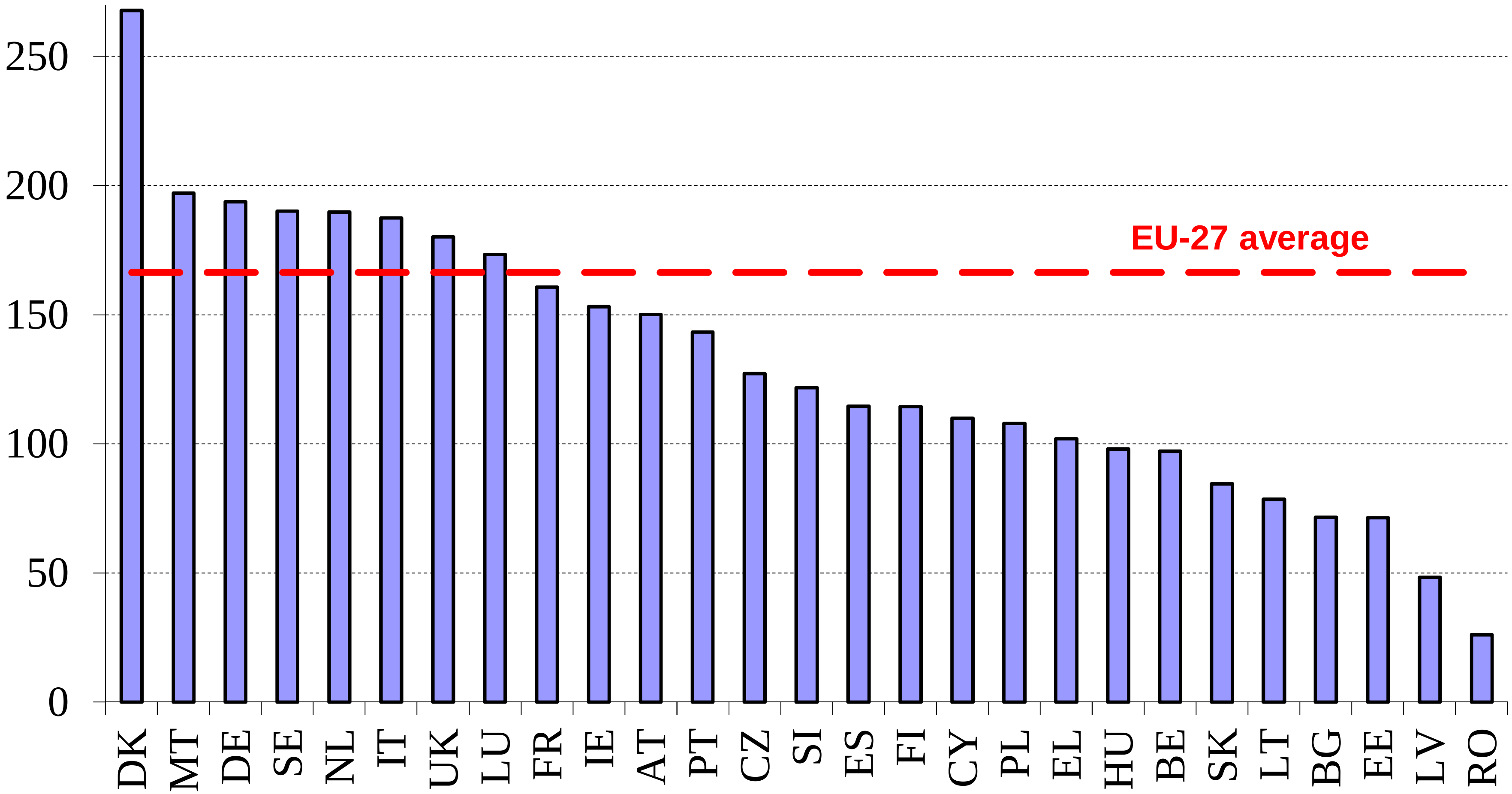
Tax wedge on labor (2009)

Tax wedge = the proportional difference between the costs of a worker to their employer (wage and social security contributions, i.e. the total labor cost) and the amount of net earnings that the worker receives (wages minus personal income tax and social security contributions, plus any available family benefits). The indicator of the tax wedge on labour measures both incentives to work (labour supply side) and to hire persons (labour demand side) and takes into account the income tax and social security components.

Source : Joint European Commission-OECD project, using OECD Tax -Benefit models - October 2010

Single person without children, 100% of AW	Total Tax Wedge 2009	Of which		
		Personal Income Tax	Social Security Contributions Employee	Social Security Contribution Employer
Belgium	55.2	21.1	10.7	23.3
Hungary	53.4	15.9	12.8	24.6
Germany	50.9	17.3	17.3	16.3
France	49.2	9.9	9.6	29.7
Austria	47.9	11.4	14.0	22.6
Italy	46.5	15.0	7.2	24.3
Sweden	43.2	13.9	5.3	23.9
Slovenia*	42.9	9.3	18.9	14.7
Finland	42.4	18.6	5.1	18.7
Romania*	**42.4**	**9.4**	**12.3**	**20.6**
Czech rep	41.9	8.3	8.2	25.4
Lithuania*	41.6	15.5	2.3	23.8
Latvia*	41.6	14.9	7.3	19.4
Greece	41.5	7.1	12.5	21.9
Estonia*	39.5	12.6	2.0	25.0
Denmark	39.4	29.1	10.3	0.0
Spain	38.2	10.3	4.9	23.0
Netherlands	38.0	15.1	13.8	9.1
Slovak rep	37.6	6.3	10.6	20.8
Portugal	37.2	9.1	8.9	19.2
Bulgaria*	35.1	7.2	10.8	17.1
Poland	34.0	5.6	15.5	12.9
Luxembourg	34.0	12.7	10.9	10.3
UK	32.5	14.6	8.3	9.6
Ireland	28.6	12.9	6.0	9.7
Malta*	22.8	8.7	7.0	7.0
Cyprus**	13.9	2.1	5.9	5.9

Implicit tax rates on energy*, 2008



*Energy taxes in Euro per tons of oil equivalent (TOE), base year: 2000, calculated as the ratio between total energy tax revenues and final energy consumption.

Source: European Comission

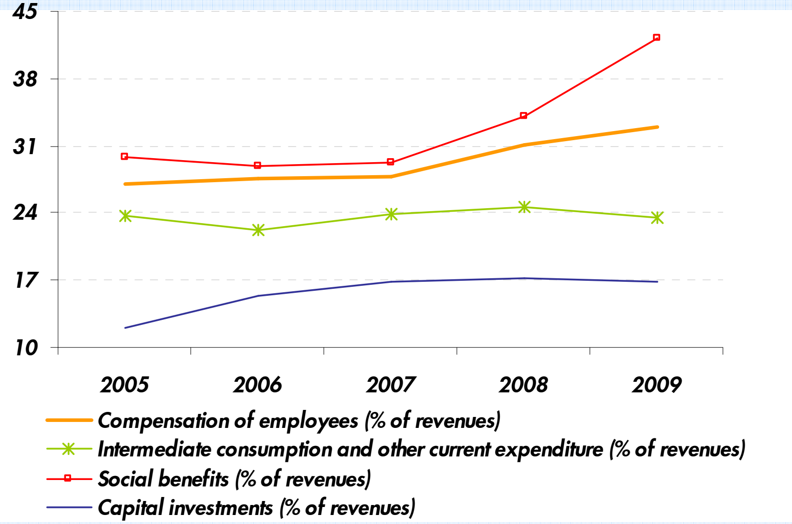
Legal tax rates in EU countries, 2010

Country	Profit tax	Personal income tax	VAT standard rate
Austria	25%	21-50%	20%
Belgium	34%	25-50%	21%
Bulgaria	10%	10%	20%
Croatia	20%	15-45%	23%
Cyprus	10%	0-30%	15%
Czech Republic	19%	15%	20%
Denmark	25%	0-63%	25%
Estonia	21%	21%	20%
France	33%	21% (social charges)	20%
Germany	29.8% (average)	0-45%	19%
Greece	22/25%	0-40%	19%
Hungary	16%	18% and 36%	25%
Ireland	13%	0-41%	21%
Italy	31%	23-43%	20%
Latvia	15%	26%	21%
Lithuania	15%	0-15%	21%
Luxembourg	30%	6-38.95%	15%
Malta	35%	0-35%	18%
Netherlands	20/25.5%	0-52%	19%
Poland	19%	0%, 18, 32% (or optional 19% flat rate for self-employed)	22%
Portugal	25%	10.5-40%	21%
Romania	**16%**	**16%**	**24%**
Serbia	10%	12-20%	18%
Slovakia	19%	19%	19%
Slovenia	21%	16-41%	8.5/20%
Spain	25-30%	0-42%	18%
Sweden	26%	28.89%-59.09%	25%

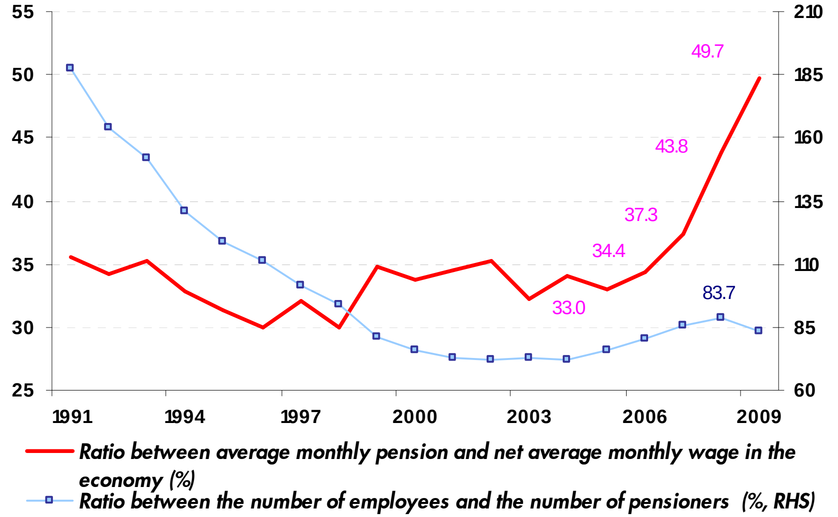
Source: Eurostat, Ministries of Finance, Fiscal Council

Very rapid increase in public spending driven mainly by social expenditures

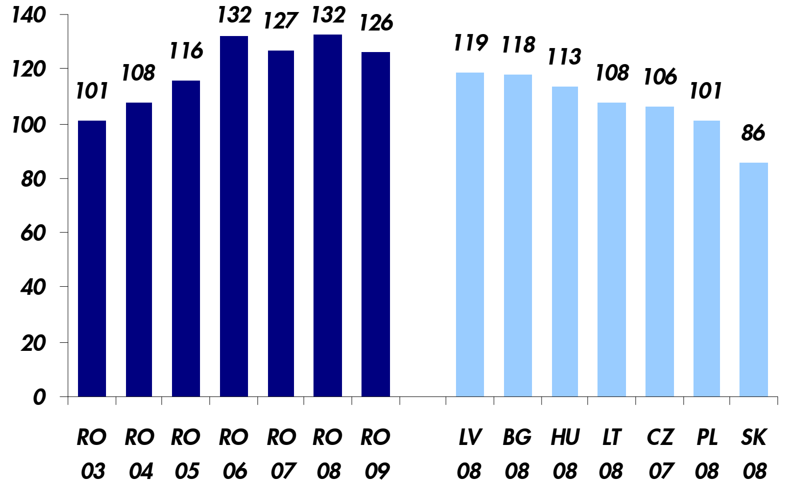
Increases in public wages and pension explained the most of the increase in budget deficit



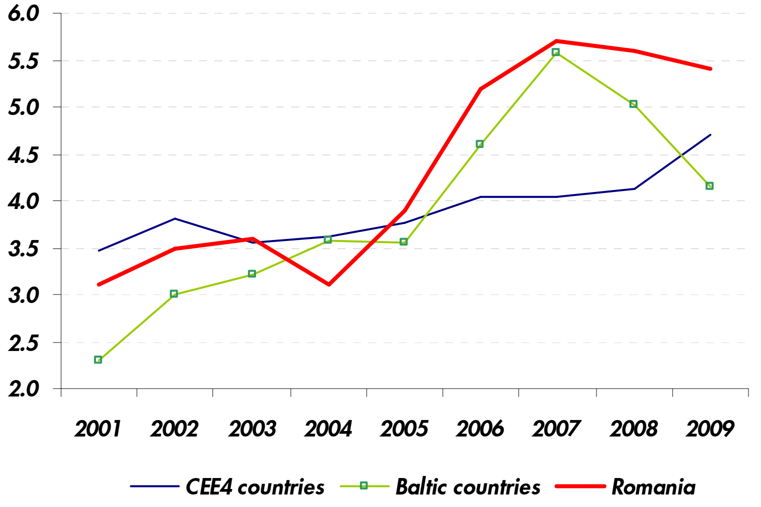
Sharp increase in pensions



Rapid increase in wages in public sector

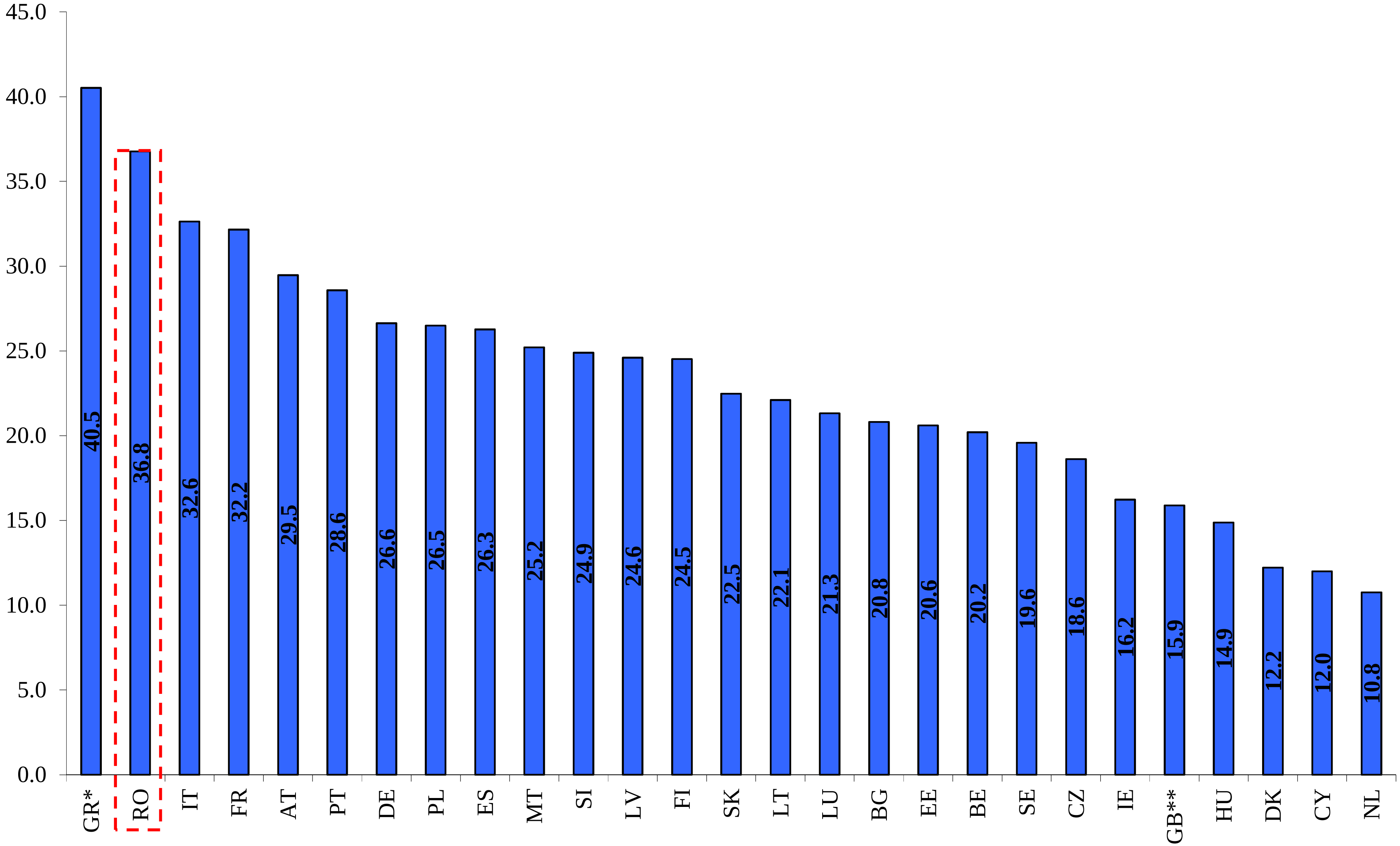


Low efficiency of investment expenditures



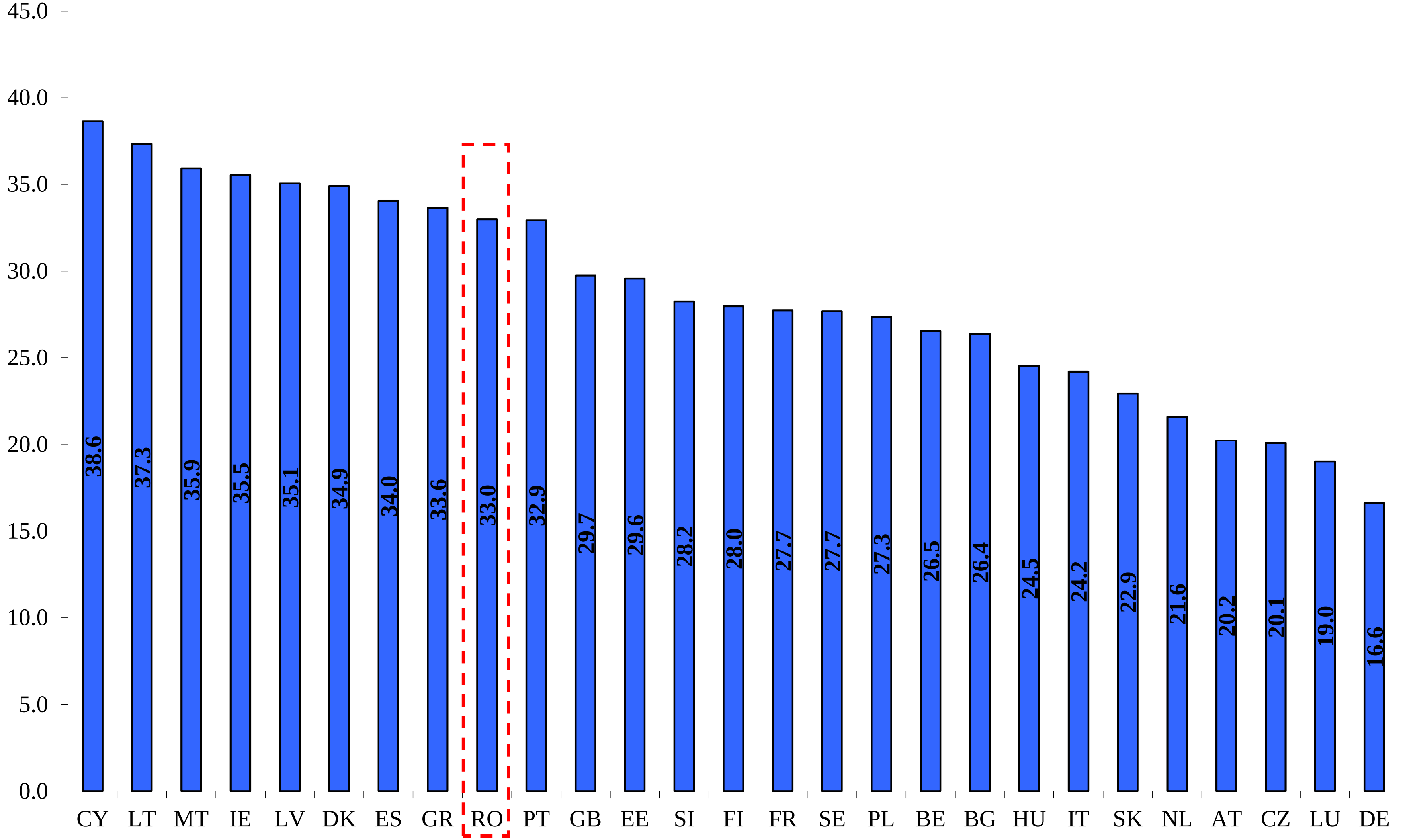
Source: Eurostat, National Institute of Statistics

Expenses with pensions (ESA 95, % of budget revenues, 2009)



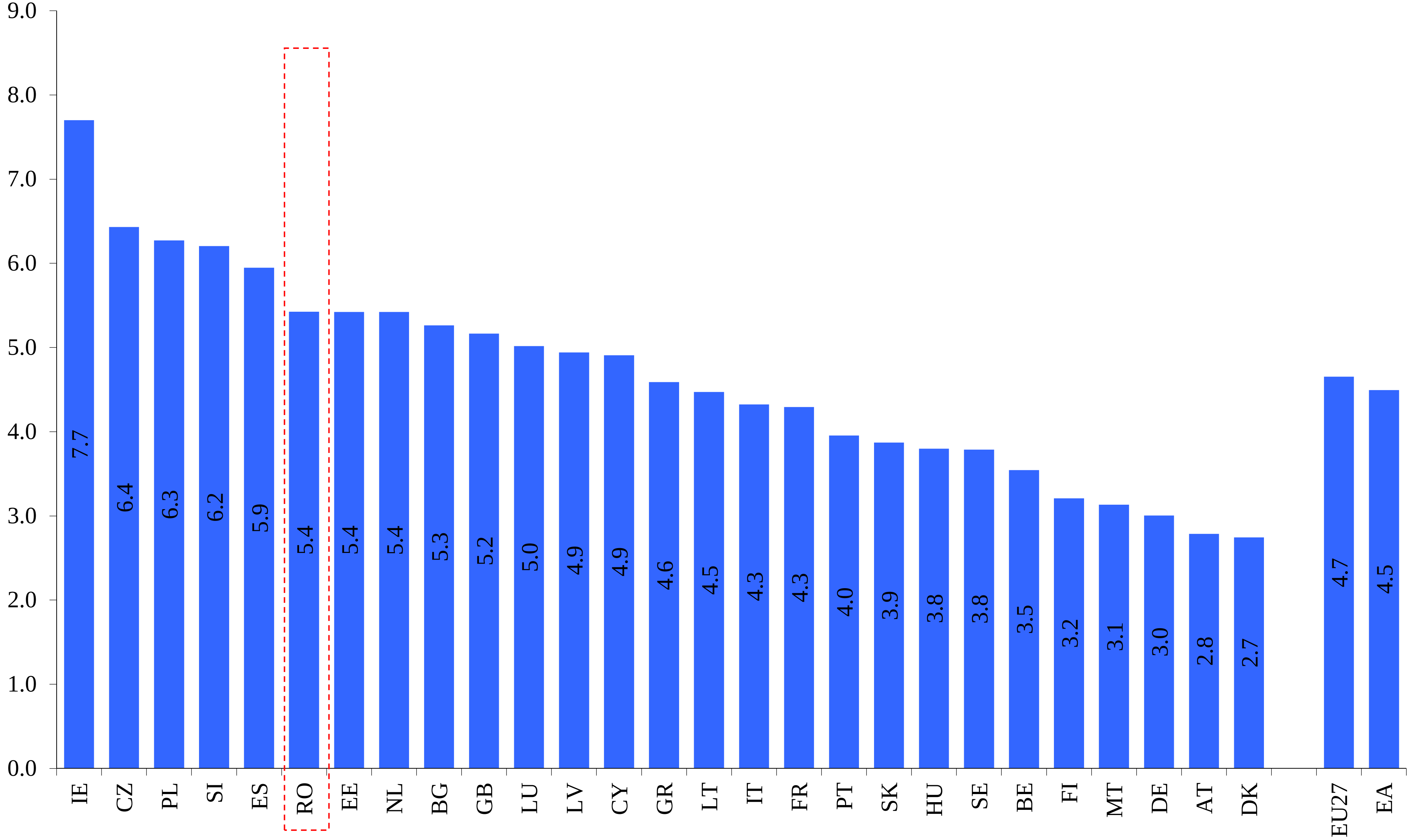
Source: Eurostat

Compensation of employees in the public sector (ESA 95, % of budget revenues, 2009)



Source: Eurostat

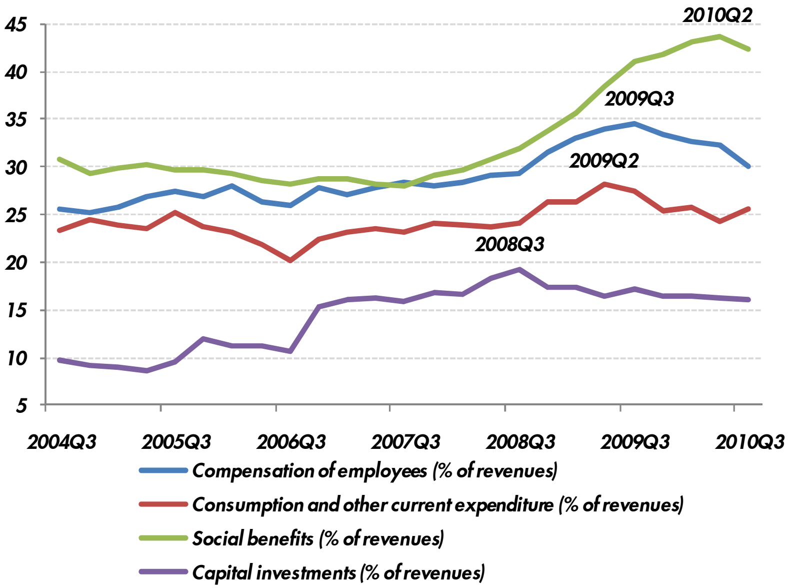
Capital expenditures (ESA 95, % of GDP, 2009)



Source: Eurostat

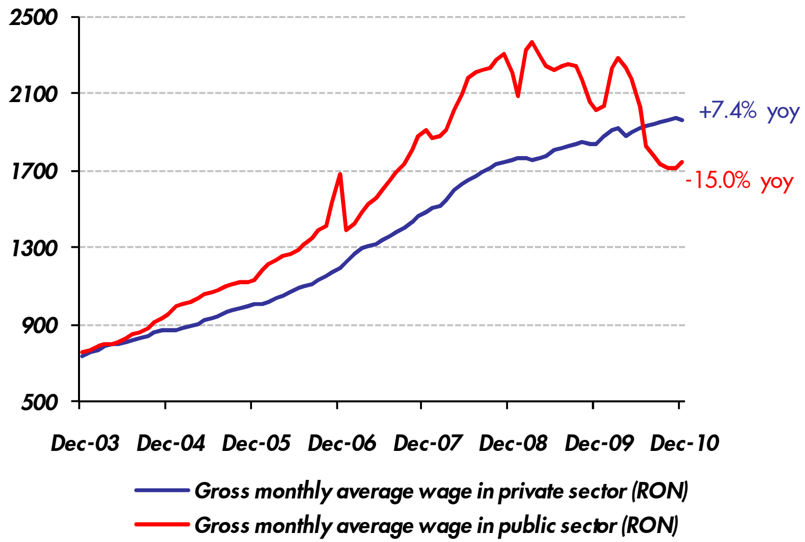
Major measures to reduce the budget deficit were taken only in 2010

Expenses with investments were first cut, while expenses with social transfers were cut last



Note: data cumulated on 4 quarters

Dynamics of wages in public and private sector



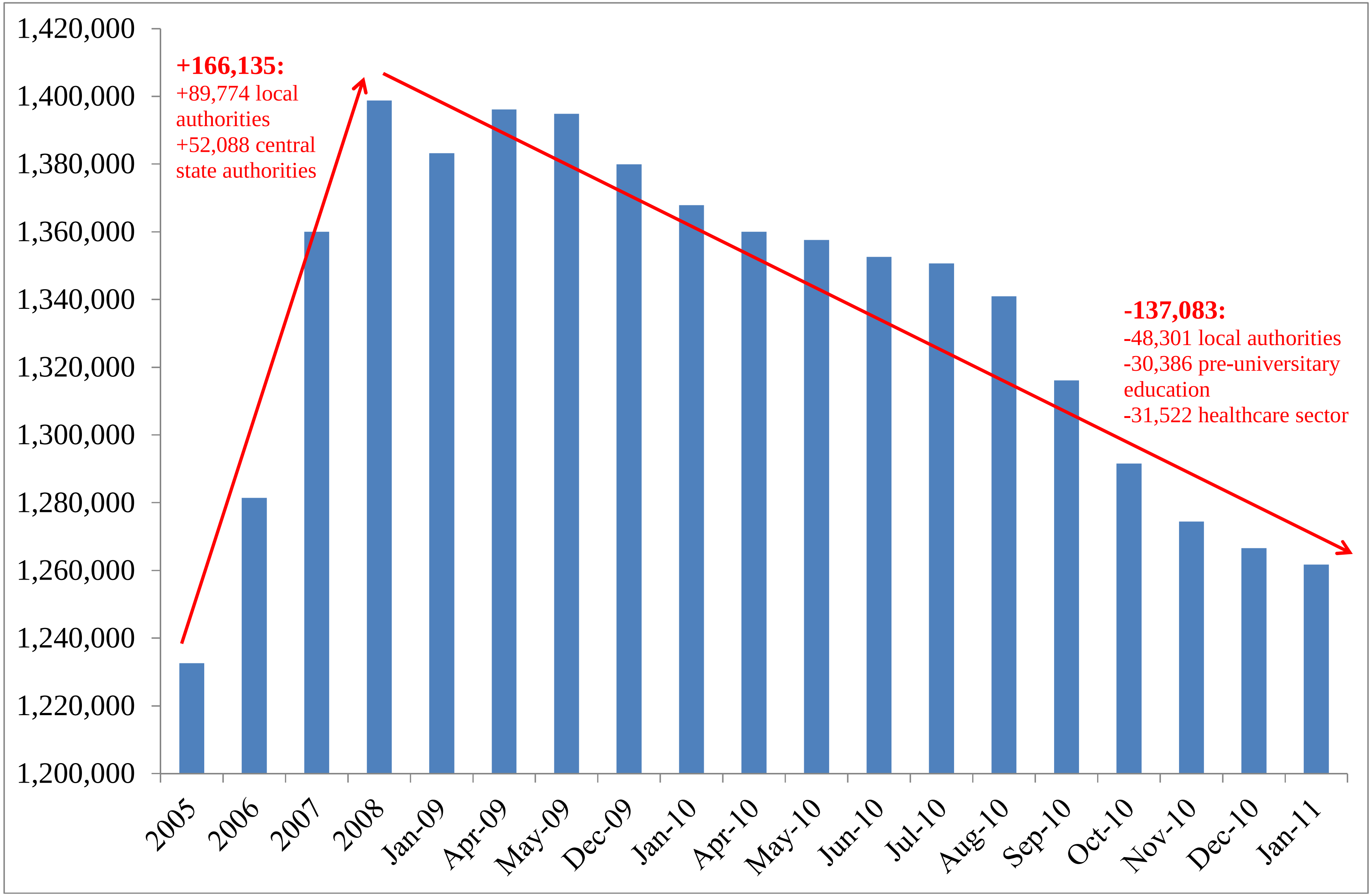
- **Initially, the government reduced spending with investments**
- **Some measures were taken in the second half of 2009 to reduce spending with goods and services and with wages in public sector**

- **The most important measures to reduce public spending were enforced in July 2010**

  Cut by 25% of wages in public sector
  Cut by 15% of social transfers excluding other than pensions
  Lay-offs in public sector
  Constraints on current spending
  Increase in VAT from 19% to 24%

Source: Ministry of Finance, NIS, Fiscal Council

No. of employees in the public sector



Source: Ministry of Finance, Fiscal Council

Conclusions (1)

- **Large macroeconomic imbalances at the beginning of crisis explain the large economic contraction and delayed recovery in Romania**

- **Economic activity most likely bottomed out – slow recovery expected in the coming quarters**

- **Structural reforms are key to speed up the real convergence and to put Romania on a long-term sustainable growth path**

- **Improvement of the flexibility of the economy, particularly a less rigid labor market is needed**

- **Upgrading the infrastructure is a must**

Conclusions (2)

- **Consolidation of the fiscal adjustment process is needed**
- **Key priorities on the revenues side of the budget:**
  - **Improve tax administration and fight tax evasion**
  - **Increase the tax base**
  - **Reduce the bureaucracy of tax payment**
  - **Increase of non-fiscal revenues (especially royalties)**
  - **Strictly avoid ad hoc changes to the tax system to ensure predictability and stability**
- **Key priorities on the expenditure side of the budget:**
  - **Increase the efficiency of spending**
  - **Tight control on social expenditures**
  - **Set up priorities and multiannual budgeting for investments**