

## **BUDGET AMENDMENT – CAUSE AND EFFECT**

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**ABSTRACT:** *This paper analyzes both the causes and effects of budget amendment in Romania, taking into account the Fiscal Budget Responsibility Law. Reduction by 5% of the CSI payable by the employer from the 1st of October 2014 should be necessarily accompanied by a reform of the social security system, starting from the principle of equal treatment of taxpayers irrespective of their type of income and the elaboration and implementation of a medium-term strategy for financially rebalancing the social security budgets, especially the pensions' budget. Such a strategy should aim to increase the number of taxpayers, in particular by reducing "black" labor, and ensure a total transparency of budget expenditures as a whole in order to stimulate the growth of voluntary compliance to payment of taxes.*

**KEY WORDS:** *budget amendment, taxpayers, social contributions, fiscal income, budget expenses, commitments, EU legislation*

**JEL CLASSIFICATIONS:** *G01, G28, H25, H32, H68.*

### **1. INTRODUCTION**

Reduction of the social security contributions by 5 percentage points on behalf of the employer, starting with the revenues afferent to October 2014, involves certain risks in terms of Romania's fiscal stability and, in the absence of some operational measures, this procedure puts at risk the agreement with IMF and the country's fiscal and budgetary stability.

### **2. THE ANALYSES OF THE SOCIAL CONTRIBUTION**

At present, social contributions for normal working conditions (for the special working conditions, CSI shares are at a higher level by 5 and 10 percentage points compared to normal working conditions and the legislative proposal seeks to reduce all these shares by 5 percentage points) paid by the employer and employee are at a level of 44.35% of the gross salary, being distributed as follows: 16.5% paid by the

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employee - 10.5% social security contribution (SSC), 5.5% health insurance contribution (CASS), 0.5% contribution to the unemployment fund (CS) and 27.85 % paid by employer - 20.8% CAS, CASS 5.2%, 0.5% CS, 1.35% other contributions (contribution of insurance against accidents at work and occupational diseases, the contribution to the Guarantee Fund for the payment of wage claims that is not paid by public institutions, contributions for holidays and allowances).

**At the same time, Romania must take into account its commitment to respect the rule regarding the annual structural balance of general consolidated budget, as provided in EU regulations.**

The promotion of the legislative measure is justified by "the existence of a large fiscal pressure on the labor market associated with the high level of social contributions that feeds the pension system, which acts as a disincentive factor to the employment and stimulation of business and investment."

Thus, in the first place, it would be of interest, to place in a regional context the labor force costs incurred by an employer through a brief comparative analysis of these in the new member states in Central and Eastern Europe.

In strict terms of the level of contributions for the pension system, Romania is really situated on the first place (out of nine countries) with 31.3% (a share of 20.8% paid by the employer, respectively a share of 10.5% supported by employee) at a distance of about 3 percentage points from the next ranked (The Czech Republic).

In the case of Hungary the contributions can not be broken down similar to other countries - separately on pensions, health and unemployment - due to the fact that in this country, the employer pays an aggregated contribution of 27 pp, without detailing their distribution of the three categories.

Taking into account only the contributions to the pension system which are the employer's duty, Romania continues to be at the top of the hierarchy, but behind countries such as Lithuania (23.3% share) or Czech Republic (21.5% share).

However, **in terms of the costs supported by an employer with the labor force the total level of social contributions is relevant**, irrespective of their destination (the public system of pension, the health insurance and unemployment insurance ones or other destinations).

Considering the accumulated contributions payable by the employee and employer, Romania is placed on the fourth place, the level being with about 4 percentage points lower than in the case of Slovakia, the country with the highest contributions, and with approximately 4 percentage points above the average; the relatively higher contributions to the pension system is partially compensated by the one relatively lower in terms of rates of contributions to health insurance, where Romania is placed on the 5th place out of 9 (with a level of contribution very close to the average) especially that of other social contributions (including unemployment insurance), where Romania ranks 8 of 9, with a level of contributions significantly below the regional average.

If we analyze the social contributions incurred by employers, Romania slightly overpasses the national average, placing in the bottom of the hierarchy (the 6th place out of 10). The upward deviance from the average is significantly higher in the case of

contribution rates supported by the employee, the occupied position in terms of level being the fourth, as in the case of aggregated social contributions.

### **3. THE „NEGATIVE” BUDGET AMENDMENT**

**The source of coverage of the budget deficit for the current year** is represented by the additional revenues from the tax on special constructions which are already included in the current form of the rectified budget without leading to a reduction in the budget deficit.

The first budget amendment in 2014 is actually a negative one, after the first half of 2014 brought a major goal of budget revenues both on the tax receipts side and the absorption of European funds.

At the end of June 2014, both revenue and budget expenditures were significantly situated below the half-yearly program related to the initial form of the consolidated general budget (CGB). Thus, according to the Annexes of the half-yearly report on the economic and budgetary situation, the total revenues of the consolidated general budget were lower than the planned amount with approximately 4.5 billion lei and the expenses with approximately 9.4 billion lei, the largest contribution going to the underperformance in absorbing grant European funds whose ultimate beneficiary is the state. These European grant funds only transits the consolidated general budget. The calls for projects financed with post-accession EU funds were lower by 2.8 billion lei compared to the programmed amounts, failure of these projects entailing also cost savings compared to the programmed level of about 4.4 billion lei.

At the level of budget revenues, the amendment proposal aims at correcting their increase by 1.54 billion lei, but after adjustment for the impact of the scheme of chain extinguishing chain arrears towards the CGB (with impact on VAT and social contributions) and the change in the accounting treatment of the operations of sale and purchase of goods from the state reserve (the impact on the capital income) that artificially increases the revenue by 1.66 billion lei, revenues appear as revised slightly negative, respectively by 128 million lei.

At the level tax revenue, the minus comparative to the initial half-yearly programming is about 954 million lei and has the following sources:

- achieving a rate of only 96.4% of the revenues program from payroll and income taxes, which resulted in shortfall revenue of 426 million lei. Thus, the collections of this category of income increased only by 0.6% compared to revenues in the first six months of the last year (compared with a scheduled dynamics of 4.4%), given that the number of employees increased during January-May 2014 compared to the same period of the last year by 0.8% and the annual growth of the gross salary corresponding to the same period was 4.95%.
- evolution raises questions especially if it is seen in correlation with the growth in revenues from social contributions, which have mostly the same tax base and on whose terms the negative differences towards the scheduled level are substantially low. The unfavorable evolution of income from tax on wages and income reflects a **significant decrease in the tax collection’s efficiency**, but

there are some signs of recovery the collections in the last month of the semester (in June the revenue streams have exceeded those of June 2013 by 8.9%).

- achieving a rate of only 94.3% of the VAT revenue semester program, resulted in a shortfall of revenues of 1.49 billion lei, corresponding to only a 1.9% annual growth compared with a scheduled one of 8.1%.

This evolution reflects a significant decrease in collection efficiency, especially given the high annual growth in the volume of retail sales (8.2% in the period January to May 2014 in real terms), even if the failure of the program is explained by:

a) the execution of the scheme of chain extinction of the outstanding budgetary obligations, which generated revenues of 257.2 million lei compared to a programmed level of 425 million lei (negative impact of 168 million from the proceeds of VAT);

b) the postponement by three months to the increase of excises on petrol (the excises fall under the VAT taxation), which generated a revenue shortfall of 164 million lei from the proceeds of VAT.

Also, the substantial lack of achieving the investment costs compared to the scheduled level was likely to also generate a minus in the VAT collections towards the scheduled program - it has the potential of being significant given the amounts involved, but its precise quantification is impossible in the absence of relevant information about the size of intermediate consumption involved in these investment projects: the failure of achieving such expenditure generates, on one hand, minuses to the VAT collected (quantifiable to about 1.26 billion lei given the differences to programmed levels of investment spending) and minuses in the deductible VAT (unquantifiable in the absence of some data concerning the size of intermediate consumption) and income tax from the budget execution are recorded on a net basis, representing the difference of the two units. To the extent that investment spending are accelerating in the second semester so that their volume converge to the annual scheduled levels, it is expected for revenue losses from VAT recorded in the first semester to be recovered to some extent in the second part of the year.

At the end of June 2014, capital expenditures accounted for only 69.3% of the half-yearly timetable - smaller with 2.13 billion than the planned expenditure and with 2.34 billion versus capital expenditure incurred in the first half of 2013, the project expenditure funded by external grants accounted for only 51% of the programmed level - lower by 4.4 billion lei and expenditures related to call projects represented 81.5% of the programmed level - lower by 54.4 million lei.

The information contained in the text of biannual report on the annual evolution of VAT revenues – respectively the revenue reduction from delay penalties and increased VAT reimbursements - are not relevant for explaining deviations from the schedule: diminishing the revenue reduction from delay penalties was due to the modification of their amount from July 1, 2013, already producing effects in the second semester of the previous year and are therefore anticipated in the biannual budget programming, while the increasing VAT repayments did not outmatched the increasing rhythm of the collected VAT, being only effect of growing in yearly terms the volume of economic activity;

- achieving a rate of only 97.4% of the program of excise collection, which resulted in a revenue shortfall of 301 million lei. The program of excise collection had as a hypothesis the application from 1 January 2014 of increasing fuel duty and actual collections occurred given that the measure in question was delayed by three months (the losses of income, fully reflected in the budgetary execution in the first semester are about 683 million lei), the postponement being given the measure of repaying to large carriers a part of the additional excise. The execution reflects a better excise collection than scheduled one, whose maintenance in the second part of the year would be liable to compensate the negative impact of the mentioned discretionary measures and thus does not lead to reduction in excise revenues for the whole year compared to the annual level originally scheduled.

Income aggregates which in the context of execution at the half year are identifiable failure due to lower collection efficiency are negatively reviewed, low efficiency of collection is extrapolated to the entire year where appropriate. Thus:

- estimates of tax revenues from income and wages are lower with 1.274 billion lei compared to the initial budget. Estimates of VAT collections, eliminating the impact of the scheme of the chain extinction outstanding liabilities to CGB newly introduced (692 million lei) are revised downward with 1.75 billion lei. At the end of the first semester they were below the scheduled level by 1.54 billion lei, but part of this deviation is explained by the difference between the assumed and actual execution of the initial swap scheme of the chain extinction liabilities to CGB to 850 million lei (168 million lei) and the three-month postponement of the introduction of excise duty on fuel (164 million), factors that will not generate similar deviations in the second semester of the year. In addition, lack of achieving the investment spending and their presumed acceleration in the second half of the year with an eye to convergence towards the budgeted annual amounts are likely to generate an acceleration to the budget revenues from VAT during this period also;
- estimates of social contributions, eliminating the impact of the scheme of the chain extinction outstanding liabilities to CGB newly introduced (56 million) are expected to be lower than the initial budget of 504 million lei, accommodating the failure of achieving 478 million lei on the first semester program. Social contributions revenue projection for 2014 does not include the negative impact of the measure already passed by the Parliament to reduce the employer CAS with 5 pp starting with October the 1st, 2014 (estimated at 1.1 billion lei in the aggregate of income and 850 million lei impact on the budget deficit).

In contrast, other categories of budget revenues are significantly increased, reflecting the evolutions already manifested at the end of the first semester, as well as very presumable evolutions in the second part of the year:

- estimates concerning profit tax are revised upward with 423 million lei, reflecting also a loss of revenue related to introducing the tax exemption on the reinvested profit evaluated by the Ministry of Finance to 137.5 million lei. Introducing the tax exemption on the reinvested profit is an undervalued

procedure, estimating a negative impact of at least 475 million lei in the year 2014 (a loss of revenue of 338 million lei higher than the one taken into account by the Ministry of Finance);

- estimates concerning collections from taxes and estate duties are revised upward by 1.26 billion lei, mainly due to the difference between the initial estimates concerning the collections from taxes on special constructions (488 million lei) and the tax statements applied on time by the taxpayers which indicate collections of about 1.5 billion lei;
- the revised estimates concerning the collections from excise confirm the initial ones, given that the negative deviation from the half-yearly program reflects mainly recorded the delay in increasing fuel duty and it is expected to be fully recovered in the second semester on the supposition of maintaining the plus of collections regarding the apparent initial program on the execution level in the first semester;
- estimates concerning collections from other taxes and taxes on goods and services are reviewed upward with 808 million lei (the overflow of the programmed at the level of the first semester was 431.5 million) while additional revenue expected to be collected from additional income obtained as a result of the deregulation of prices in natural gases area (432.4 million lei) and the claw back tax in health (350 million lei);
- estimates concerning non-tax revenues are revised upward by 707.83 million lei due to additional revenue estimated to be collected by the Ministry of Economy from selling certificates of gas emission with a greenhouse effect (+726.0 million lei);
- Estimates concerning the capital income are revised upward to 1.08 billion lei, out of which 917 million lei come from the change in the accounting treatment of the transactions of sale and purchase of goods from the state reserve mentioned above.

Current projections of budgetary income are generally realistic and the projection of income from European funds and those from the profit tax may be an unrealistic one.

Negative revisions of estimates of budgetary revenues are concentrated at the level of some aggregates whose level this year are likely to influence their projections in the coming years, and compensatory increases in income are significant to a temporary extent - the legislation regarding the additional taxation of income from the liberalization of gas prices expire at the end of this year, and revenues from the sale of certificates of gas emission with a greenhouse effect are by definition temporary (English. one-off).

This phenomenon is likely to create additional pressures on the level of budget construction in the coming years in order to comply with deficit targets, especially if we take into account the adverse impact on budget collections which is expected to be generated by the discretionary measures (i.e. tax exemption of reinvested profits and reducing employer CSI).

At the level of budget spending, the increase with 1.81 billion lei is also explained mostly by the scheme of the chain extinction outstanding liabilities to CGB,

plus impact on the costs of the change in the accounting treatment of the transactions of sale and purchase of goods from the state reserve (with an impact on the capital expenditures of 917.2 million lei), in the absence of whom the increase would have been of only 142 million lei.

Expenditure categories were reviewed in relation to the initial allocations as follows:

1. Staff costs are revised upward with 289 million lei;
2. Costs of goods and services are revised upward with 830 million lei;
3. Transfers between units of the public administration have been revised upward with 251 million lei;
4. Reserve funds were increased by 292 million;
5. Interest expenses were revised downward by 116 million lei;
6. Grants were revised downward by 250 million lei;
7. Capital expenditures were revised downward to 1.15 billion lei.

When referring to the absorption of European grant funds whose ultimate beneficiary is the state - compared to half-yearly program, the degree of achievement on income is of 49%, while the expenditure is 51% - the proposed amendment does not modify the initial estimates concerning them.

The budgetary execution on six months and the amendment proposal contain very few elements that can lead to optimism regarding the possibility of coverage of income minuses generated by the legislative changes mentioned above to be achieved at the expense of improving the efficiency of collection, which would have covered some legislative proposals.

The current amendment is done by derogation from certain articles of the fiscal responsibility law, which has negative effects on the credibility of the law.

The reducing of the social contributions from October 1, 2014 is not covered in the current budget, which will lead to further reductions in spending towards the end of the year. Negative revisions of estimates of budgetary revenues were concentrated in some aggregates whose level this year are likely to influence their projections in the coming years, and compensatory increases in income are significantly temporary.

Compared to the original approved budget, the draft amendment budget increases the total revenues with 1.54 billion lei, and budget expenditures with 1.81 billion lei, the upward revision of the budget deficit being of only 270 million lei.

If the budget deficit and that of the staff costs expresses as a percentage of GDP remain at 2.2% and 7.3% of GDP as defined in Law 355/2013 for the approval of the limits of some indicators specified in the fiscal-budget frame for 2014 and thus following the fiscal rule established by art. 6 letter a) of the Fiscal Budget Responsibility Law (FBRL); the proposed nominal levels of the deficit of the Consolidated General Budget, of the primary deficit of CGB, the personnel expenses and total expenses excluding financial assistance from the EU and other donors exceed the limits of the law 355/2013 being inconsistent with the fiscal rules imposed by art. 6 letter b) and c) of FBRL, as well as article 9, paragraph 2 that prohibits the increase of staff expenditures during the budget amendments, article 16 that prohibits the increase of total CGB expenditures during budget amendments other than for payment of debt service and payment of Romania's contribution to the EU budget, and article 18,

paragraph 4 which reaffirms the obligation to respect the limits imposed by law for the next budget year.

In these circumstances, the annualized loss for the year 2014 would be 2.31 billion lei, which corresponds to an average quarterly loss of about 607 million lei.

Extrapolating the volume of gross investment in technological equipment eligible with nominal GDP variations from the Convergence Programme 2014-2017 (5.5% in 2015 and 5.5% in 2016), the estimated losses of budget revenues according to the same scenario would be of 2.53 billion lei in 2015, 2.67 billion in 2016 and, respectively, 675 million lei in 2017. Considering the alternative scenarios, the range for revenue losses would be (475, 740) million lei for the year 2014 (1.98, 3.08) billion lei for 2015 (2.08, 3.25) billion lei and (528, 823) million lei in 2016, respectively, in 2017.

Depending on the considered scenario, the size of the estimated revenue loss is about 3.5 to 5.5 times higher than the amounts advanced by the Ministry of Finance.

## 5. CONCLUSIONS

The planned budget amendment is negative because, on one hand, the new projections do not show how they will cover the "holes in collections" in the first semester of 2014 and any future minuses from reduced social contributions. This will put pressure on future budgets. On the other hand, if accounting fireworks are excluded from the calculation of the budget, then the budget amendment is negative.

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