

The Challenges to Long Run Fiscal Sustainability in Romania

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Abstract

Romania, along with many other countries in the European Union, faces daunting fiscal challenges. Fiscal balances deteriorated sharply following the global economic crisis, forcing Romania to implement a fiscal consolidation that was one of the largest in the European Union, but which may not be sustainable without a recovery of economic growth. Although the ratio of public debt to gross domestic product is still relatively

modest, at around 35 percent, long-term fiscal solvency is threatened by the costs of funding the public pension system in the face of adverse demographic shifts over the next 50 years. Because of widespread tax evasion, the tax system in Romania is one of the least efficient in the European Union. Tax reforms that can reduce the amount of tax lost to evasion and fraud could make a major contribution to enhancing fiscal sustainability.

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The challenges to long run fiscal sustainability in Romania

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1. Introduction

Fiscal sustainability has emerged as a key policy issue throughout Europe in recent years, in part because the fiscal positions of many countries on the continent were badly affected by the global financial and economic crisis and also because of an increasing public recognition of the magnitude of the long-term fiscal costs of demographic change, notably aging populations. Several of the new member states of the European Union, including Romania, face major challenges to ensure fiscal sustainability. The sustainability of Romania's public finances deteriorated sharply in the years leading up to the global economic crisis. The global economic crisis triggered a severe recession in Romania, exposing the fragility of public finances. To bring the fiscal deficit back into line with the targets in the EU's Stability and Growth Pact, the government implemented a draconian fiscal consolidation in 2010, but it still faces huge long-term fiscal costs as a result of population aging. Long-term fiscal sustainability, along with meeting the fiscal criteria required for membership of the Eurozone monetary union, is also threatened by the poor management of public expenditures.

Maintaining fiscal sustainability should be a priority for policy makers. An unsustainable fiscal position threatens both macroeconomic stability and the financial capacity of the state to deliver essential goods and services to citizens. Moreover, if fiscal positions are perceived to be unsustainable over the long term, the reaction of the markets on which governments finance their borrowing requirements could trigger a fiscal crisis much sooner than might be expected by fiscal planners.

Fiscal sustainability is essentially a forward looking macroeconomic concept which is related to the solvency of government. It is closely linked to the future course of the fiscal deficit and the evolution of public debt and to the government's capacity to mobilize finance for the deficit and/or to refinance its debt. Alvarado et al. (2004) define a sustainable fiscal policy as a set of fiscal policies which will not lead to the government having, at some point in the future, to

default on its debt or to monetize its debt, or be forced to undertake a major fiscal retrenchment to avoid default or monetization.

A starting point for analyzing fiscal sustainability is the current levels and medium-term projections of general government fiscal balances and public debt. It is relatively straightforward to determine the impact of such fiscal balances, if extrapolated forward into the future and combined with some basic macroeconomic projections, on the evolution of public debt levels, with debt sustainability being defined as a situation where public debt as a ratio of GDP is stable or falling and/or does not exceed some critical threshold.² Section 2 of this paper examines the general government fiscal balances and public debt levels in Romania and the medium-term projections of these variables. The general government fiscal data include the local governments.

The data captured in the general government budget, however, often provide an incomplete and hence misleading picture of the sustainability of public finances over the long term. This is starkly illustrated by a comparison of current public debt levels with calculations of the long-term net worth of the government in Romania, taking into account the long-term costs of aging. Romania's outstanding public debt amounted to 32 percent of GDP in 2010, a relatively moderate level. In contrast, Velculescu (2010) estimates the inter-temporal net worth of the Romanian government at negative 252 percent of GDP, based on a finite horizon approach and negative 1,097 percent of GDP based on an infinite horizon approach.

Risks to fiscal sustainability may emanate from activities of the public sector, which are not currently part of the general government budget, but which might eventually impose fiscal liabilities on the budget. These could include contingent liabilities of government, such as loan guarantees, or the quasi fiscal deficits (QFDs) of state owned enterprises. The QFDs of the state owned enterprises are discussed in Section 3.

² An example of such a threshold is the ceiling of 60 percent of GDP for public debt set by the Stability and Growth Pact of the EU for countries which aim to join, or are members of, the Eurozone.

A major long-term threat to fiscal sustainability, in Romania and elsewhere in Europe, are what Heller (2004: 1) terms “constructive fiscal obligations”. These are obligations such as public pensions and other social security payments which government bears for political and social reasons and which, although not formal, irrevocable, legal obligations, would nevertheless prove difficult for government to renege upon. Constructive fiscal obligations are critical in Romania because of the adverse demographic trends that the country faces over the next 50 years. The demographic trends and their implications for the public pension system are discussed in Section 4.

Fiscal sustainability is affected by the revenue side of the budget as well as by expenditure obligations. The tax effort in Romania, as measured by the share of tax revenue in GDP, is weak in comparison to other EU countries, largely because of extensive tax evasion and weaknesses in tax policy. Hence there is scope, through improvements in tax administration, to enhance fiscal sustainability by reducing tax evasion and strengthening revenue collection. This issue is explored in Section 5.

Finally, any evaluation of fiscal sustainability must take into account the inherently political nature of fiscal policy. Fiscal policies entail the distribution of resources, both across society at a given point in time and between different generations. Whether or not fiscal policies are sustainable is not just a technical issue, to be determined by economists. Given the circumstances which prevail in Romania, maintaining fiscal sustainability will entail some sections of society bearing a heavy burden. Romania is a democracy and so sustainable fiscal policies will only be feasible if they can command support from the electorate over the long term. Romanian voters, in common with voters in many other countries, have not shown much support for the austerity measures which fiscal consolidation entails. Fiscal policies are more likely to be politically feasible if they are perceived to be equitable, in terms of the sharing of the burden of costs, compatible with sustainable economic growth and the provision of essential public services, as well as being necessary to ensure fiscal sustainability.

2. Fiscal deficits and public debt in the medium term

2.1 Fiscal deficits

The fiscal position of the general government and medium term fiscal projections are shown in table 1. Romania ran a pro-cyclical fiscal policy during the economic boom of the mid 2000s, with a structural fiscal deficit of 8.5 percent of GDP in 2008, at the height of the boom. The severe recession which struck the economy in 2009 – real output contracted by 7.1 percent – exposed the fragility of the fiscal stance and forced the government to begin to implement a radical fiscal consolidation. The government has made tangible progress in reducing the structural fiscal deficit, to 5.1 percent of GDP in 2010 and to a projected 2.8 percent of GDP in 2011; if the latter target is achieved there will have been a fiscal consolidation amounting to 5.7 percent of GDP in the space of 3 years, one of the largest in the European Union (figure 1).

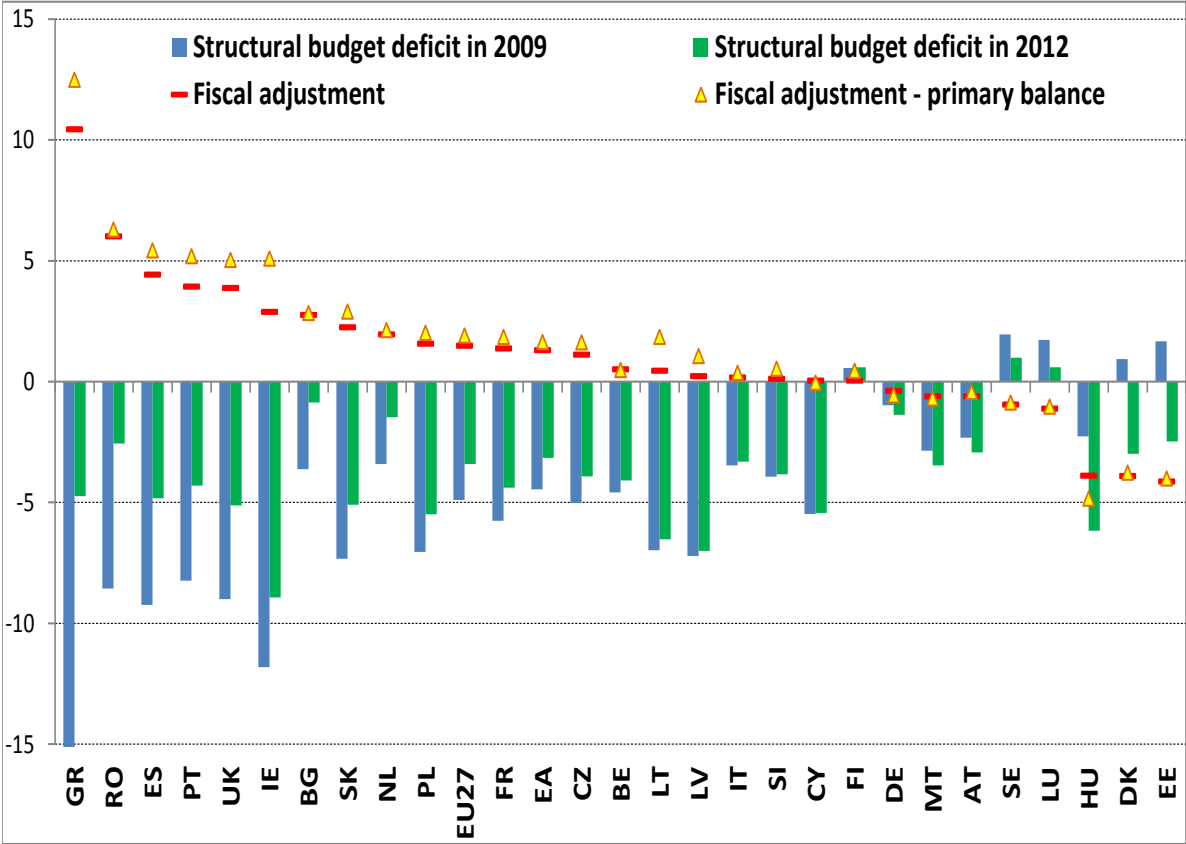
Table 1: Key macroeconomic and fiscal data and projections (percent of GDP): 2008-2016

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Real GDP growth	7.3	-7.1	-1.3	2.0	1.8	3.5	4.0	4.0	4.0
Revenue and grants	32.2	31.4	32.8	33.0	33.6	34.1	34.3	34.4	34.6
Expenditure	37.0	38.7	39.4	37.3	35.5	35.5	35.6	35.3	34.9
Fiscal balance	-4.8	-7.3	-6.5	-4.3	-1.9	-1.4	-1.3	-0.9	-0.3
Structural balance	-8.5	-7.0	-5.1	-2.8	-0.1	0.2	0.0	0.1	0.6
Gross public debt	13.6	23.9	31.7	34.5	35.8	34.5	32.8	30.9	28.5

Source: IMF, World Economic Outlook, September 2011

Fiscal consolidation began in 2010 and comprises several measures on both the expenditure and revenue sides of the budget. The number of employees on the public payroll has been reduced from 1.399 million at its peak in 2008 to 1.267 million in January 2011 (Romania Fiscal Council, 2011: 19). Salaries have been cut by about 10 percent on a net basis during 2010 and 2011 (there was a 25 percent cut in 2010 and a 15 percent rise in 2011) and various bonuses and the 13th month salary payment have been abolished. The cuts in the public payroll and salaries have reduced salary and wage expenditures in the general government budget from 9.4 percent of GDP in 2009 to a projected 7.5 percent of GDP in 2011. On the revenue side there have been increases in the VAT rate, the elimination of some minor VAT loopholes and increases in social security contributions.

Figure 1: Romania’s fiscal consolidation in comparison with that of other EU countries; percent of GDP



Source: European Commission (forecasts from Autumn 2010)

The central government had almost eliminated expenditure arrears by the end of 2010, although local government arrears remain.³ Revenues have been boosted by a hike in the VAT rate from 18 to 24 percent and a rise of 3 percentage points in social security contributions.

The medium-term fiscal framework envisages that the structural fiscal balance will be slightly positive on average from 2013 through to 2016. The conventional (nonstructural) fiscal balance is projected to be lower than the structural fiscal deficit, because the economy will operate with a negative output gap throughout the medium-term horizon. Nevertheless, from 2012 onward the conventional deficit will be lower than 3 percent of GDP and hence will be in compliance with the fiscal deficit ceiling of less than 3 percent of GDP in the EU's Stability and Growth Pact (SGP).

2.2 Public debt

Gross public debt rose sharply between 2008 and 2011, by 21 percent of GDP, because of the large fiscal deficits incurred in this period (table 1). However, public debt as a share of GDP is projected to flatten out at just under 36 percent of GDP during 2011-2013 before declining to 28.5 percent of GDP in 2016; a debt burden which does not, per se, signal major dangers to debt sustainability and is well within the 60 percent of GDP ceiling in the SGP.

Table 2 details some of the pertinent characteristics of public debt. The share of multilateral debt in total debt rose by 8 percentage points between 2008 and 2010, reflecting the government's recourse to borrowing from the EU, the World Bank and the IMF following the global financial crisis. Multilateral loans have been contracted at interest rates more favorable than those available on the international financial markets: interest rates on multilateral loans have ranged

³ Local Government arrears are relatively small: the stock amounted to 0.4 percent of GDP in 2010 and is owed mostly to private sector contractors and suppliers. Fiscal management is weak in some local authorities, but the structure of their finances means that the deficits that they can incur are limited mostly to payment arrears; hence public finance in local government is not a serious threat to fiscal sustainability at the national level.

between 2 percent and 3.4 percent, compared to 5-6 percent for foreign currency denominated securities issued on international markets.⁴

Table 2: Characteristics of public debt, percent of total public debt: 2008-10

	2008	2009	2010
<i>Share of debt by type of creditor</i>			
Multilateral	20.4	25.4	28.8
Bilateral	0.3	0.2	0.2
Private banks and other	79.3	74.4	71.0
<i>Share of debt by currency</i>			
Domestic	59.7	47.1	45.3
Foreign	40.3	52.9	54.7
<i>Share of debt by maturity</i>			
short term	49.3	37.8	35.2
medium term	10.7	19.9	23.4
Long term	40.1	42.4	41.4
Average remaining maturity of debt (years)			
domestic	1.4	2.0	2.1
External	5.5	6.5	7.0
<i>Share of debt by interest rate</i>			
Fixed	31.3	42.4	52.0
Floating	68.7	57.6	48.0

Source: Romanian Ministry of Public Finance (2011), "Report on Public Debt Management", Bucharest, <http://www.mfinante.ro/rapoarteMFP.html?pagina=domenii>

Recourse to multilateral loans has brought about some positive movements in the characteristics of public debt (table 2). The maturity structure of public debt has been lengthened, with short-

⁴ The Government issued a 5 year Eurobond at a yield of 5.17 percent in March 2010.

term loans falling by 14 percentage points as a share of total debt and medium-term loans increasing by 13 percentage points between 2008 and 2010. The average remaining maturity of public debt increased from 3 years in 2008 to 4 years in 2010. The government's debt strategy aims to raise the average remaining maturity of the public debt to 4.5 years over the medium term, by issuing more medium and long-term securities on the domestic market and reducing the amount of short-term securities issued (Ministry of Public Finance, 2011). The share of fixed interest rate debt in the debt portfolio also rose from 31 percent to 52 percent. On a less positive note, the share of foreign currency denominated debt in the debt portfolio increased from 40 percent in 2008 to 55 percent in 2010, which is attributable to both the borrowing from multilateral lenders and the issuance of foreign currency denominated securities on the domestic market to meet demand for these securities from local banks.

The measures taken to strengthen public finances and thus curb the growth of public debt appear to have brought about an improvement in investor confidence. Standard & Poors and Fitch both revised the outlook on Romania's sovereign credit rating of BB+ from negative to stable in 2010. CDS spreads on public debt dropped from 610 basis points (bps) in February 2009 to 290 bps at the end of 2010 (Ministry of Public Finance, 2011).

Romania's medium-term public debt dynamics appear quite favorable, in the main because the average real interest rate on government debt is very low; it was 0.8 percent in 2010 and is projected to decline to zero by 2016.⁵ The low real interest rate on public debt is attributable to the large share of loans from the multilateral lenders in the public debt portfolio which are at interest rates which are lower than those which Romania pays on the debt which it has issued to the market. Nevertheless, it is likely that the average real interest rate on government debt will rise above zero over the long term, because Romania will gradually reduce its borrowing from the multilateral lenders and replace it with borrowing from the domestic and international markets, where interest rates will be higher. In 2011, the government issued Euro denominated medium-term notes on the international market, to maintain Romania's presence in the international capital markets.

⁵ This projection is from the Debt Sustainability Analysis of the World Bank and IMF.

Slower medium to long-run GDP growth will adversely affect long-run debt dynamics. If the real growth rate falls below the average real interest rate on public debt, government will have to accumulate primary fiscal surpluses in order to stabilize the debt/GDP ratio. Moreover, lower real GDP growth will reduce the growth of the tax base and hence make it more difficult to achieve an increase in the primary fiscal balance. The possible consequences of demographic changes for long-term real GDP growth are discussed in Section 4.

Romania's planned adoption of the Euro in 2015 will affect public debt management. All domestic currency denominated debt will have to be converted into foreign currency denominated debt, most probably Euro denominated debt. Once Romania enters the Euro Zone, the distinction between domestic and foreign currency denominated debt will disappear and hence the exchange rate risk attached to the former, for foreign investors, will no longer be applicable, which could help to ease borrowing costs.

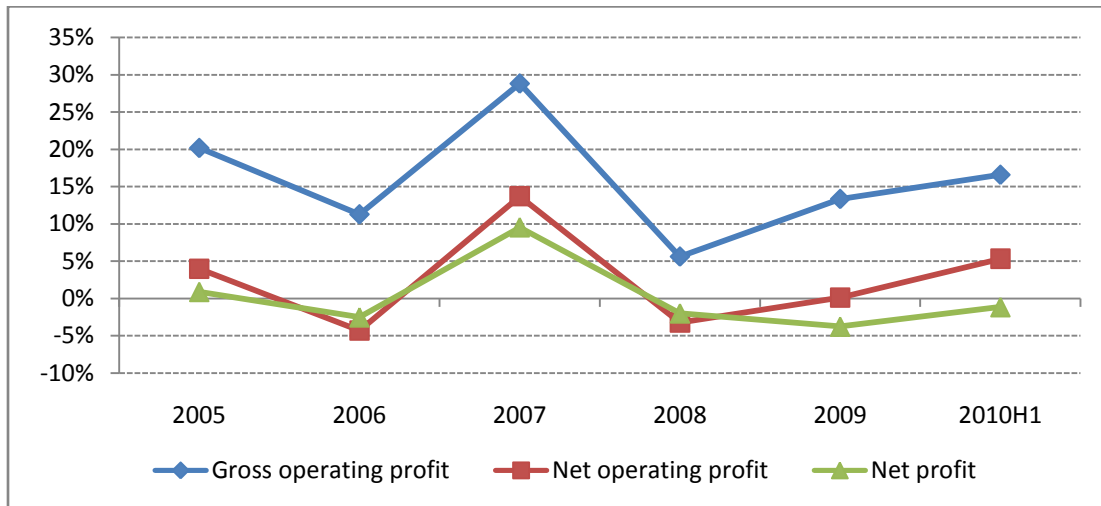
To conclude this section, the data on general government deficits and public debt reviewed above do not, per se, indicate serious threats to fiscal sustainability in Romania. However, two caveats are necessary. First, the improvement in the structural balance equivalent to 5.7 percent of GDP between 2008 and 2011 has only been possible as a result of draconian cuts to public expenditure, including cuts in the public payroll, public sector wages and a range of social welfare benefits as well as increases in VAT rates and social contributions. Political support for these cuts and tax hikes may dissipate once the immediate fiscal crisis has passed; hence they may not be politically sustainable. The forthcoming elections in 2012 and 2014 will be a test of public support for fiscal consolidation. Second, there are threats to fiscal sustainability arising from public sector deficits which are not currently captured in general government fiscal data and from long-term demographic trends. These issues are addressed in the following two sections.

3. Quasi fiscal deficits of state owned enterprises

Romania has a large public enterprise sector, comprising 722 state owned enterprises (SOEs) which account for 8.9 percent of employment and 10 percent of GDP.⁶ The most important SOEs, in terms of size, are in the energy and transport sectors. Comprehensive financial data on all SOEs are not available. Based on the data which are available, the SOE sector in aggregate was barely profitable in the mid-2000s. Its performance deteriorated from 2007 and the SOE sector in aggregate incurred losses in 2008 and in subsequent years. However, the financial performance of SOEs is heterogeneous; about 70 percent of SOEs are both profitable and solvent, although some nevertheless receive budget subsidies, including cancellation of debts owed to the state. The remaining 30 percent of SOEs are making losses and/or are insolvent. These losses represent quasi fiscal deficits (QFDs); deficits incurred off budget by public agencies in the pursuit of public policy objectives. The trends in profitability should be interpreted with caution, however, because the financial statements of the SOEs, from which these data are drawn, sometimes disguise hidden subsidies or costs.

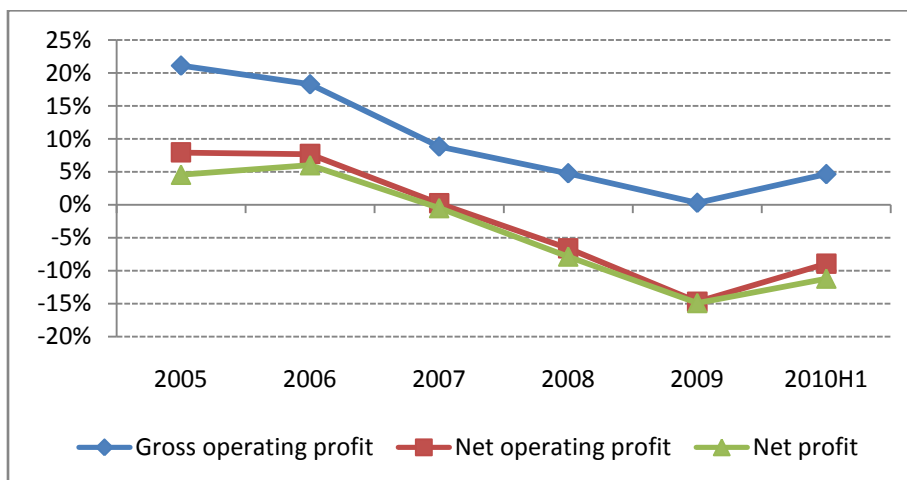
⁶ These are World Bank estimates. Official data on the exact number of SOEs and their contribution to the economy are not available.

Figure 2: Trends in profitability of the SOEs in the energy and gas sector; 2005-2010H1



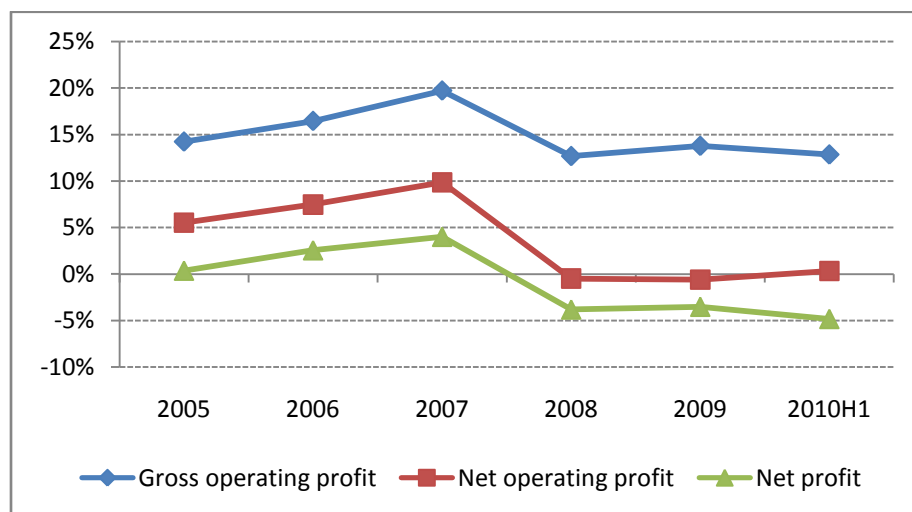
Source: Romanian Ministry of Public Finance (2011), "Fiscal Information and Balance Sheets", <http://www.mfinante.ro/pjuridice.html?pagina=domenii>, and authors' calculations

Figure 3: Trends in profitability of the SOEs in the transport and storage sector; 2005-2010H1



Source: Romanian Ministry of Public Finance (2011), "Fiscal Information and Balance Sheets", <http://www.mfinante.ro/pjuridice.html?pagina=domenii>, and authors' calculations

Figure 4: Trends in profitability of the SOEs in the mining and quarrying sector; 2005-2010H1



Source: Romanian Ministry of Public Finance (2011), "Fiscal Information and Balance Sheets", <http://www.mfinante.ro/pjuridice.html?pagina=domenii>, and authors' calculations

Figure 2 shows the trends in profitability of the SOEs in the energy and gas sector, which accounts for 31 percent of total SOE activity. The net profit of the SOEs in the energy and gas sector has been negative since 2007. The profitability of the SOEs in the transport and storage sector, accounting for 24 percent of total SOE activity, has deteriorated even more sharply (figure 3), with the sector suffering large losses in 2008, 2009 and the first half of 2010. The third largest SOE sector, mining and quarrying, has also incurred losses since 2007 (figure 4). The SOE sector also has incurred an increasing amount of arrears, mainly to suppliers, the social insurance budget and taxes. Total SOE arrears amounted to 4.8 percent of GDP in 2010 (Romania Fiscal Council, 2011:44).

The poor financial performance of the SOEs weakens fiscal sustainability through two channels. First, the accumulation of arrears to the state undermines tax revenue collections and the

revenues of social insurance funds. Second, the SOEs which are receiving large subsidies from central government are a direct burden on the state. SOEs are not included in the general government fiscal data. However, under Eurostat rules, an SOE should be included in the general government data if more than half of its revenues are derived from government subsidies over a three year period. Around 30 SOEs are likely to be included in the general government budget in 2011, which will worsen the recorded general government fiscal balance by about 0.5 percent of GDP.

4. The fiscal challenges of an aging population

4.1 Long-run demographic trends

Romania's long term demographic forecasts are a source of concern for both economic growth and public finances. The population has already fallen by about 10 percent since 1990, from 23 million to the current level of 21 million, of whom 2-3 million are working abroad. Romania's population is forecast to shrink further, by 20 percent between 2008 and 2060.⁷ The contraction in the population of working age over this period is even larger – about 35 percent – the second largest in the EU, after Bulgaria. The share in the total population of people aged 65 and above will rise from the current level of about 15 percent to over 30 percent by 2060, the third oldest in the EU.⁸ The old age dependency ratio – the ratio of people aged 65 and above to the working age population is forecast to rise from the current level of about 20 percent to 65 percent by 2060 (figure 5).

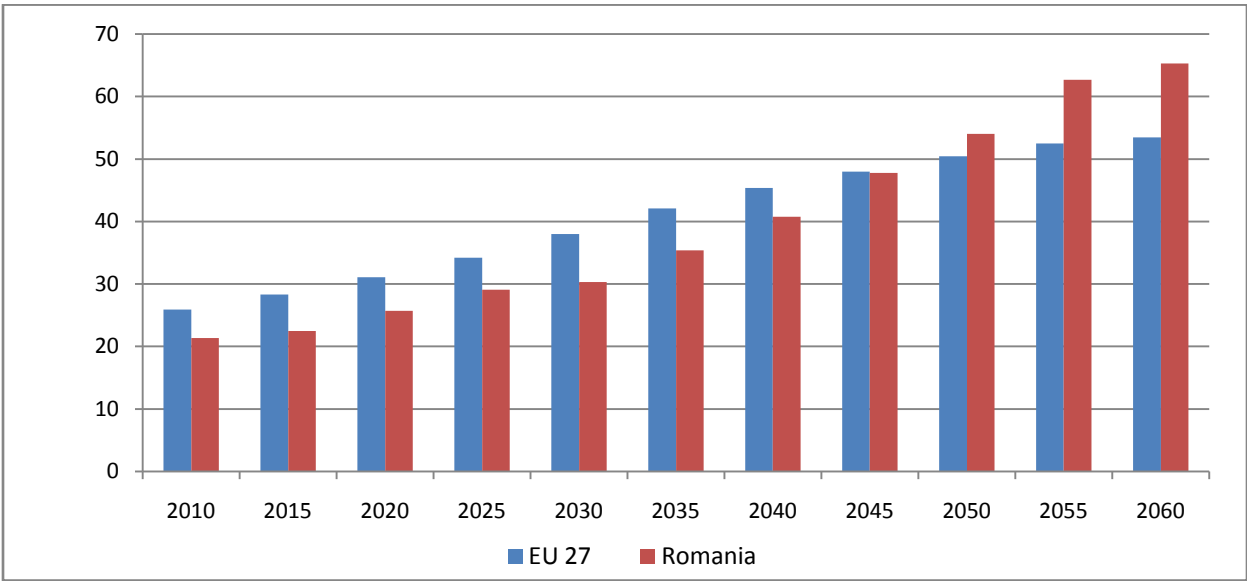
Demographic trends of this nature are clearly an impediment to long-term growth. With the workforce contracting by an average of 0.8 percent a year over the next half century, it is unlikely that Romania will be able to sustain the 4 percent real GDP growth which is forecast for

⁷ The population has already fallen by about 10 percent since 1990, from 23 million to the current level of 21 million.

⁸ The data are from Eurostat.

2014-16 beyond the medium term, because this would require annual increases in labor productivity of 5 percent, which is unrealistic. Moreover, the adverse demographic trends will reduce domestic savings, because of the rise in the dependency ratio, which will undermine the economy’s capacity to undertake the investment in physical and human capital which will be needed to achieve rapid growth in labor productivity.

Figure 5: Projections of Dependency Ratios in Romania and the European Union



Source: Eurostat, EUROPOP2008 Convergence scenario, regional level, April 2011
http://epp.eurostat.ec.europa.eu/portal/page/portal/product_details/metadata?p_product_code=PROJ_R08C_ESMS

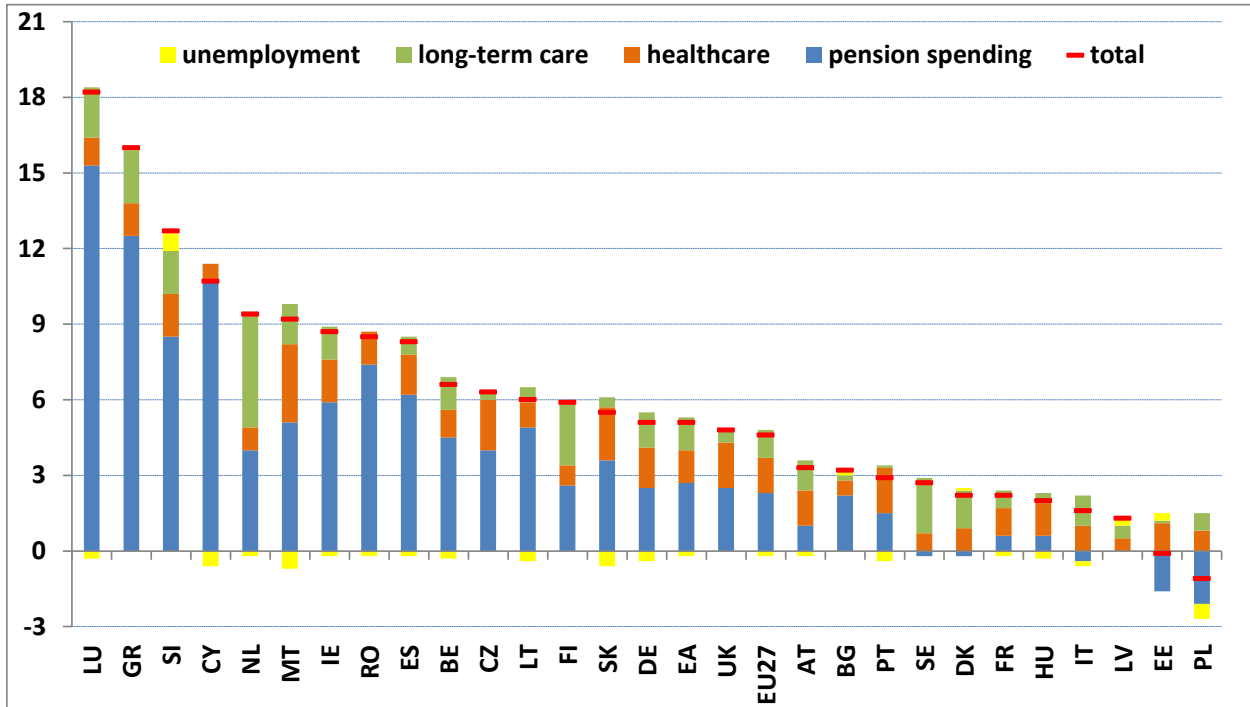
4.2 Fiscal implications of population aging

The EU Commission’s Ageing Working Group has prepared estimates of the age related fiscal costs for all EU members over the next 50 years. The Ageing Working Group has combined these costs with the current fiscal position of EU members to derive estimates of the upfront fiscal adjustment which is required to ensure long run fiscal sustainability. Two separate measures of the fiscal adjustment needed to achieve fiscal sustainability are estimated; the first

(S1 indicator) is the adjustment needed to bring public debt to the SGP target of 60 percent of GDP or less by 2060. The second (S2 indicator) is the fiscal adjustment needed to satisfy the government’s intertemporal budget constraint over an infinite horizon.

The Ageing Working Group estimates that age related expenditures will increase by 8.5 percent of GDP in Romania by 2060, almost double the EU average of 4.4 percent of GDP (figure 6). It estimates that the upfront fiscal adjustment needed to ensure fiscal sustainability, as a result of the fiscal costs of demographic aging alone, are between 3.2 percent and 4.9 percent of GDP.

Figure 6: Increase in Age-related Public Expenditures in the European Union, 2010-2060, percent of GDP



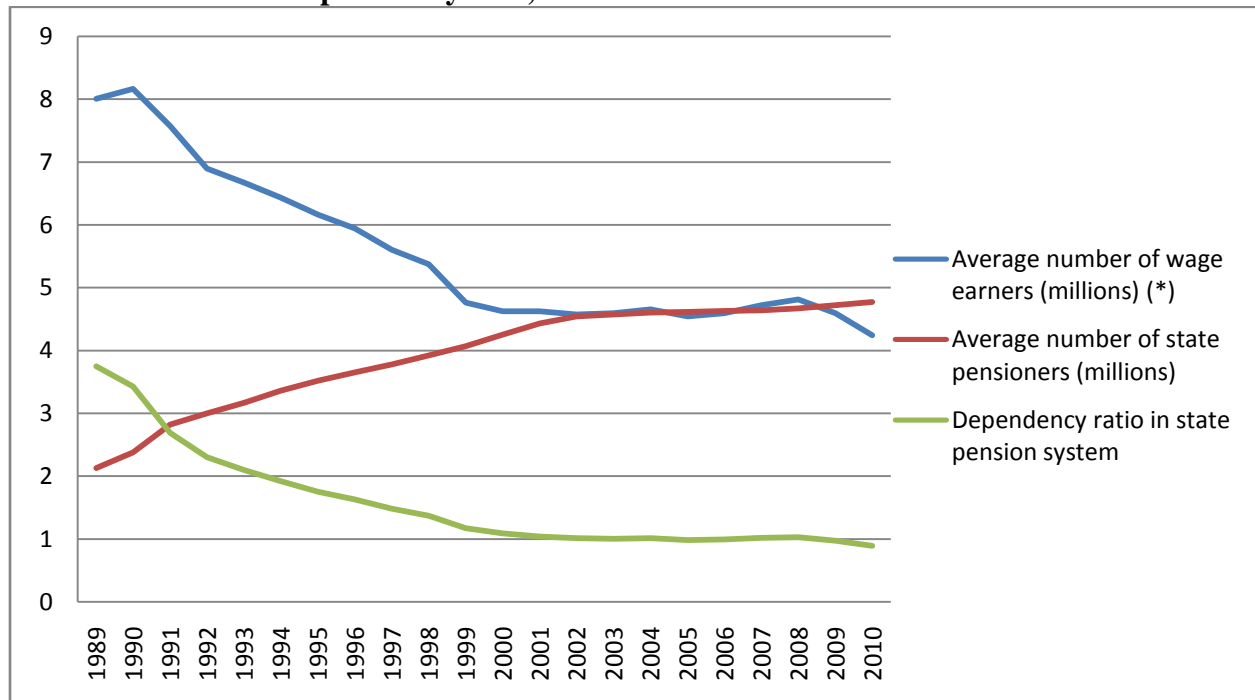
Source: European Commission (2009), “2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060)”, Brussels

4.3 The state pension system

The sustainability of Romania's state pension system has already worsened sharply in the 20 years since the transition from the socialist economy began. The state pension system in the socialist economy was a pay-as-you-go system with relatively generous benefits. In the last two decades the number of wage earners in the economy, who make contributions to the state pension scheme, has fallen by almost 50 percent, from 8 million to over 4 million, because of migration, a fall in the labour force participation rate, unemployment and the growth of informal employment. During the same period, the number of state pensioners has risen from just over 2 million to nearly 5 million. As a result the dependency ratio in the state pension system – the ratio of contributors to the state insurance funds to pensioners - fell from 3.43 in 1990 to 0.89 in 2010 (see figure 7).

The Romanian government has implemented a number of measures over the last two decades to restore financial viability to the social security system. Contribution rates have been raised. The combined contribution rates for pensions, unemployment and health insurance are now over 44 percent of salaries, which is in itself a disincentive to formal sector employment. Social security contribution rates in the 10 new member states of the EU are shown in table 3. As can be seen in the table, contribution rates are very high in several of the new member states which share similar problems with Romania in respect of their social security systems.

Figure 7: Numbers of wage earners and pensioners (millions), the dependency ratio in the state pension system; 1990-2010



Source: National House of Public Pensions of Romania (May 2011), "Statistical Indicators Pillar I", Bucharest. <http://www.cnpas.org/portal/media-type/html/language/ro/country/null/user/>

Further reforms to the pension system were implemented during the 2000s. These included an increase in the retirement age by 5 years, reform to the benefit formula and the introduction of a multi-pillar pension system in 2008. The multi-pillar system added a mandatory, privately managed, defined contribution, second pillar and a voluntary, privately managed, third pillar to the existing public, defined benefit, first pillar of the pension system.⁹

⁹ Multi pillar pension systems have been introduced in most of the new member states of the EU.

Table 3: Social security contributions rates in the 10 new member states in 2010, percent

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 Commission (2011) "Taxes in Europe - Tax reforms" database, http://ec.europa.eu/taxation_customs/tedb/taxSearch.html

The pension reforms reduced pension expenditures by the state pension system and, together with strong economic growth in the 2000s, which boosted contributions from wage earners, improved the financial performance of the state pension system (table 4). The pension system even managed to achieve a small surplus of revenues over expenditures in 2006 and 2007. However, several changes were implemented in 2007 which increased pension benefits, such as restoring the indexation of net benefits to gross wages, and the introduction of a mandatory gross replacement ratio of 45 percent.¹⁰ There were further changes in 2009 and 2010, including the guarantee of a minimum pension for low income pensioners and increases in contribution rates. Another “pension reform” was introduced for agriculture pensioners, in 2010, which implies significant additional costs for the state. As a result, pension expenditures have risen steeply, from 5.4 percent of GDP in 2006 to 8.3 percent of GDP in 2010. The increase in expenditures

¹⁰ The replacement ratio is the ratio of net average pensions to gross average earnings. The average replacement ratio in Romania was 0.56 in 2009, compared to the average for the EU of 0.51.

has plunged the pension system back into deficit. It incurred a deficit equivalent to 2.1 percent of GDP in 2010 (table 4).

Table 4: Revenues and Expenditures of the State Pension Fund (percent of GDP); 2001-2011

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenues	6.3	6.2	6.2	6.1	6.1	5.7	5.9	6.1	6.9	6.2
Expenditures	7.2	7.0	6.5	6.8	6.3	5.4	5.7	6.6	8.1	8.3
Balance	-0.9	-0.8	-0.4	-0.7	-0.2	0.3	0.2	-0.5	-1.2	-2.1

Revenues exclude state subsidy

Source: National House of Public Pensions (2011), "Social Insurance Budget", Bucharest

<http://www.cnpas.org/portal/media-type/html/language/ro/country/null/user/anon/page/buget>

A new pension law was enacted in December 2010 to improve the financial viability of the public pension system. The new law included the following provisions: a phased increase of the retirement ages of women to 63 years; a phased switch to the price indexation of pension benefits (from wage indexation); increased penalties for early retirement; the incorporation into the public pension scheme of the special sectors pensions schemes (for defense, interior, intelligence, etc.)¹¹; the integration of new categories of contributors (e.g. the self-employed) within the public pensions system; the introduction of a maximum ceiling for the contribution base; and tightened eligibility criteria for disability benefits.

The new pension law is projected to reduce public pension expenditures substantially over the long term. By 2025, pension expenditures based on the pension legislation in force immediately prior to the enactment of the new law, were projected to reach 10.5 percent of GDP, with the

¹¹ The state pension system included, alongside the ordinary public pensions, separate schemes for specific categories of state employees; the army, the police, the secret services, civil aviation and support staff, Parliament, diplomats, magistrates and support staff, etc. These special pension schemes provided much more generous benefits than the ordinary public pensions, with replacement rates of 80-100% of the last 1-6 month salary earnings. In 2010, about 200,000 people received special pensions at a total cost to the budget of 1 percent of GDP. The special pension schemes are analysed in Dragota and Miricescu (2010).

pension system deficit projected at 4.5 percent of GDP. The new pension law is projected to cut pension expenditures to 6.9 percent of GDP by 2025, a fall of 3.5 percent of GDP, with a fall of similar magnitude in the pension system deficit (table 5). The new pension law still leaves the public pension system in deficit over the long term, but the deficit is reduced to relatively low levels.

Table 5: Projected expenditures and balance of the public pension system, percent of GDP; 2011-2025

	2011	2012	2013	2014	2015	2020	2025
Baseline							
Expenditures	7.9	7.9	8.0	8.1	8.1	9.1	10.5
Balance	-1.7	-1.7	-1.8	-1.8	-1.9	-3.2	-4.5
New law							
Expenditures	7.5	7.2	7.2	7.1	7.1	6.9	6.9
Balance	-1.5	-1.2	-1.2	-1.2	-1.3	-1.4	-1.0

Projections do not include special pension regimes

Baseline refers to projections based on the pension legislation prior to 2010

Source: World Bank PROST projections

The rationale for the introduction of new, defined contribution pillars is to reduce the burden on the defined benefit state pension system, as well as to stimulate capital market development. However, the transition to a multi pillar pension system involves budgetary costs, because a share of the contributions of the working population has to be diverted from the state pension system to finance the second pillar. Because they are designed to be fully funded, the second pillar pension systems raise fiscal costs in the short to medium term, but reduce costs in the long term. The government froze a planned increase in contribution rates to the second pillar in 2010

because of the fiscal costs.¹² However, this only creates future fiscal liabilities and hence is not a sustainable long-term solution.

To conclude, the government has implemented major reforms to improve the financial sustainability of the public pension system, with the enactment of the 2010 pension law. This has curtailed the real value of benefits to pensioners and will cut pension expenditures by about a third by 2025. However, pensioners are an important political constituency and will become even more electorally powerful over the next 50 years as their relative voting strength increases. Hence government is likely to face strong political pressures to reverse some of the pension reforms and provide more generous benefits to pensioners. Any further increases in contribution rates are not likely to be feasible, because this would discourage participation by workers. Hence if there are changes to the state pension which raise the future value of real pension benefits, the deficit of the pension system will also be increased. A larger burden of financing pensions will thus fall on the general taxpayer.

5. Can revenue mobilization be strengthened?

Romania has the lowest government revenue to GDP ratio in the EU. In 2010 revenue was 33 percent of GDP compared to an EU average of 42 percent. Even relatively modest increases in the revenue/GDP ratio could make an important contribution to fiscal sustainability in the long run.

The main reason why the revenue/GDP ratio is relatively low in Romania is that tax compliance is very weak. In addition, the tax base is both narrow and there are numerous exemptions. Tax collections are only a small fraction of the theoretical maximum collection, given the legal tax rates and the size of the tax base. This can be seen by looking at the implicit tax rates for various taxes. Implicit tax rates are calculated as the ratio of the actual revenue collected from a given

¹² Similar steps have been taken by several other new member states of the EU which established multi pillar pension systems in the 2000s (Barbone, 2011).

tax handle to the size of the tax base for that tax handle. Comparing the implicit tax rates with the legal tax rates provides an indication of the level of tax compliance in the economy (table 6).

Table 6 Implicit and legal tax rates

	Legal tax rate	Implicit tax rate	Implicit rate as percent of legal rate
Personal income tax	16	5.8	36.3
Corporate income tax	16	5.4	33.8
Social contributions	43	20.8	46.8
VAT	18	10.8	60.0

Data pertains to 2010 except for VAT which is 2009

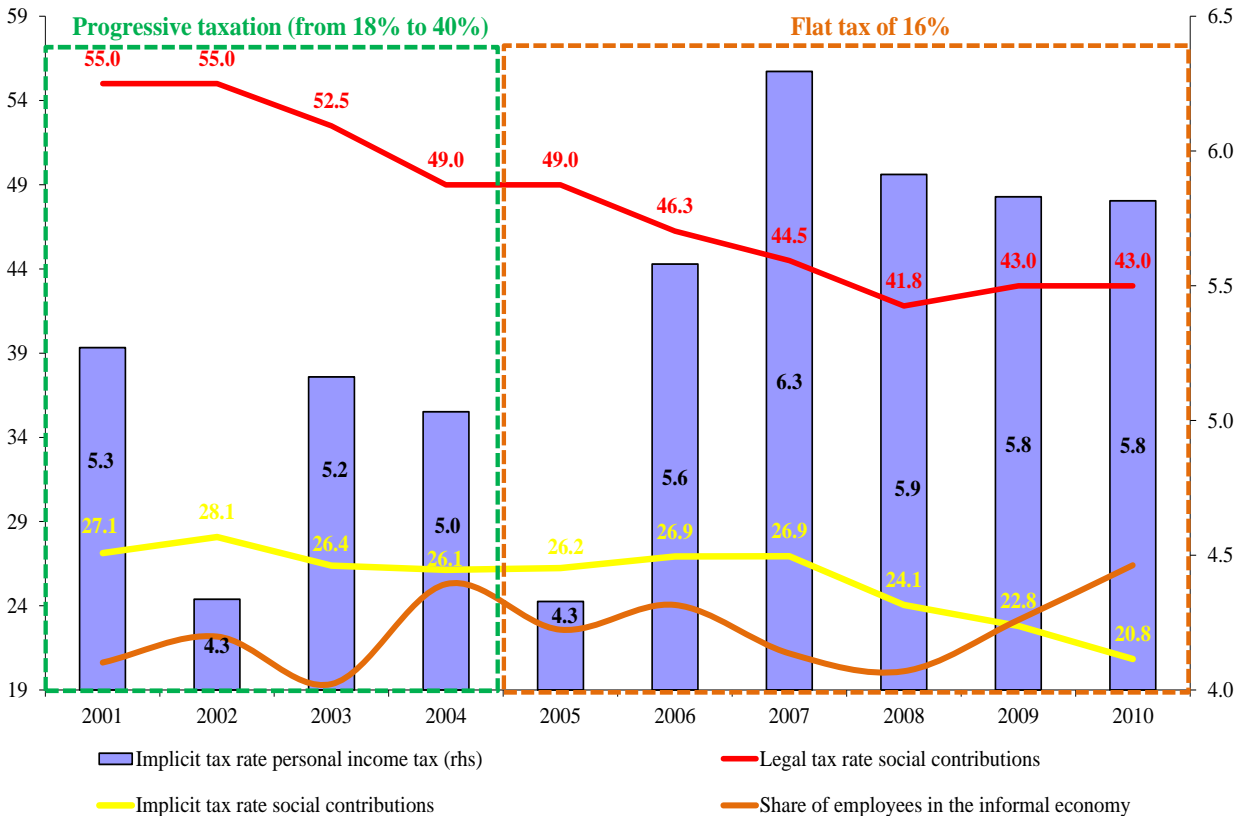
Source: Eurostat, Romanian National Institute of Statistics, Romanian Ministry of Public Finance, Fiscal Council, and authors' calculations

Tax compliance with the personal and corporate income tax is particularly poor; less than 40 percent for both tax handles which probably reflects the large share of informal employment in the economy – estimated at between 20 percent and 25 percent of total employment - as well as tax evasion. Tax compliance has also weakened since the onset of the economic crisis in 2008. The Romania Fiscal Council estimated that the losses of personal income tax arising from tax evasion from undeclared work amounted to 1 percent of GDP in 2009, while losses of social contributions from undeclared work amounted to 3.3 percent of GDP.

Romania replaced a progressive income tax, with rates between 18 and 40 percent, with a flat tax in 2005, set at 16 percent. One of the merits of a flat tax is that it is supposed to encourage compliance and simplify tax administration, but the implicit tax rate on personal income was only fractionally higher in 2010 than it was prior to the introduction of the flat tax (figure 8). For the corporate income tax, the implicit tax rate in 2010 was lower than it was prior to the

introduction of the flat tax rate. Revenue from income taxes has been undermined by many exemptions which remained in place when the flat tax was introduced.

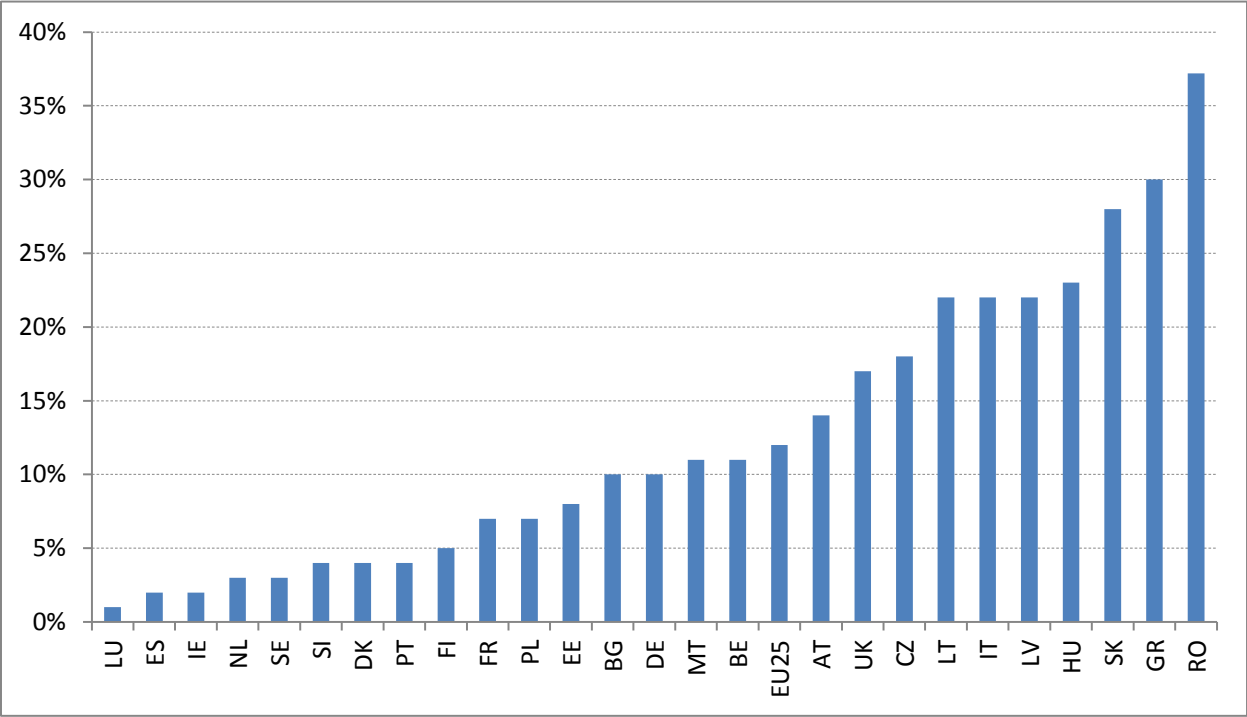
Figure 8 Trends in the legal and implicit tax rates for personal income tax and social security contributions: 2001-10



Source: Eurostat, Romanian National Institute of Statistics, Romanian Ministry of Public Finance, Fiscal Council, and authors' calculations

Compliance with VAT is the lowest in the EU. This is illustrated by the VAT gap, which is calculated as the ratio of VAT not collected to total VAT liabilities. The VAT gap in Romania was about 37 percent, the highest in the EU by a large margin (see figure 9). The Romania Fiscal Council estimates that the losses arising from VAT fraud amounted to 3.8 percent of GDP in 2009.

Figure 9 The VAT gap in EU countries (2006)



Sources: European Commission, Directorate-General for Taxation and Customs Union, Reckon Report, 2009, Romanian National Institute of Statistics, Fiscal Council

To conclude this section, revenue collections in Romania have been undermined by tax evasion of both direct and indirect taxes. With total losses from tax evasion estimated at about 10 percent of GDP or more, efforts to strengthen tax compliance should be a priority for public policy. Improving tax administration offers the scope for improving revenue collections, by reducing tax evasion, without having to raise tax rates.

6. Impact of the Euro area crisis on fiscal sustainability

The intensification of the Euro area sovereign debt crisis over the summer of 2011 has worsened the economic prospects for all of the economies on the periphery of the EU, including Romania. The core of the Euro area economy faces slower real growth and could tip back into recession. In the September 2011 volume of the World Economic Outlook, the IMF reduced the real GDP growth forecast for the Euro area by 0.4 and 0.6 percentage points respectively for 2011 and 2012, to 1.6 percent and 1.1 percent. There are substantial downside risks to these forecasts which could materialize if the financial crisis facing the Eurozone were to intensify.

The weakening economic prospects in the Eurozone have already affected growth forecasts for Romania. The IMF has downgraded the 2012 real GDP forecast from 4.4 percent to 1.8 percent. Over the five year period 2012-16, the IMF has cut a cumulative 3.7 percentage points from the medium-term growth forecasts, compared to the forecasts made in the first half of 2011. Even these new, lower forecasts for GDP growth look optimistic. Forecasted medium-term growth in Romania is largely export driven. The latest IMF forecasts (consistent with the reduced GDP growth forecasts) entail Romanian exports of goods and services in real terms growing at an average of 7.4 percent per annum during 2012-16. This is much faster than demand in the Euro area, which is the main destination for Romania's exports, is likely to grow over this period. As such it may not be possible to achieve export growth of this magnitude which in turn will depress real GDP growth in Romania.

A lower medium-term growth rate of GDP has adverse implications for fiscal balances. Revenues will be lower because of the smaller tax base, hence without expenditure cuts fiscal balances, expressed in Ron, will be lower (i.e. deficits will be larger) and public debt higher. Expressed as a percentage of GDP, deficits will be larger still because of the lower denominator, as will the public debt/GDP ratio. The Romanian government could attempt to maintain its fiscal consolidation path by cutting expenditures, but this would risk further weakening domestic demand and hence depressing the real GDP growth rate over the medium term. A further threat

to fiscal balances will arise if the sovereign debt crisis in the Euro zone triggers a rise in interest rates for all of the sovereign borrowers on the periphery, including Romania, as this will increase Romania's debt servicing costs.

7. Conclusions

Romania has recently implemented important reforms to strengthen its public finances, mainly by cutting public expenditure. As a result the structural fiscal deficit has been reduced from 8.5 percent of GDP in 2008 to a projected 2.8 percent of GDP in 2011. The fiscal consolidation is sufficient to prevent public debt from rising above 36 percent of GDP over the medium term. Even if the losses of state owned enterprises are brought into the budget, the impact on the fiscal deficit will be relatively small; about 0.5 percent of GDP. However, slower real GDP growth and/or higher borrowing costs, which could be a consequence of an intensification of the financial crisis in the Euro area, could undermine the Romanian government's efforts to bring the structural balance to zero and to stabilize the public debt/GDP ratio over the medium term.

Looking beyond the short to medium term, serious challenges will emerge to fiscal sustainability. Over the long term Romania faces unfavorable demographic trends. The workforce is projected to contract at about 0.8 percent a year on average over the next 50 years. This implies that it will be very difficult to sustain the real GDP growth rates of 4 percent per annum beyond the medium term, without very high annual increases in labor productivity. Lower real GDP growth over the long term will have adverse consequences for fiscal sustainability because it means that less budgetary resources will be mobilized to fund public spending. In addition, the average real interest rate paid on public debt will rise over the long term because Romania will need to rely less on loans from multilateral institutions and more on borrowing from domestic and international markets. Higher real interest rates on public debt and

lower real GDP growth rates imply that the primary fiscal balance which is consistent with stabilizing the public debt to GDP ratio must rise.

Romania's adverse long-term demographic trends also imply increasing deficits of the public pension system, which already has more beneficiaries than contributors. The new pension legislation enacted at the end of 2010 is projected to reduce the pension deficit to about 1 percent of GDP in 2025 through drastic cuts in entitlements to benefits. Whether the financial viability of the public pension system can be sustained over the long term by holding down the value of pension benefits in a society where the aged will constitute a numerically important share of the electorate must be considered doubtful. Moreover, it is not axiomatic that the solution to the financial viability of the public pension system should be found within the system itself. There is no reason in principle why a public pension deficit should not be funded from general budgetary resources, provided that this does not undermine fiscal sustainability; the difficulty of doing this is the scarcity of budgetary resources and the many other competing claims for public expenditure.

Given that the scope for further cuts in public expenditure is likely to be very limited, Romania should look towards the revenue side of the budget to help maintain fiscal sustainability. If revenue mobilization can be strengthened, Romania may be able to maintain fiscal sustainability without imposing too great a hardship on pensioners and users of essential public services. Fortunately, there appears to be room for boosting revenue mobilization. Romania has the lowest tax effort, measured in terms of the tax/GDP ratio, in the EU, in part because of widespread tax evasion together with the large share of informal labor in the workforce. If the revenue authorities could reduce the amount of tax lost to evasion and fraud by only 50 percent, the revenue gains would amount to more than 4 percent of GDP.

Fiscal sustainability involves risk and uncertainty, because even if current fiscal policies are considered sustainable, the future cannot be known with certainty. Long term fiscal sustainability is vulnerable to fiscal shocks, such as adverse macroeconomic shocks. It is almost inevitable that

one or more major negative fiscal shocks will occur over a time horizon that extends beyond the medium term. Hence the capacity of a government to adjust to an adverse fiscal shock is also a factor which affects fiscal sustainability. This depends on various factors: Can more revenue be mobilized by raising tax rates? Is there fiscal space to run temporarily lower fiscal balances until the shock has subsided? Building more flexibility and resilience into the fiscal system would make an important contribution to enhancing fiscal sustainability in Romania.

In the final analysis, whether Romania can maintain fiscal sustainability will be determined by politics; there must be sufficient understanding within the polity of the importance of sustainable fiscal policies and a broad consensus on such policies.

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