The challenges to long run fiscal sustainability in Romania

Sudharshan Canagarajah
The World Bank
October 2011

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Fiscal sustainability

1. Key issues throughout Europe, esp since the global crisis two years ago.

2. Most governments, including Romania, had public finance deterioration leading up to the crisis – living beyond their means.

3. Solvency of government – forward looking concept

4. Government capacity to mobilize finance for deficit to maintain macro stability and deliver essential good and services to citizens

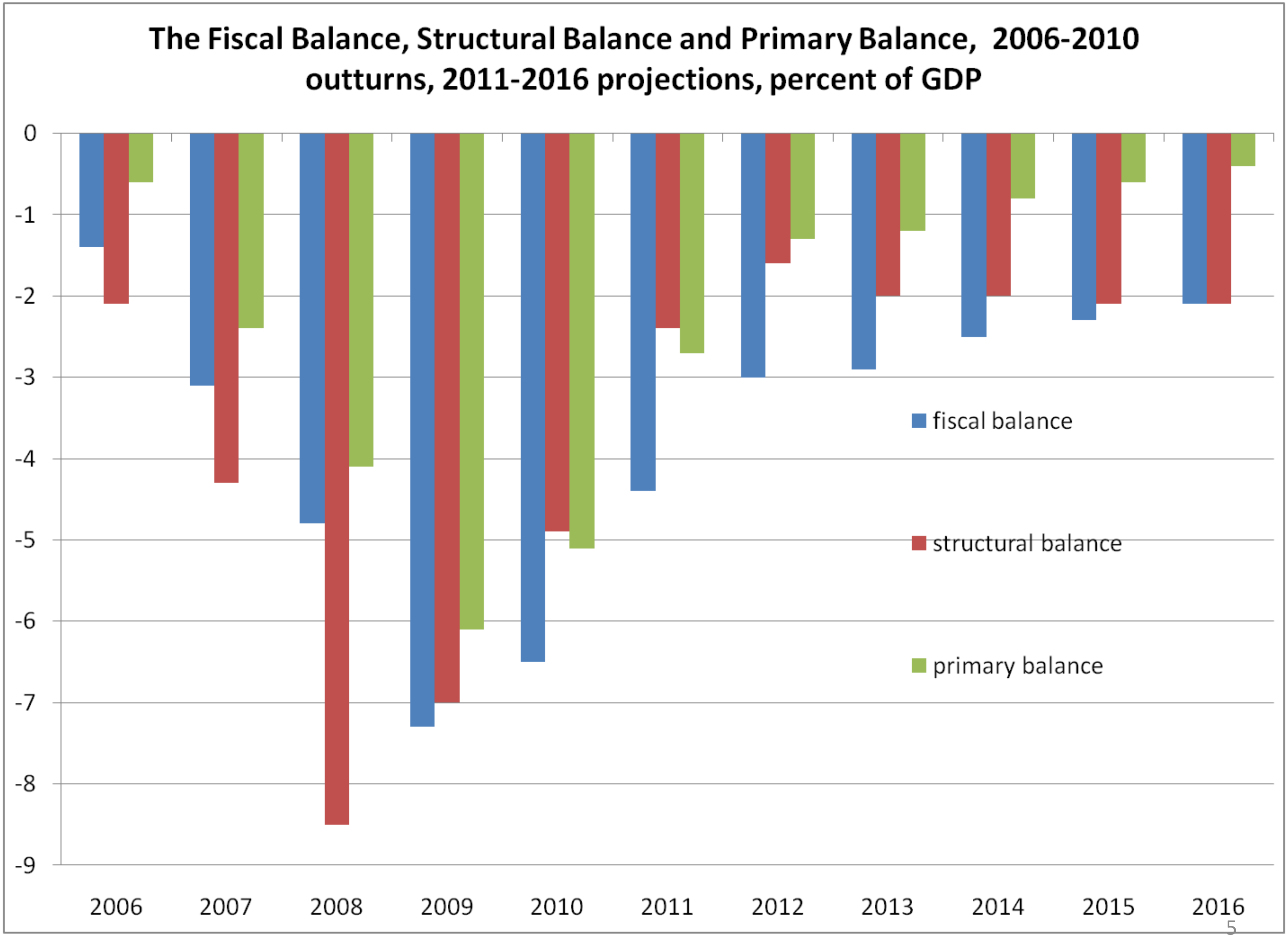
Fiscal deficits and fiscal consolidation

Pro-cyclical fiscal policy during the boom of the mid 2000s; large rise in the structural deficit to 8.5 percent of GDP at height of boom in 2008 (slide 4)

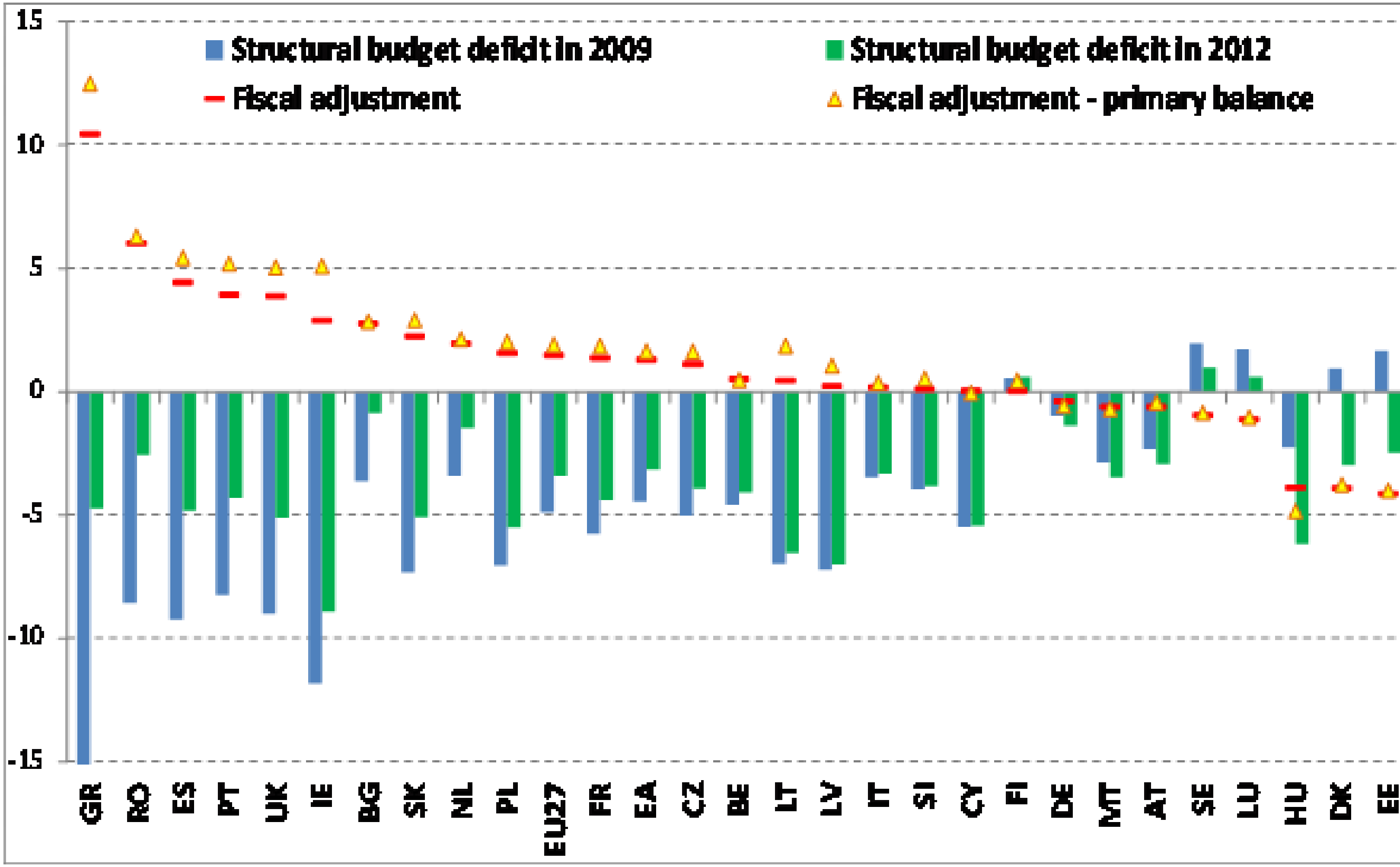
Despite severe recession in 2009-10, government implemented radical fiscal consolidation; structural deficit set to shrink by 6 percent of GDP in 3 years (2008-2011) – the largest fiscal adjustment in the EU after Greece (slide 5)

Medium term forecasts are for structural deficits to average 2 percent of GDP during 2012-16

From 2012 onwards, Romania is forecast to comply with the fiscal deficit ceiling in the Stability and Growth Pact (3 percent of GDP)


The Fiscal Balance, Structural Balance and Primary Balance, 2006-2010 outturns, 2011-2016 projections, percent of GDP
0
-1
-2
-3
-4
-5
-6
-7
-8
-9
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
fiscal balance
structural balance
primary balance

Romania's fiscal consolidation in comparison with that of other EU countries; percent of GDP, 2009-12



Source: European Commission (forecasts from Autumn 2010)

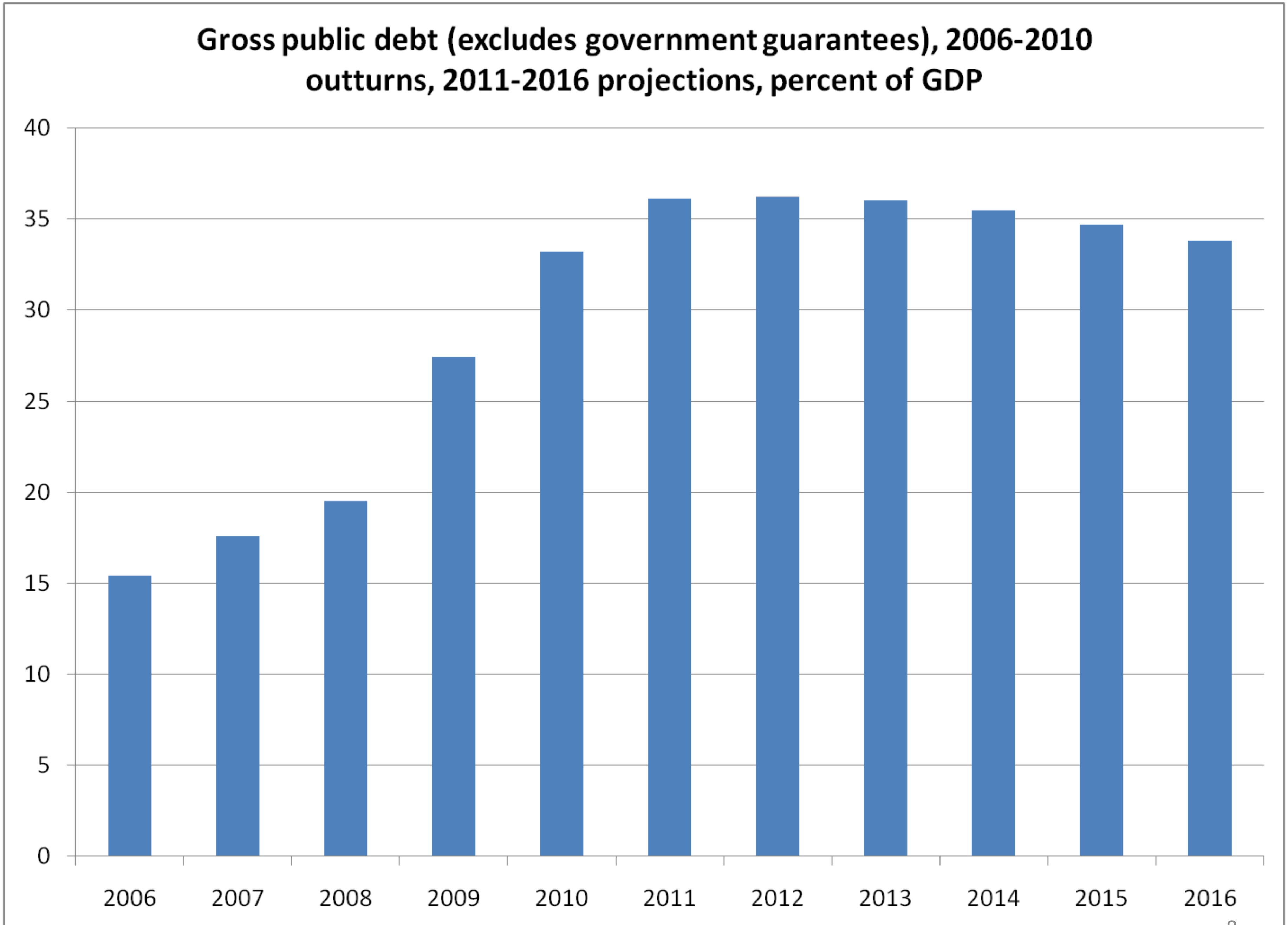
Public debt

- The deterioration in the fiscal balance has led to a sharp rise in public debt, from 15 percent of GDP in 2006 to 36 percent in 2011 (slide 7)

- But public debt as a share of GDP will stabilise at around 35 percent of GDP in the medium term because of fiscal consolidation

- Medium term debt dynamics are quite favourable given relatively low average interest rates on debt (because of borrowing from multilaterals).

- There are no major threats to public debt sustainability in the medium term


Gross public debt (excludes government guarantees), 2006-2010 outturns, 2011-2016 projections, percent of GDP
40
35
30
25
20
15
10
5
0
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016

State Owned Enterprises

- There are over 700 SOEs, accounting for 10 percent of GDP
- About one third of SOEs are making losses and/or are insolvent; biggest losses are in energy and transport sectors
- losses are quasi fiscal deficits – incurred off budget by public agencies in pursuit of public policy objectives.
- SOEs had outstanding arrears of nearly 5 percent of GDP in 2010
- SOE arrears undermine tax collection and social insurance funds
- SOE losses are relatively small as a share of GDP; including SOEs which receive public subsidy in general government data will worsen fiscal balances by about 0.5 percent of GDP

Long run demographic trends

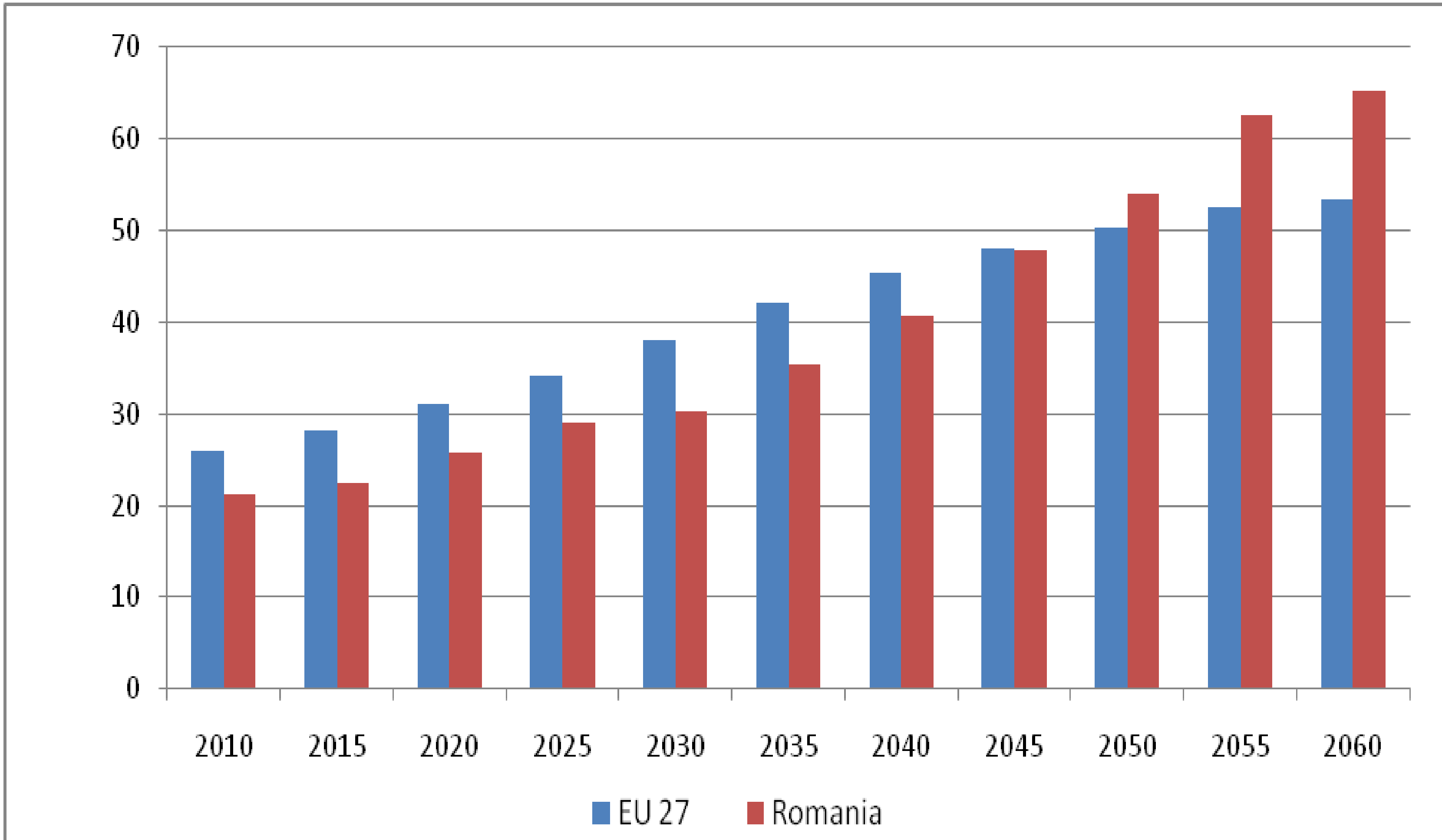
Romania's long run demographics are among the least favourable in the EU and will have a profound impact on public finances in the long term

The working population is projected to shrink by 35 percent between 2008 and 2060, pulling down real GDP growth

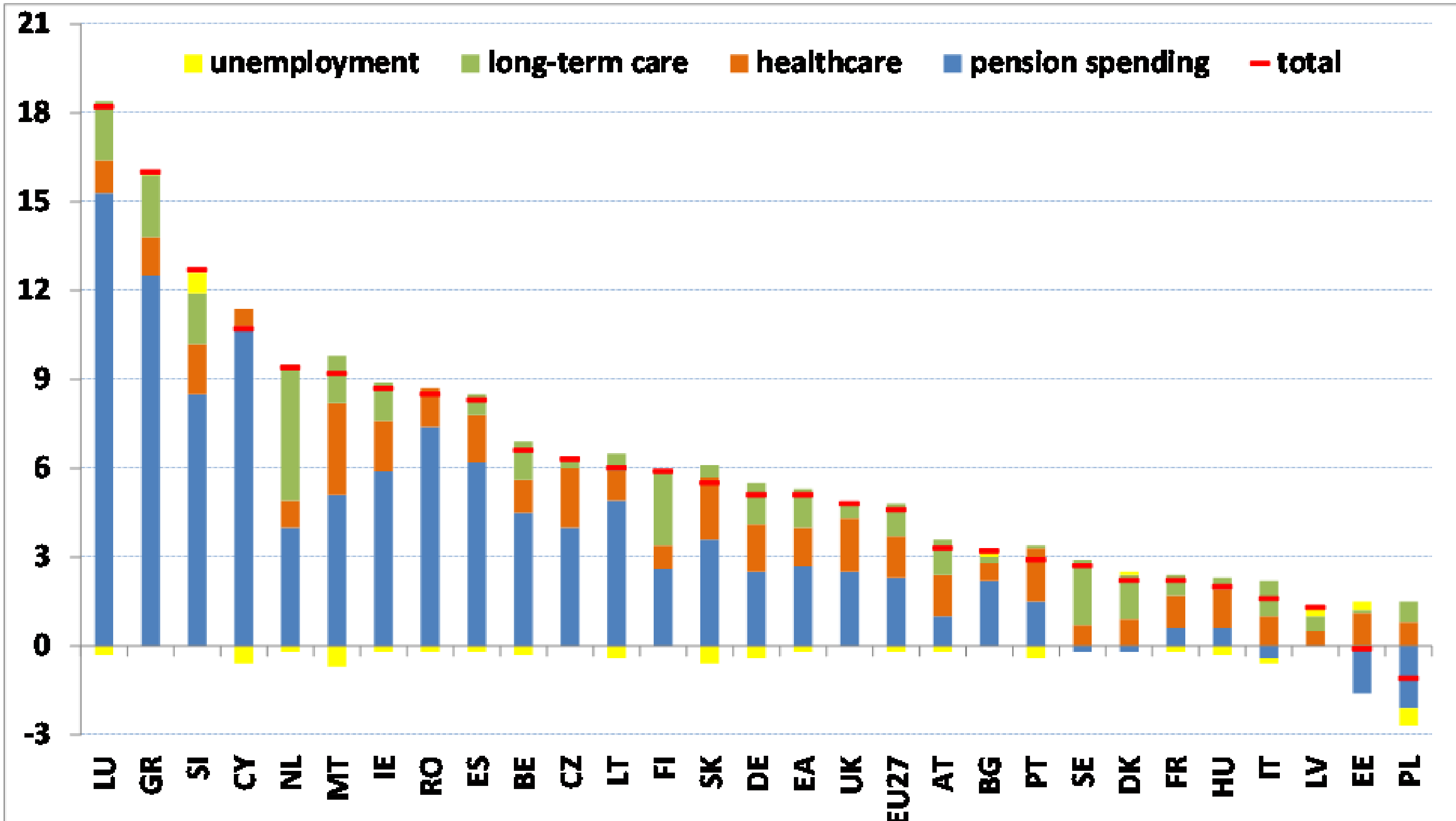
The old age dependency ratio is projected to rise from 20 percent now to 65 percent in 2060 (slide 10)

The EU's Ageing Working Group forecasts that age related public expenditures will increase by 8.5 percentage points of GDP between 2010 and 2060; double the EU average (slide 11)

Projections of Old Age Dependency Ratios in Romania and the European Union: 2010-2060



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

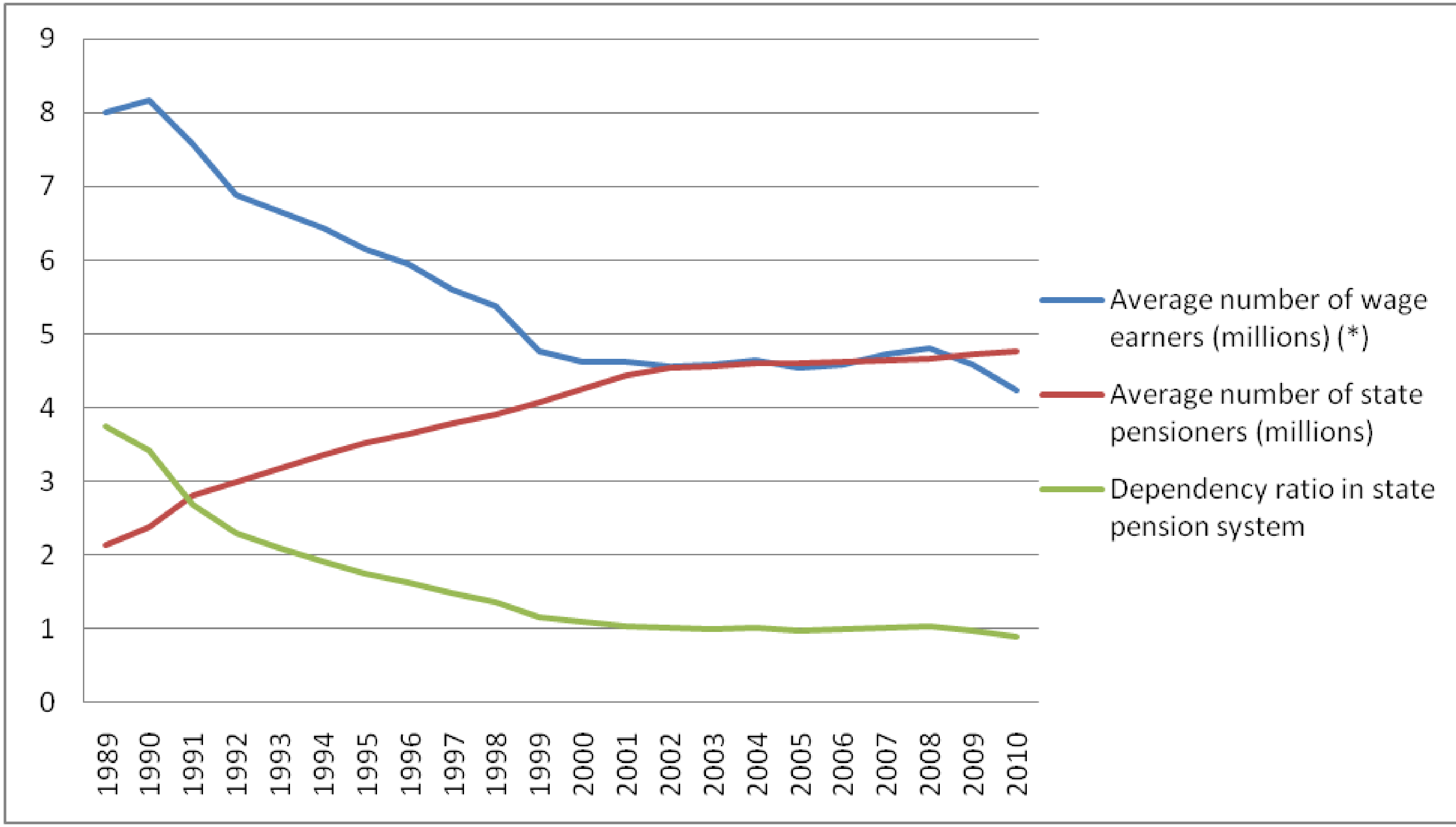


The State Pension System

Sustainability of the state pension system has worsened since 1990 because:

1. The number of wage earners who contribute to social security funds has fallen from 8 to 4 million
2. The number of state pensioners has risen from 2 to 5 million
3. Dependency ratio (contributors to state pensioners) has fallen from 3.4 in 1990 to 0.9 in 2010 (slide 13)

Numbers of wage earners and pensioners (millions), the dependency ratio in the state pension system; 1989-2010



Reforms to State Pension System

Reforms implemented in 2000s:

1. Increases in contribution rates (total contributions are now 44 percent of wages, with pensions alone comprising 31 percent of wages, see slide 15)

2. Increase in retirement age

3. Introduction of multi-pillar system; added to the public, defined benefit first pillar is a mandatory privately managed defined contribution second pillar and a voluntary private third pillar

4. But revisions to benefit entitlements and coverage in 2007-10 have increased pension costs and worsened long term viability

5. Pension costs in 2010 were 8.3 percent of GDP compared to revenues from contributions of 6.2 percent of GDP; a deficit of 2.1 percent of GDP (see slide 16)

Social security contributions rates in the 10 new member states in 2010, percent of wages

Social Contributions		SK	HU	CZ	RO	PL	LT	SI	LV	EE	BG
	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
Old-age pensions	Total	**18.0**	**33.5**	**28.0**	**31.3**	**19.5**	**26.3**	**24.4**	-	-	**16.0**
	Employer	1.0	-	1.2	0.5	-	1.1	0.1	-	-	0.4
Unemployment	Employee	1.0	-	0.0	0.5	-	-	0.1	-	-	0.6
insurance	Total	**2.0**	-	**1.2**	1.0	-	**1.1**	**0.2**	-	-	**1.0**
	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
Health insurance	Total	**14.0**	**8.0**	**13.5**	**10.7**	**9.0**	**9.0**	**13.5**	-	-	**8.0**
	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
Other	Total	**14.6**	**7.0**	**2.6**	-	**8.9**	**3.7**	**0.2**	-	-	**3.9**
	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	Total	**48.6**	**48.5**	**45.3**	**44.4**	**41.2**	**40.1**	**38.2**	**33.1**	**33.0**	**30.5**

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

2010 Pension Law

Aims to improve financial viability of pension system

Measures include:

a) phased increase of the retirement ages of women to 63 years;

b) phased switch from wage to the price indexation of benefits;

c) increased penalties for early retirement;

d) incorporation into the public pension scheme of the special sectors pensions schemes

e) integration of new categories of contributors (e.g. the self employed) into the public pensions system;

f) introduction of a maximum ceiling for the contribution base;

g) tightened eligibility criteria for disability benefits

Projected expenditures and balance of the public pension system, percent of GDP; 2009-2025 - new pension law substantially reduces pension expenditures relative to baseline

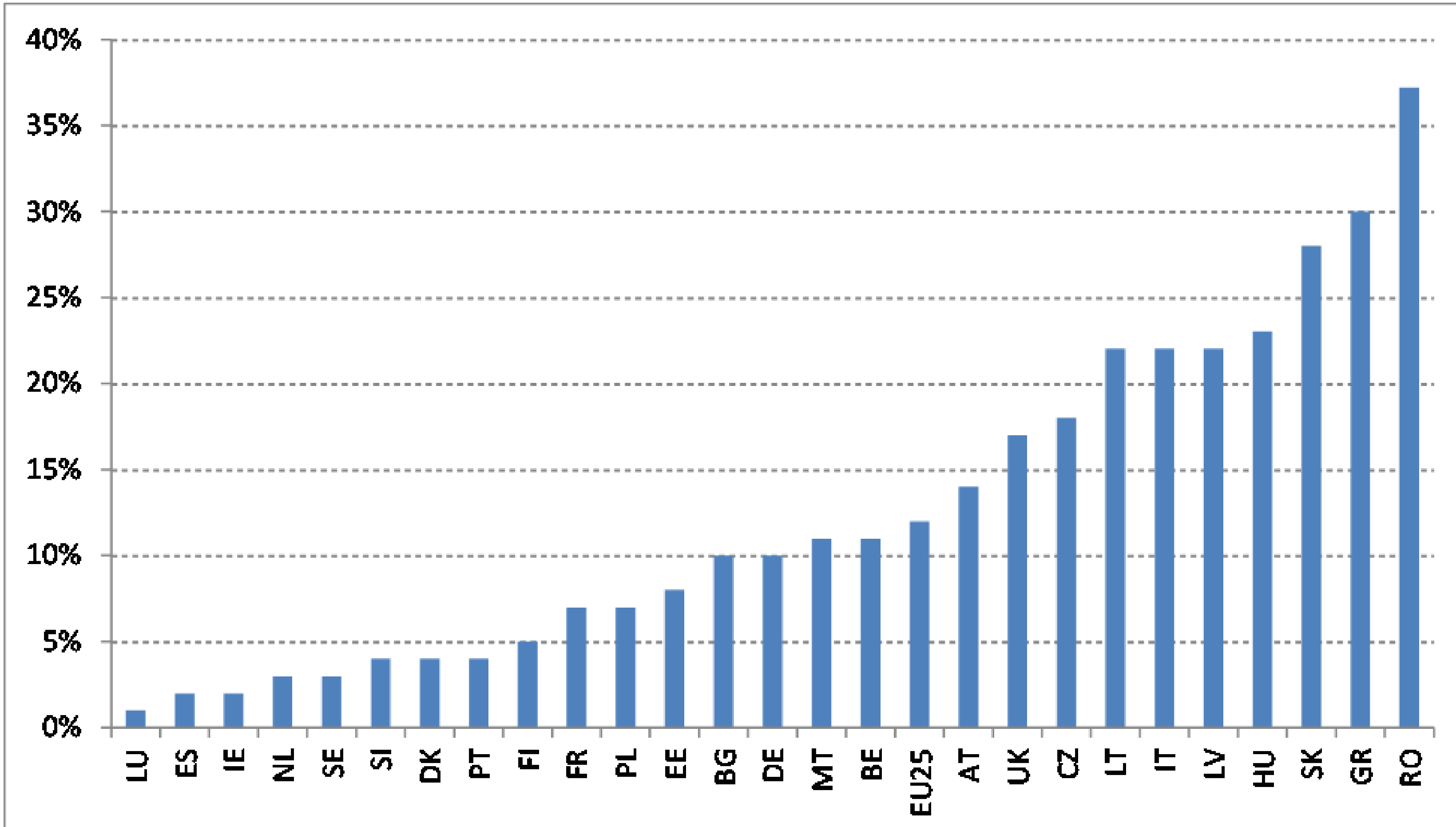
source: World Bank PROST projections

	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

Tax System

- Romania has lowest tax/GDP ratio in EU (33 percent compared to EU average of 42 percent)
- Weak tax compliance is main reason for low tax effort
- The tax base is narrow with many exemptions
- Romania has the largest VAT gap in the EU at 37 percent (ratio of VAT uncollected to total VAT liabilities) see slide 20
- Implicit taxes as percent of legal tax rates are very low (see slides 21 and 22)

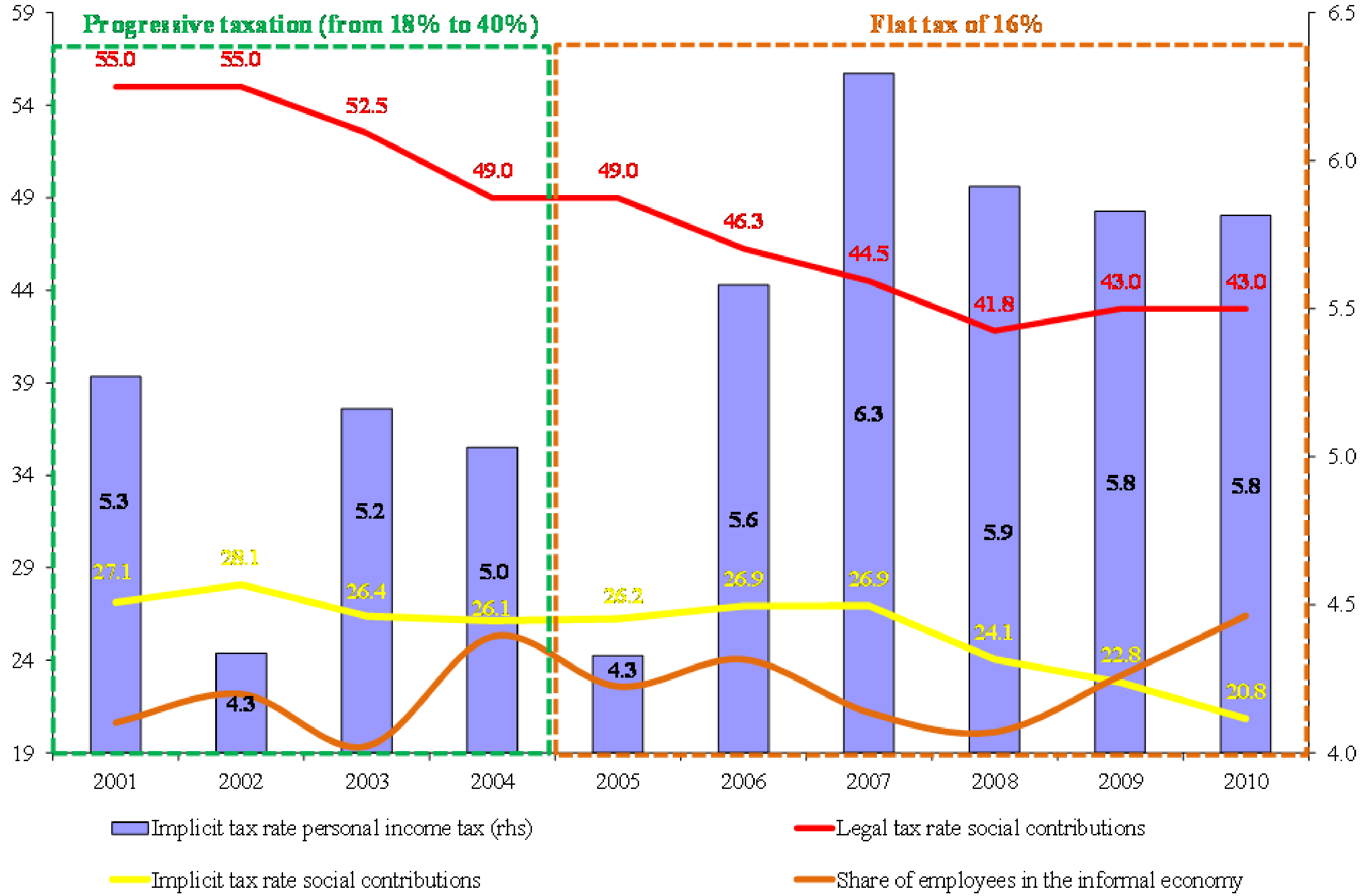
The VAT Gap in EU countries: Romania has the largest VAT gap in the EU



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

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



Medium term threats to public finances: the crisis in the Euro area

- Sustaining fiscal consolidation is sensitive to economic growth, to generate revenues (and increase the denominator of the fiscal balance/GDP ratio).

- Medium term fiscal forecasts are premised on 4.4% real GDP growth in 2012 and an average of 4.2% growth during the 5 year period 2012-16.

- This forecast now looks over-optimistic in the context of Euro crisis. Some have already downgraded the medium term real GDP growth forecasts highlighting further fiscal challenges.

- The medium term macroeconomic framework involves exports of goods and services growing by almost 9% per annum in Euro terms between 2011 and 2016. If the Euro area economy stagnates, this rate of export growth will be difficult to achieve, which in turn will further reduce real GDP growth in Romania.

Conclusions

Projected medium term fiscal balances and public debt are not an imminent threat to fiscal sustainability

The main medium term threats are the political sustainability of maintaining fiscal consolidation

Adverse demographic trends will worsen fiscal position over the long term through lower real GDP growth and larger state pension deficits

Solutions to long term fiscal viability should focus on revenue mobilisation, especially by improving tax compliance