In Romania, the Buzzing Economy is Unable to Attenuate the Uproar Caused by Economic Backslides

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Abstract

The aim of this article is to show that Romania has ended the second quarter of 2017 with a deficit of 4.1 percent, the highest in the European Union, according to seasonally corrected variations, which were published on Tuesday, October 24, 2017, by Eurostat. Even though Romania has experienced one of the greatest economic growths in the EU, there is an equally rapid growth in the structural deficit and these two trends are not compatible. Romania's economy could face problems in the near future, given the fact that the current development is largely due to consumption and the government is forced to massively cut off investment budgets, in order to sustain the announced wage increases. One should also note the high risk of pro-cyclicality in both fiscal and revenue policy, coupled with an unfavourable structure of budgetary expenditure, which are likely to boost primarily consumer demand and to increase both aggregate demand surplus and the current account deficit.

Key words: budget implementation, current account, household consumption, economic growth, global competitiveness
J.E.L. classification: E03, E60, H30, H60, O11

1. Introduction and literature review

In an established, well-balanced and economically healthy country, the laws that are the hardest to amend (and only after carefully conducted impact studies) are the Constitution and the Tax Code (fiscal legislation). In Romania, tax laws are the first ones to be modified by governments, whenever imbalances caused by superficial policy begin to take effect. This gives us a constant position of strange originality among other European states. As a consequence, panic in the business environment gets so strong sometimes, that the so-called consultations with partners in the economic and social environment, discussions and negotiations between the authorities and business environment have come to be done not on the basis of positive taxation strategies, but vice versa, in order to prevent malfunctions or chain effects, which the legislators had neither the patience to analyze nor the expertise to foresee. Thus, the real issue for the Romanian economy has shifted from the constructive details of tax regulations to the overall defense of the real economy, faced by the aggressive unpredictability of Romanian legislation.

Romania's government deficit climbed to 4.1 percent of the GDP in the second quarter of 2017, up from 3.6% of the GDP in the first quarter of this year. This represents the highest level of this indicator among the states of the European Union, according to the European Statistics (Eurostat) reports, published on Tuesday, October 24, 2017. The European Institute of Statistics has adjusted the figure upwards to -3.6% (for the first quarter of 2017) from the previous estimate of -3.2%. Thus, Romania experienced the highest deficit in the European Union, followed by the United Kingdom, which had a deficit of -3.4 percent during the second quarter of 2017. The Eurostat figures are based on the balance of ESA (European System of Accounts) 2010.

When it finds a budget deficit which exceeds the limit of 3% of the GDP in a member state, the European Union may start the excessive deficit procedure for the country in question. The target deficit set by the Romanian Government when planning the state budget for the year 2017 was 2.98% of the GDP (according to ESA methodology) or 2.96% of the GDP (according to cash methodology).

However, according to the consolidated budget execution during the first nine months of the current year (2017), as recently published by the Ministry of Public Finance, the budget deficit has doubled, reaching 6.8 billion lei, which means 0.81% of the GDP - as compared to the deficit of 3.7 billion lei (or 0.49% of the GDP), which was recorded during the same period (January-September) of the previous year (2016).

The characteristics of the world economy show that the entire pattern of future GDP growths is influenced by changes in the financial conditions. The mix of macroeconomic and financial policies will have to be consolidated by decision makers at national and global level (IMF, 2017).

In Romania, the wrong mix of economic policies, which has stimulated consumption at the wrong time, underpinned economic difficulties and aggravated imbalances (Voinea, 2009).

The accumulation of financial excesses, which allow a prolonged increase in consumer spending, is due to the lack of effective macro-prudential supervision (Catte et al., 2011). The effectiveness of fiscal and budgetary measures in boosting GDP growth is diminished by the existence of a positive excess in demand (Caggiano et al., 2015 &; Mittnik and Semmler, 2012; Auerbach and Gorodnitchenko, 2011; Baum et al., 2012).

The worldwide controversy regarding the effects of fiscal policy implementation has caused economic policies of states to vacillate between tax increases, accompanied by a reduction in government spending, on the one hand, and the adoption of Keynesian financial stimulation measures, on the other hand (Mencinger et al., 2017).

The fiscal position of a country has a direct impact on the level of deficit and government borrowing. When the fiscal position is weak, the fiscal policy effects have a lower rate of spreading, because decision makers adopt pro-cyclical fiscal measures at a time of expansion and vice versa (Spilimbergo et al., 2009; Nickel and Tudyka, 2014).

2. A few incongruities at the end of the first nine months of 2017

In October 2017, Romania's National Institute of Statistics (NIS) announced that it adjusted upwards the estimates regarding the growth rate of Gross Domestic Product (GDP) for the second quarter of this year. Thus, the estimates published in August and September were increased, as a gross series, from 5.9% to 6.1%. This is the fastest growth rate among the states of the European Union (EU), but it is based on a consumption which was spurred mostly by the wage increases announced by the government - and only to a very limited extent, by investments.

Thus, investments in infrastructure have been drastically reduced, while wage increases, along with tax cuts, could lead to a significant increase in the public debt.

After the first eight months of 2017, the current account of the balance of payments underwent a shortage of 4.043 billion euros, 52.4% higher than the level recorded during the same period of 2016. This was mostly due to a disproportion in the balance of trade, according to the official data recently published by the National Bank of Romania.

Direct investments by non-residents in Romania amounted to 2.518 billion euros after the first eight months, down by 18.6 %, as compared to January-August 2016. At the same time, the country's public debt reached 33.898 billion euros in August 2017, 5% higher than it was on December 31st 2016.

At the end of the first nine months of the current year, the general consolidated budget suffered a deficit of about 6.8 billion lei, an amount equivalent to 0.81% of the GDP, which was estimated to 837.1 billion lei for the current year (following the first budget revision of 2017, in September). The recorded result is below the performance of the same period of last year, when, at the end of the third quarter, there was a lower deficit in nominal terms (-3.7 billion lei) and 0.49% of the 2016 GDP, respectively. This increase in the budget deficit is a cause for concern, given that, at the end of last year, we barely managed to keep our deficit below the maximum limit, which is 3% of GDP, according to the European calculation methodology (ESA). And over the first 9 months of 2017, our position has been even worse than last year, which we simply cannot afford.

This weaker result (as compared to the first three quarters of 2016) arose from a combination of factors: on the one hand, the surplus of 14.65 billion lei in revenues (+8.8% in nominal terms) and on the other, the increase of 17.77 billion lei in expenditure (+10.5%). This clearly shows that the expenses exceeded the revenues generated by the economic growth, given the fact that the exceedance of the 3% deficit limit was only narrowly avoided in 2016.

It should be noted, however, that the pace at which money reached the State Treasury surpassed quite well the excellent advance of the GDP, but still couldn't keep up with new public spending, the most significant expenditure incurred during the third quarter of 2017 being the 9% rise in the pension point. This rise, effective from July 1st, only adds to the 5.25% indexation at the beginning of 2017, which would have fit much better in the budgeted economic growth.

From a strictly technical point of view, Romania should have used the benefits generated by economic growth for financial consolidation and reducing public debt. The latter, however, slightly resumed its growth (from 37.1% of the GDP in the first trimester, to 37.2% in the second trimester of 2017), despite the remarkable economic performance. This reflects a less than optimal management of the economic situation, as the state wasted this gain, instead of taking advantage of it to consolidate public finance.

Table no. 1 Evolution of budget revenue and expenditure in the first nine months of 2017, as compared to the same period in 2016

Category	**Period**		**Period**	
	9 months 2016 (bn lei)	**% of GDP**	**9 months 2017 * (bn lei)**	**% of GDP**
Revenues	165.79	21.8	180.44	21.6
Expenditure	169.49	22.,3	187.26	22.4
Surplus / Deficit	-3.70	-0.49	-6.82	- 0.81

Source: Ministry of Public Finance data processing
* GDP estimated in September following the first 2017 budget revision

It is a cause for concern that, while expenses have increased in a proportion significantly higher than revenues, they have not even been geared towards development and investments, but instead they went down the bottomless pit of consumption, according to questionable criteria (for example, the artificially inflated pension point, which rose in equal proportions for all pensioners, regardless of their pension level; starting from July 1st 2017, the pension point increased by 9% and reached 1,000 lei, according to the Government's Emergency Ordinance no. 2/2017).

It is important to remember that September 2017 was the maturity date for over 1 billion euros of the macroeconomic stabilization loan, borrowed from the European Union in 2009. This is an expenditure that Romania did not have in 2016, for reasons related to the scheduling of electoral expenses.

Basically, all the increased expenditure focused on personnel expenses, which rose by 0.5% of the GDP during the first nine months of 2017 (after an obviously exaggerated increase of +21.6% from one year to the next). It is worth remembering that, even by taxing such increased expenses (by moving money from one pocket to another), there was no GDP-related increase in revenues.

Essentially, within the budgetary execution in the first nine months of 2017, the wage increase was sustained through a significant reduction in the expenditure on goods and services (-0.2% of the GDP) and by cutting capital expenses (-0.4% of the GDP). The only area where things were a little better than last year was that of non-refundable financing projects (+ 0.1% of the GDP).

Table no. 2 Evolutionof budget expenditure during the first 9months of 2017, compared to the same period in 2016

Category	**Period**		**Period**		**Variation % GDP 2017 / 2016**
	9 months 2016 (bn lei)	**% of GDP**	**9 months 2017 * (bn lei)**	**% of GDP**	
Total expenditure, of which:	169.49	22.3	187.26	22.4	+0.1
- Personnel expenditure	41.50	5.5	50.49	6.0	+0.5
- Goods and services	26.68	3.5	27.65	3.3	-0.2
- Interests	8.45	1.1	7.99	1.0	-0.1
- Subsidies	4.34	0.6	4.51	0.5	-0.1
- Non-refundable	7.10	1.0	9.08	1.1	+0.1

external financing projects					
- Social security	60.62	8.0	67.69	8.1	+0.1
- Capital expenditure	9.64	1.3	7.69	0.9	-0.4

Source: Ministry of Public Finance data processing
* GDP estimated in September following the first 2017 budget revision

Social security expenditure increased over the first three quarters of 2017 by only 0.1% of the GDP, which is somewhat surprising, considering the social-democrat orientation of the government and the increase in pensions. This shows a tendency for the minimum resistance solution, namely giving some extra money directly and lacking a superior, European management of the social security services.

The allocation of budgetary funds and, in particular, the preparation of urgent infrastructure projects (compatible with European claims, very thorough about possible misuse of funds) would have allowed a higher absorption of European non-refundable loans, towards the limit set roughly at 4% of the GDP per annum, as this is the sole sufficiently large source to significantly balance the public budget.

According to the budget structure, the investments are based mostly on attracting European funds. But in this sector, Romania has delays, for bureaucratic reasons. The main issue is that, when we solve these issues and we are finally able to attract funds, the Government will have to co-finance the projects, by contributing 15% to the investments; but, with these 15% for investments, we risk exceeding the 3% deficit margin.

Household consumption of the population will probably remain the sole main determining factor of economic growth in the interval 2017-2018, while the contribution of gross fixed capital formation (GFCF) is expected to get even lower than previously foreseen.

3. Romania's competitiveness according to the research of the World Economic Forum 2017: the contribution of the businesses environment to our 6 position drop in their ranking chart

The World Economic Forum has published a new Report of Global Competitiveness, in which Romania holds the 68th position among the 138 states targeted by the research.

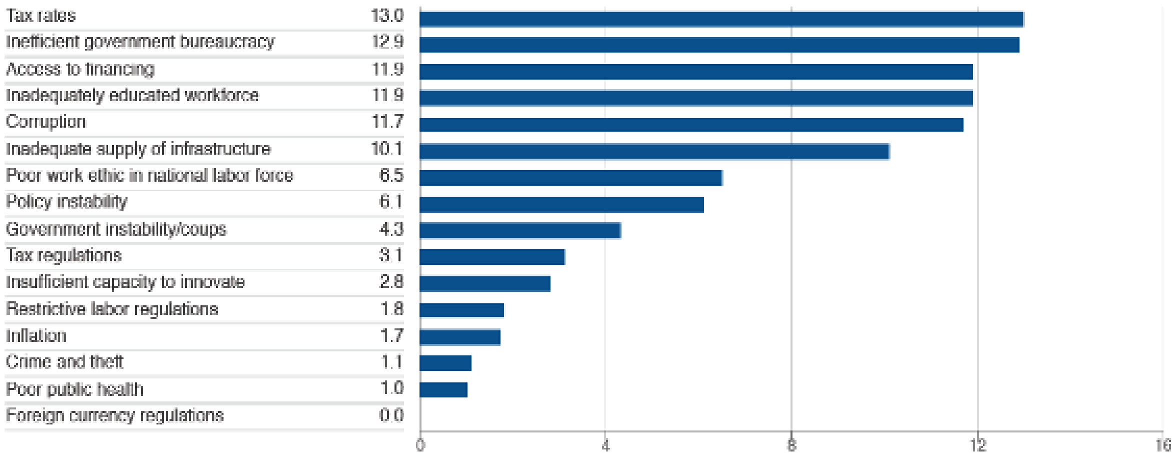
Since the last report, Romania has lost 6 positions in this Index of global competitiveness, while keeping, however, a score identical to the one recorded in 2016 (4.28 out of a maximum of 7). According to the research conducted by the World Economic Forum, Romania's score has been about the same since 2014, which means that the fluctuations recorded in the rankings over the last few years are directly linked to what and how much things change in other states and they have nothing to do with our national economic and administrative performance. In this ranking, Romania's "neighbors" are Georgia and the Islamic Republic of Iran.

Romania's greatest problems are the same, they are well known and largely attributable to the State: bureaucracy, poor infrastructure, difficult access to financing, incoherent taxation policies, etc.

At a careful reading, the indices included in Romania's economic profile show that even the business environment has important issues, as revealed by several relevant figures: the ability to keep talents – position 132 of 137; the ability to attract talents - 131/137; willingness to delegate authority - 129/137; staff's level of education - 123/137; the quality of local suppliers - 122/137; companies' spending on research and development - 110/137; companies' ability to innovate - 109/137; companies' work ethics - 100/137; companies' ability to assimilate new technologies - 95/137; the complexity of the manufacturing processes - 94/137.

According to the research of the World Economic Forum, the main factors that hinder the development of businesses in Romania are: tax rates, bureaucracy, access to financing, inadequately educated labor, corruption, the poor quality of infrastructure.

Figure no. 1. Most problematic factors for doing business



Source: World Economic Forum - The Global Competitiveness Report 2017–2018, available at: https://www.weforum.org/reports/the-global-competitiveness-report-2017-2018

In short, about the „contribution" of the business environment to lowering Romania's competitiveness, we can say that, in the current business circumstances, there are too many over-controlling entrepreneurs, who are unwilling to delegate responsibilities, do not really look at the future from a full perspective: workforce, technology, market trends.

It should be noted that a sustainable economic growth means keeping macroeconomic balance and developing those elements that contribute to a rise in the potential gross domestic product: capital, labor and productivity. Romania cannot sustain a long-term economic growth only by means of fiscal relaxation policies.

4. Conclusions

We note that, in recent years, Romania has deviated from its medium-term budgetary objectives. In 2014-2015, the structural deficit was supposed to be 1% of the GDP, but over the past two years, Romania has substantially moved away from this target and is now the only member state of the European Union in a deviation procedure, according to the Stability and Growth Pact (SGP).

Therefore, the real problem is not a quarterly figure, which seems, at a simplistic level, far above the budgetary balance requirements. It's still possible to turn the investment tap off again (thus seriously affecting future development) or to perform a balancing act in the absence of monetary and financial policies and consistent revenue. The problem lies in the fact that we have reached the point where populist allocations will drive us out of this delusion straight into the land of financial reality.

An increasing number of economists have been expressing their concern about this pattern of growth, given its unfavourable implications on the potential GDP. An increase in investments is conditioned by the absorption of EU funds, public investment and the financial situation of companies, which is in turn affected by the costs of wages and raw materials; other important factors are the predictability of the legal framework, the quality of infrastructure and the availability of skilled workforce. The need for some deep structural reforms in these areas cannot be overemphasized.

The sad fact is that Romania is making the same mistakes as Greece and keeps augmenting its public debt at a time of economic boom. There is a danger of pro-cyclicality of fiscal and revenue policy, coupled with an unfavourable structure of budgetary expenses, which are likely to boost primarily consumer demand and to increase the surplus of aggregate demand, as well as the current account deficit.

An even higher increase in wage costs, as an effect of demonstrations and tensions on the labor market, in conjunction with the narrowing of profit margins for companies, may have similar implications, including by means of weakening competitiveness.

Unfortunately, immediate tactical interest and maximizing personal benefits have prevailed – which was somewhat to be expected, given the current electorate - over the country's medium and long term development strategies. Beware, however, that the limit of 3% of the GDP was set for recession times and not for periods of record economic growth.

The attempt to carbon-copy last year's budget implementation, by narrowly escaping the deficit limit imposed by European rules and regulations, is already a bit off track and certainly not the best idea at the time. It may prove quite dangerous, actually, by exposing Romania to possible external and (why not?) domestic turmoil, thus turning into a risky bet with national safety, with implications that go beyond the strictly economic area.

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