

Quantitative vs. Qualitative in the Romanian Fiscal Adjustment

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Abstract. *As it encountered a fiscal event (budget liquidity crisis) in 2009, Romania should have proceeded to one of the most ambitious fiscal correction in the last 30 years in EU. Nevertheless, the absence of vision regarding the increase in quality of the fiscal adjustment is obvious. The fiscal correction made until now has rather been a quantitative one, falling within certain strictly numerical targets. In this paper, we present a series of signals arguing for the necessity to increase the fiscal quality. Moreover, we propose a few immunization mechanisms of the Romanian economy against the contagion of the current uncertainty in the Euro area or against the future crises.*

Keywords: fiscal adjustment; contagion; immunization mechanisms.

JEL Codes: E61, E63.

REL Codes: 8M, 18B.

Introduction

The economic crisis showed that Romania did not have good policies in good times. The pro-cyclic policies represented the main factor of the macroeconomic drifts recorded during the period 2005-2009. On the other hand, it is obvious that the methods for the analysis of the fiscal and budgetary policy's efficiency during the pre-crisis period – based on the analysis of the real budget deficit – proved to lack relevance (Table 1).

Table 1

The cyclic budget deficit and the structural budget deficit in Romania

– %GDP –

Years	Output gap	Structural budget deficit (% real PIB)	Structural budget deficit (% potential GDP)
2000	-1,55	-3,86	-3,43
2001	-0,57	-3,22	-4,06
2002	-0,60	-2,56	-3,89
2003	-0,91	-2,14	-3,78
2004	0,86	-1,09	-2,96
2005	2,60	-2,70	-1,42
2006	6,05	-4,36	-4,91
2007	8,81	-5,16	-6,13
2008	9,13	-8,57	-7,06
2009	-1,92	-8,26	-9,11
2010	-4,00	-6,53	-8,26

Source: Author's calculations, 2011.

The estimation of the cyclic budget deficit and of the structural budget deficit has been made according to the EU method, in 3 stages: a) The estimation of the gap between the real gross domestic product and the potential gross domestic product (potential GDP), according to the method recommended by the European Commission – the production function method, according to the procedure described by Denis et al. (2006); b) The estimation of the cyclic component based on the output gap and on the sensitivity of the budget deficit; c) The estimation of the structural component by means of eliminating the cyclic component out of the current budget component (see details in Socol, 2011).

Romania makes a purely quantitative adjustment, with future consistent payment delays (half-wits, amend for those who obtained the revenues recovery in court etc). Even though Romania has the second most ambitious fiscal

correction program (with an annual average fiscal adjustment speed of 1.9% of the GDP with reference to the decrease of the structural deficit), the quality of the fiscal adjustment is poor. There are a few signals showing this fact:

The first one is related to the analysis of the budget executions from the second half of 2011. We may easily notice that the positive evolution of the budget revenues are firstly due to the consistently higher returns from VAT (which increased from 19% up to 24%) and from the increase of the excises. The private environment is not stimulated to make investments and to create jobs. The decrease of consumption has determined constant nominal evolutions regarding the tax on profit and the tax on salaries and on income (even real losses of 4.5% for the tax on profit and for the tax on salaries). The rigidity of the budget expenses have not decreased, with reference to the goods and services (plus 11.5% on nominal, showing the incapacity to clean the budget system of corruption, the persistence of half-wits etc.) and to social assistance (minus 2.4% only, reflecting the incapacity to correspondingly aim to the assistance forms for the vulnerable persons). The decrease of the costs with the personnel in 2010 and 2011 is a good thing, but it is not actually but a payment delay for them. The budget execution shows that the total savings regarding the costs with the personnel, by means of income cuts proposed during the period between June 2010 and June 2011 are approximately 2% of the GDP, almost 8 billions of RON, and the amends won by the public employees in court during the last year are 8 billions of RON, too. So, actually, the austerity measures in these fields only represent a deficit which is delayed until the period 2013-2014, when these amends should be paid, and they will be indexed to inflation. The high increase of the costs with interests is also worrisome (plus 27.3% nominal, plus 22% real) showing financing difficulties and the increase of the burden for the next generations. Last but not least, the increase of the capital expenses (plus 16.5% on nominal) represent a positive but weak signal for the stimulation of the economic growth. Weak because the public investments do not represent a priority, generating low multiplication effects.

The second signal for the low quality of the fiscal adjustment in Romania is related to the fact that there are no consistent programs for creating jobs. The economic crisis has strongly struck the Romanian labour market, the total of the employees decreasing by 640,000 persons during the period September 2008 – August 2011 (according to the data from the Romanian National Institute of Statistics, 2011). The result is high pressures upon the budgets for social assistance, pensions, unemployment, health etc where higher and higher deficits are recorded.

The third signal may be argued by making an analysis for the dynamics related to the contribution of the total factor productivity to the economic growth. The IMF forecasts and those of the National Forecast Committee regarding the contribution of the production factors to the economic growth are not consistent with each other. In case both International Monetary Fund and National Forecasting Commission of Romania forecast an average 2.8-2.9% economic growth rhythm for the period 2010-2015, when the factors' contribution to the economic growth are detailed, there are significant differences between the calculations of the two institutions. If IMF anticipates a major contribution of the capital factor to the economic growth (3.4 percents) and a negative contribution of the total-factor productivity (TFP) (0.4 percents), NFC estimates an average contribution of the capital factor which is much lower (1.2 percents) and a significantly positive contribution of the TFP (1.6 percents). This means that IMF considers that the intensive elements of the economic growth – TFP contribution – institutional development, add on the technical progress, research development innovation, competitiveness increase, add on investments in human capital, financial markets maturity etc. – have a lower contribution if compared to the extensive ones – keeping the sustainable growth model – while NFC forecasts a change of the model by predominant elements of economic growth quality until 2015 (Dinu et al., 2011).

The fourth signal is related to the high decrease of the Romanian economy's potential. Romania's post-crisis economic potential is half of the pre-crisis one. The potential GDP increase ratio decreased to a half of that from the pre-crisis period. If during the period 2005-2008 Romania had a potential GDP increase rhythm of 5-6%, the studies show that it will get decrease to 2.5-3% on a medium term. The IMF estimation regarding Romania's economic growth in 2012 got decreased from 3.7-4% to 1.5-2%, i.e. to a half.

The fifth signal is related to the fact that Romania has the lowest degree of absorption of the European funds. If we exclude the pre-financing, we find a real degree of absorption of 4% only.

Table 2

The situation of the structural and cohesion funds' absorption by Romania
(December 31st 2010)

– Mil. Euros –

	Total allocations 2007-2013	Payments - december 2010			Absorption rate (%)	Absorption, exclusive prefinancement (%)
		Total, from which	Prefinancement	Rambursments UE		
Regional development	3,726	554.9	381.4	173.5	14.9	4.7
Environment	4,512	318.5	266.2	52.3	7.1	1.2
Infrastructure	4,565	47.2	0.0	47.2	1.0	1.0
Competititivy	2,554	251.2	106.3	144.8	9.8	5.7
Human capital	3,476	464.2	416.6	47.6	13.4	1.4
Administrative capacity	208	10.2	4.1	6.1	4.9	2.9
Technical assistance	170	9.0	1.2	7.8	5.3	4.6
Total	19,211	1655.3	1175.8	479.5	8.6	2.5

Source: Authority of Coordination Structural Instruments, Fiscal Council calculus.

On march 31st 2011, the absorption rate increased by 1.5 – 2 percents for each program. Totally, the absorption rate increased from 8.6% at the end of 2010 up to 11.06% at the end of the first quarter of 2011. if we exclude pre-financing, the indicator corresponding to the real absorption is of approximately 4% of the total EU assignments for Romania, related to the period 2007-2013.

Starting from the signals listed before and considering the last evolutions of the global economy (especially the turbulences determined by the Euro area sovereign debts crisis), we may agree that the risk of overlaid crises in the Romanian economy has not passed. It is obvious that Romania should avoid the black scenario given by the series of internal shocks which degrade the macroeconomic environment → the uncertainty of the financial markets increases → CDS explodes → we enter a partial default – determined by the impossibility to access the external markets + high depreciation of the RON → liquidity crisis of the budget and so on. We must admit that the vicious circle can be broken with difficulty as we are inside it. The solution of fast indebtness does no longer represent an observable option, as Romania has exceeded the sustainability threshold for the total public debt estimated to 37% of the GDP for a while. Any additional loan will deepen the low economic growth rates, and it will put pressure on the real rates of interest and it will make economy less immune to the future crises.

The following question arises: what has to be done to immunize the Romanian economy? We consider that, firstly, a pack of institutional measures is necessary (this paper will only make reference to this type of measures).

The introduction of the fiscal rules in Constitution. Setting up a fiscal rule of 0.5% of the GDP as a target to be reached by the structural budget deficit until 2016 + a rule for limiting the public debt to maximum 45% of the GDP, with corrective actions at certain thresholds.

Then, it will be necessary to settle a crisis cell in the Minister of Public Finances, which should implement a series of early fiscal stress/ fiscal warning indicators, according to the method proposed by IMF. The crisis cell will implement a report including two signaling instruments: *an indicator for the fiscal vulnerability*, which permanently measures the degree of fiscal vulnerability, and *an indicator for the fiscal stress*, which provides an assessment for the Romanian economy's tendency towards extreme "events", such as non-fulfillment of the fiscal obligations and high peaks in the extent of the interest rate (methods detailed in Baldacci et al., 2011).

In order to efficiently benefit from the financing opportunities existing on the market, the Minister of Finances should conclude cooperation partnerships with investors brokerage companies existing on the international capital markets. Moreover, the Minister of Finances should implement partnerships with famous bank consortiums which should prepare the entrance on the external credit markets in a very short time under favorable conditions. Romania should base on the experience of the brokers and of the bank consortiums in order to speculate the financing opportunities occurring over time, thus reducing the costs with the loans for refinancing the debt or for covering new expenses.

Setting up the Economic Programming and Forecast Council (by restructuring the CNP), an institution which will settle Romania's strategic and development directions, by means of orientative economic programming. CPPE will elaborate a sectoral development strategy, based on the analyses made by the economic research institutes, with reference to the competitive advantages available to the Romanian economy. During the second stage, CPPE will propose a method to prioritize the public investments (the next step being to provide multi-annual financing for the listed investments and to game on the public and private partnership solution for the other investments, their sale or providing financing from extra-budget sources only). By means of its available supports, the government will involve the economic agents in this new development pattern. The state will make massive and priority investments, which will stimulate the economy. Municipal bonds and fiscal facilities will be given for investments in infra-structure, in research and development, in the

human capital, in renewable energy, in IT, in ecologic agriculture and in other superior fields. By means of the multiplying effects of these public funds, orders will be given to the private companies, which will begin to make investments. The subsidies and the state assistance will be conditioned and they will be prioritarily given to the highly competitive potential sectors, settled in the CPPE analyses. CPPE will quarterly monitor the efficiency of investing such public funds towards strategic directions settled according to the EU system of structural indicators.

An emergency could also be the implementation of a pack of measures for the faster absorption of the European funds. The negotiation with EU for the re-assignment of the structural and cohesion funds for Romania + the realistic estimation of the degree of absorption regarding the European funds until 2015 + the remaining amounts enter an Economic Re-launching Fund together with the amounts which have not been attracted by the other cohesion countries + application to EC with reference to the amounts related to co-financing not to be included in the deficit + declaring VAT as exigible.

We consider that Romania should continue the fiscal correction, moving the focus on mechanisms related to the continuous fiscal discipline, to the prioritization of the public investments, to sustainable reforms in education and health and also schemes for the stimulation of the private investments in field with high added value.

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