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REPORT ON GOVERNMENT DEFICIT

25 October 2017

Deficit kept near 3% in Q2, by sacrificing investments; There is no room for further meaningful fiscal easing

- After taking a short pause in the previous quarter, Romania's consolidated ESA deficit widened again in Q2 2017, reaching 3.1% of GDP on 4Q rolling basis (see Chart 1). In addition, the Q2 2017 annualized government balance registered larger deficit too, at 3.7% of GDP, the highest value since the beginning of 2013, our in-house seasonally adjusted data showed. It is worth mentioning that Eurostat's similar indicator for Q2 pointed to even more sizeable budget gap of 4.1% of GDP (the 0.4 percentage-points discrepancy between our and Eurostat's data is explained by methodological differences). This figure put Romania on the first place on the EU's top list, ahead of the United Kingdom (3.4%) and France (2.8%), and far from the 1.3% average deficit of the European community.
- The fresh data can be perceived as a warning sign that decision-makers have gone too far with stimulus measures and more prudent policies should come in order to avoid the risk of an excessive deficit procedure as well as the potential overheat and building up vulnerabilities. We recall that on the back of a prolonged and painful period of consolidation, supervised by international institutions, Romania's budget position improved remarkably until 2013/14, helping the economy to get back to a sustainable trajectory. However, after the return of healthy growth rates, implying more room for manoeuvre, fiscal policy became strongly pro-cyclical again, putting significant pressure on government balance.
- Albeit less sharply than in the previous few quarters, revenue collection continued to shrink, ending Q2 2017 at only 30.9% of GDP (4Q rolling), down from the post-crises peak of 35.0% (Chart 2). This was one of the lowest figures in the EU28 (Chart 3). We also point out the fact that Q2's 30.9% level is even below the bottom seen in Q2 2010, before the budget consolidation process (a key condition of the IMF-EC bailout package) had started. It should be added that revenue collection has been a persistent bottleneck of Romania's government finances, as revenues never exceeded 36% of GDP in the past two decades, given the relatively moderate tax rates and sizeable shadow economy. Apparently, the latest tax reductions exacerbated the situation (Chart 2). Curbing production taxes was the key factor behind falling budget revenues, after the government scaled back the VAT rates several times and provided other fiscal reliefs too (Chart 4). At the same time, struggling EU fund absorption also weighed on revenues, while social security contributions helped to ease the negative effects, after getting a boost from the cyclical upswing of the economy.
- The evolution of VAT revenue was clearly disappointing in Q2 2017, as it reached only RON 11.6 bn, falling 5.9% YoY (Chart 5). The one-percentage-point reduction of the standard VAT rate (from 20% to 19%) together with rebounding consumption (households' expenditures grew by 9.8% YoY in nominal terms in Q2 2017) had indicated a much more favourable outturn. This suggests that collection efficiency might have worsened. We recall that Romania recorded the largest VAT gap in the EU28 in 2015 (Chart 6), losing around RON 34 bn (4.8% of GDP) from uncollected value added tax. In this context, it is important to underline that efficiency improvement should to be a crucial objective. The example of other CEE countries underpins that important results can be achieved even in a relatively short period.
- Amid sharp public wage hikes and higher social benefits, the main tool to cut back government expenditures was sacrificing public investments (Chart 7). To a lesser extent, a tight control over purchases of goods and services as well as contracting financing costs also helped to keep government expenditures under control. Nevertheless, it is important to note that the current mix of expenditures, with supporting consumption on the detriment of investments, is set to fuel further overheating concerns and likely will take toll on the country's growth potential. The most frequently cited impediments of Romania's economic outlook are underdeveloped infrastructure, low quality of health services and primary education as well as corruption. Given the strong economic performance on the domestic front and the supportive external environment, we think that there is still a window of opportunity to address these structural bottlenecks, but we afraid that the under current policies this chance will be missed.
- Regarding the 2017's perspective, we think that the deficit will meet the 3% objective, as several correction measures were already enforced or announced, including the extra dividends from majority state-owned companies, the threshold for social security contributions in the case of part-time workers and the re-introduction of the special excise duty on fuels. Nevertheless, the outlook for 2018 remains foggy, as the government keeps to its plan to lower the personal income tax to 10%, down from 16%, and also aims to cut social security contributions by 4.25 percentage points, to 35%, while further public wage hikes are also on the agenda. These actions are set to lift the deficit above 4% in 2018, calling for proper correction measures. In this context, it seems that the government budget will remain the primary macroeconomic risk of the country next year too, even though Romania's public debt is still low (Chart 9).

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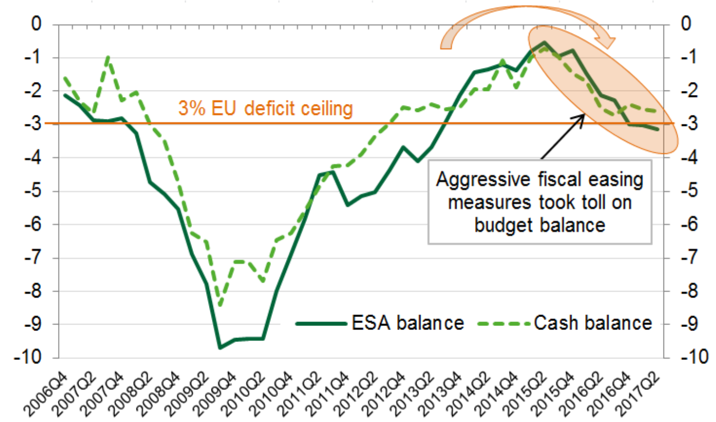
- Given the already increased financing need of the government (Chart 10), pro-cyclical fiscal policy in an economic expansion raises the chance that austerity measures will have to be implemented when significant external or domestic shocks come up.

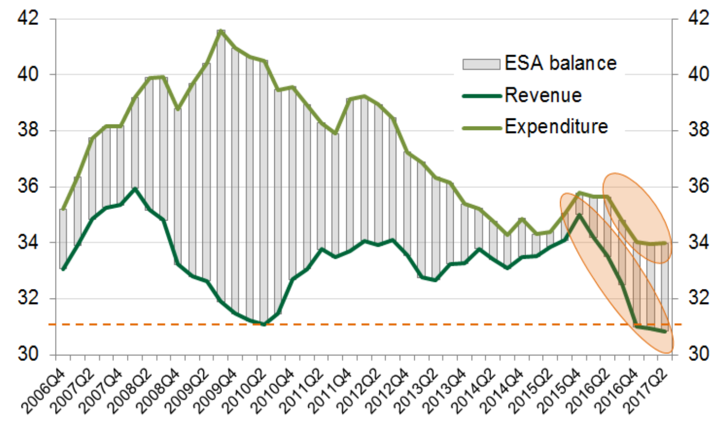
Chart set:

Chart 1: Consolidated general government balance (as % of GDP, 4Q rolling)



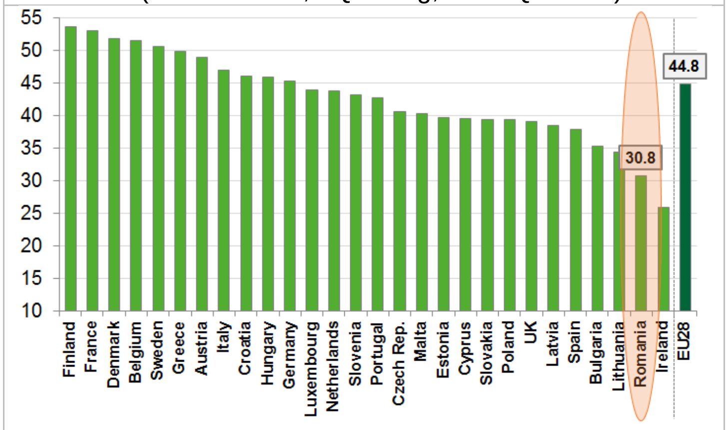
Sources: Eurostat, Ministry of Finance, OTP Research

Chart 2: Consolidated general government balance, revenue and expenditure (as % of GDP, 4Q rolling)



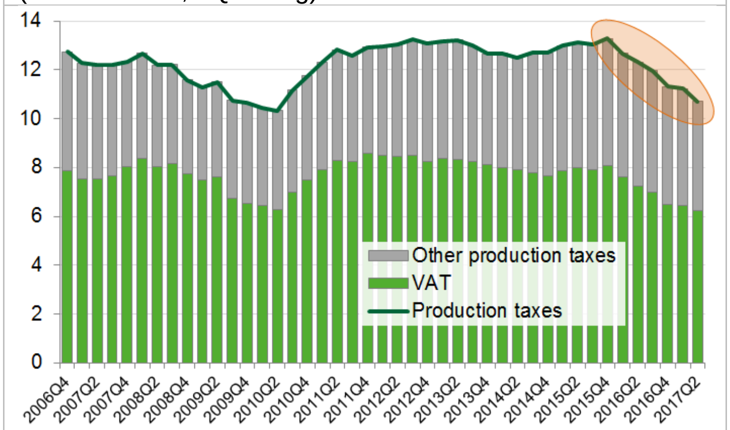
Sources: Eurostat, OTP Research

Chart 3: Consolidated general government revenue in the EU28 (as % of GDP, 4Q rolling, as of Q2 2017)



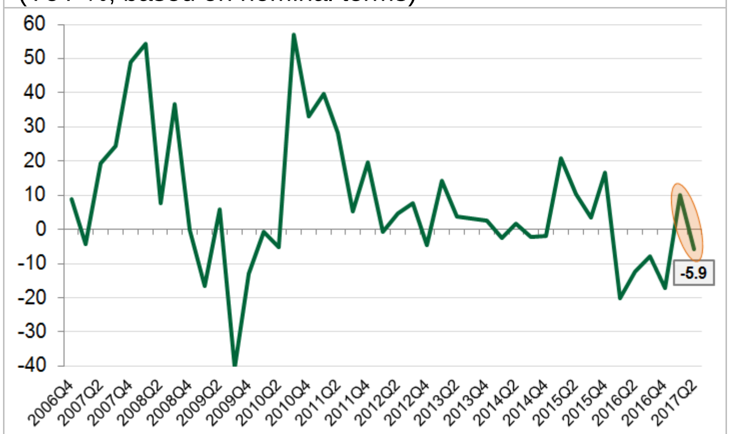
Sources: Eurostat, OTP Research

Chart 4: Production taxes (as % of GDP, 4Q rolling)



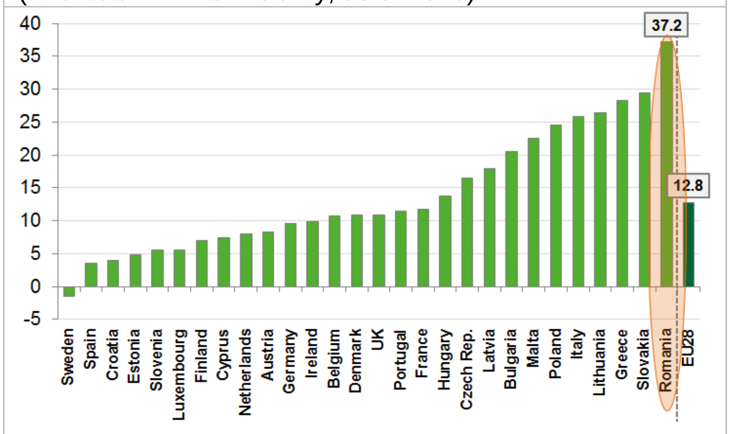
Sources: Eurostat, OTP Research

Chart 5: Revenues from VAT (YoY %, based on nominal terms)



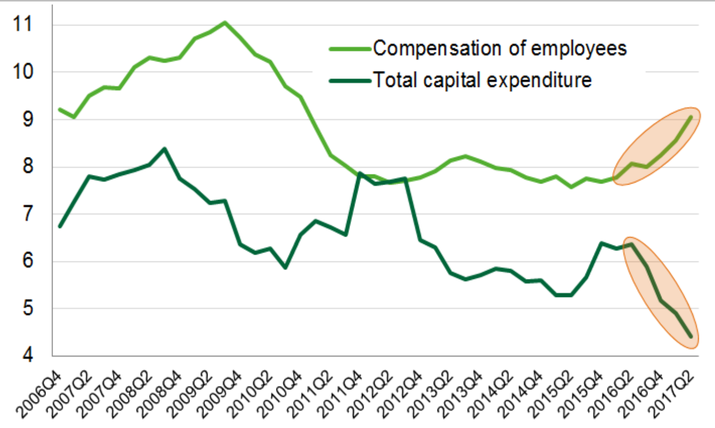
Sources: Eurostat, OTP Research

Chart 6: VAT gap estimates in the EU28 (% of total VAT tax liability, as of 2015)



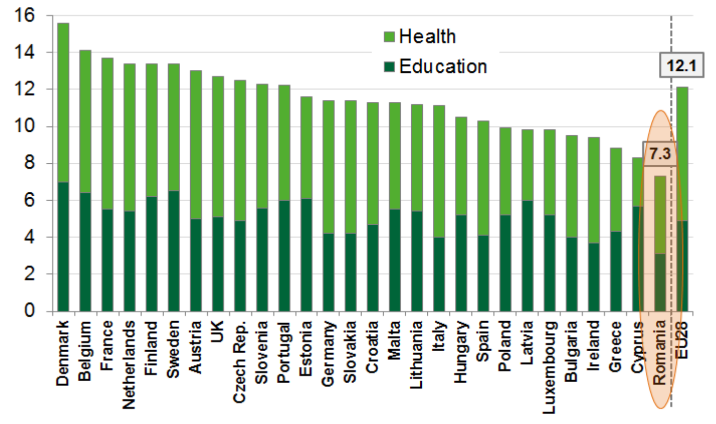
Sources: European Commission, OTP Research

Chart 7: Compensation of employees vs. public investments (as % of GDP, 4Q rolling)



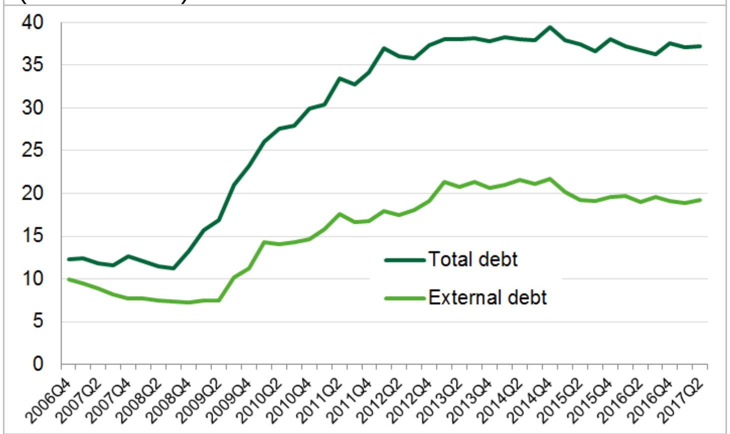
Sources: Eurostat, OTP Research

Chart 8: Expenditures for education and health in the EU28 (as % of GDP, as of 2015)



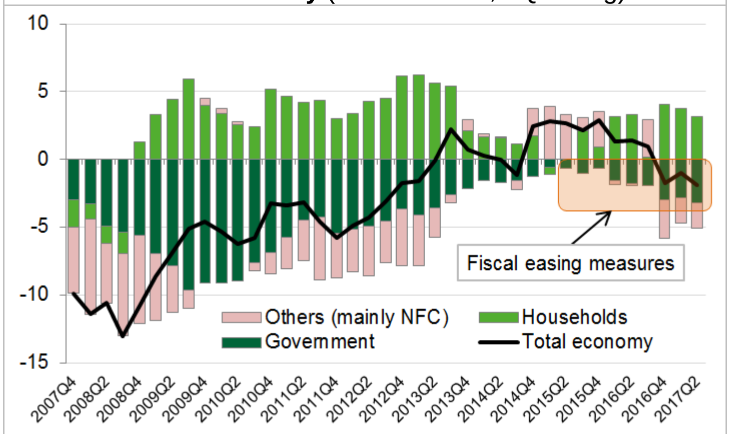
Sources: Eurostat, OTP Research

Chart 9: Public debt (as % of GDP)



Sources: Eurostat, NBR, OTP Research

Chart 10: Net financing capacity of the main sectors and the whole economy (as % of GDP, 4Q rolling)



Sources: NBR, NIS, OTP Research

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