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REPORT ON GOVERNMENT DEFICIT

5 February 2018

Deficit dancing near 3%

- Romania's ESA deficit, the key indicator monitored by the European Commission to evaluate the budget performance of EU member states, was near 3.1% of GDP at the end of Q3 2017, a touch lower than a quarter earlier (data calculated on 4Q rolling basis, see Chart 1). This gap exceeded by a slim margin the ceiling specified under the terms of the EU's Stability and Growth Pact. Nevertheless, deficit is likely to have met or even undershot the 3% objective at the end of 2017, helped by several correction measures and Romania's strong economic performance. High-ranking officials in the Ministry of Finance also noted that the government budget registered no more than 2.8% deficit under ESA rules in 2017. Timelier cash-basis data pointed to 2.88% gap at the end of last year, in a recent report of the finance ministry. Eurostat estimates the seasonally adjusted Q3 ESA deficit at 2.5% of GDP, implying some improvement from Q2's 3.7% (revised down from 4.1%).
- We reiterate that on the back of painful consolidation efforts, supervised by the IMF and the EC, Romania's budget position improved remarkably until 2014 (Chart 3), also helping the economy to get back to a sustainable trajectory. Nonetheless, the big picture has started to change, as policy-makers decided to utilize the fiscal room to implement a series of aggressive stimulus measures. Therefore, the budget became again highly pro-cyclical, putting important pressure on the government balance. Romania's large-scale loosening policy was in contrast with the general improvement of the EU's fiscal framework. In order to keep the deficit close to the 3% limit, Romanian authorities sacrificed public investments and enforced several other correction measures, including the re-introduction of the special excise duty on fuels and extra dividends from majority state-owned companies. However, the surprisingly strong performance of the economy also helped to keep the gap under control.
- Admittedly, revenues seemed to stabilize near 31% of GDP in Q3, after a period of sharp falls triggered by tax cuts (Chart 2). This level is still extremely low compared to other EU countries (for further details see our previous report) and therefore it continues to represent an important bottleneck for government finances. Production tax collection remained subdued, even if VAT revenues rebounded in Q3 (Charts 4 and 5), after Q2's definitely disappointing performance. The sluggish evolution of production taxes was mainly offset by rising social security contributions, which were helped by the booming economy and exceptionally tight labour market.
- The worrisome trends on the expenditure side were not contained in Q3. Labour compensation increased further, but indeed at a slightly slower pace, reaching almost 9.4% of GDP, a new multi-year peak (Chart 6). Undoubtedly, a ratio exceeding 9% is not an extreme one in the EU28 (the EU average was at 10% at the end of Q3 2017), but this indicator masks the fact that Romania persistently suffers from low revenue collection. Personal expenses compared to general government revenues (an alternative measure, which more accurately reflects the budget's capacity to sustain public wages) reveal a concerning picture (Chart 7). On average, Romania's government spent RON 30.4 out of RON 100 collected revenue in Q3 2017. This is significantly higher than the similar indicator for the EU28 (22.2). In addition, the ratio is set to increase further in 2018, given new wage hikes. Admittedly, salary increases are almost unavoidable due to the tight conditions on the labour market and as these also help to keep qualified workforce in the country, but more prudent policies would be welcome in order to preserve budget equilibrium.
- Similarly to the previous quarters, the main tool to keep the deficit under control was sacrificing investments (Chart 6). Romania usually registers significantly higher capital expenditures than the EU average, a rather common feature for countries with weak infrastructure. However, this has changed recently (Chart 8). A pick-up in public investments is still expected in 2018, underpinned by higher EU fund absorption; but negative risks prevail.
- With a quite stretched budget plan, this year's 3% deficit target appears to be challenging too. The plan relies on 5.5% GDP growth projection. This is not completely out of the range, but still seems to be very ambitious. In our opinion, the planned VAT revenues are rather overestimated and question marks surround certain one-off revenues too. Meanwhile, important tax changes (primarily, the transfer of social security contributions from employers to employees and the PTI cut) adds to uncertainties. Summing it up, we expect 3.8% GDP deficit under the current form of the plan, but similarly to 2017 correction measures may follow to keep the gap at the 3% ceiling. The long-term budget strategy points to a gradual consolidation in the following years. Nonetheless, we have doubts about the plausibility of these plans, particularly given the latest promises included in the updated governing programme of the new, Dancila cabinet. Among others, the updated programme foresees another one-percentage-point VAT rate cut starting from January 2019, gradual but significant pension hikes (around +60% until 2020), tax relief for certain professions, and lifting social transfers. The government will also analyse the modifications of the PTI system, including a tax relief for low-income individuals. In the absence of adjustment actions, these measures may lift the deficit to around 4% after 2018.

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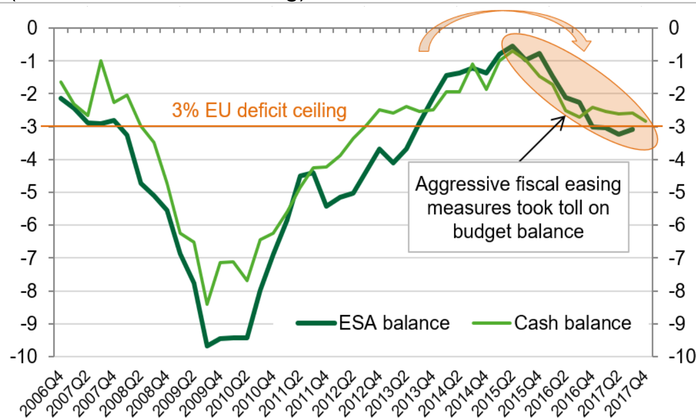
- Nevertheless, the government looks to be committed to the target, and therefore, we do not expect a major slippage from the 3% target but risks have definitely increased. In the light of the latest statistics, as well as the old and new plans of the government, we maintain our opinion that Romania's key domestic risk is coming from the pro-cyclical fiscal policy. Beyond the size of the deficit, the revenue and expenditure structure is also a key issue. If decision-makers had maintained capital expenditures at the average level of the past decade (6.4% of GDP), the budget deficit would have risen above 5.5% at the end of Q3 2017, underscoring that a re-calibration of policies would be welcome (including the enhancement of tax collection efficiency) in order to support Romania's growth potential. Equally importantly, under the preventive arm of the EU's Stability and Growth Pact, the country's government budget is already closely monitored by EU authorities, with the EC recommending 0.8 pps adjustment in 2018 relative to the 2017 gap. We recall that pro-cyclical fiscal policy in boom period adds to chances that austerity actions will have to be enforced when a downturn hits the economy. Undoubtedly, the low public debt is a strong point of the country (Charts 9 and10), but given the current domestic and external inflationary environment as well as due to concerns around the budget, financing costs are expected to increase.

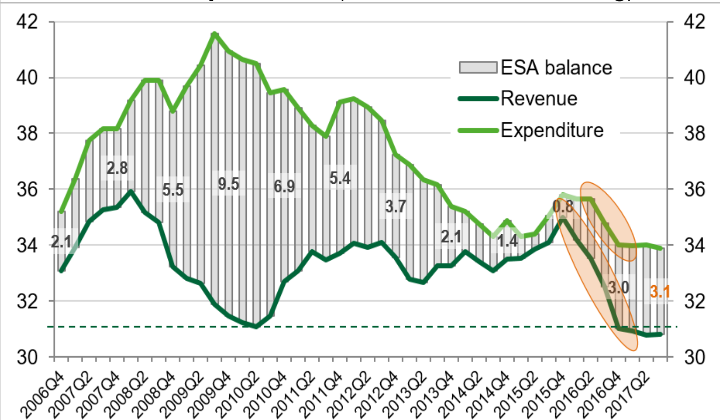
Chart set:

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



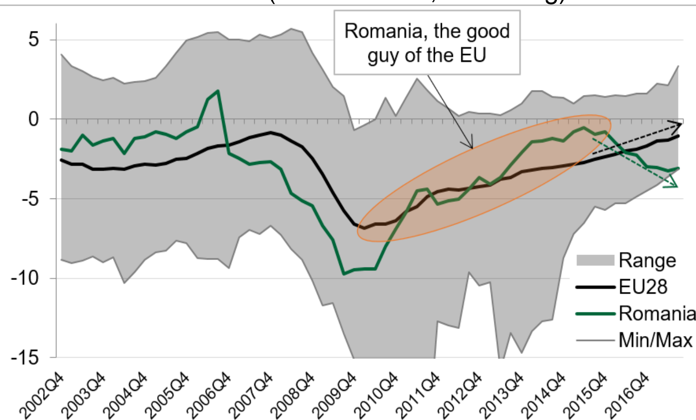
Sources: Eurostat, Ministry of Finance, OTP Research

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



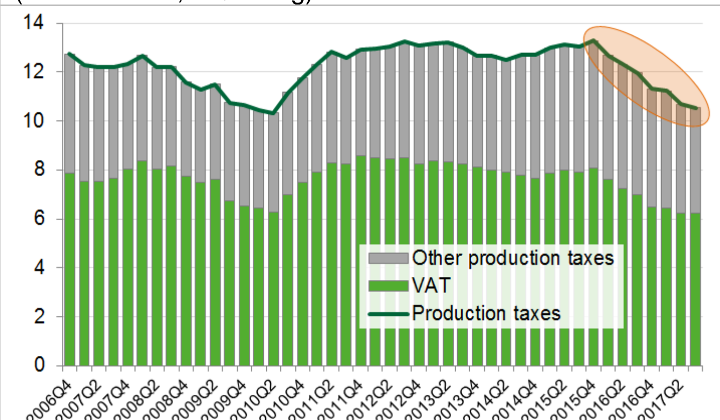
Sources: Eurostat, OTP Research

Chart 3: Consolidated general government ESA balance in the EU28 (as % of GDP, 4Q rolling)



Sources: Eurostat, OTP Research

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

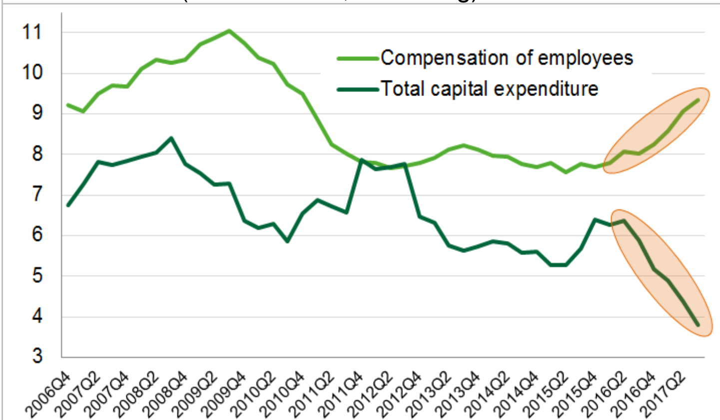


Sources: Eurostat, OTP Research

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

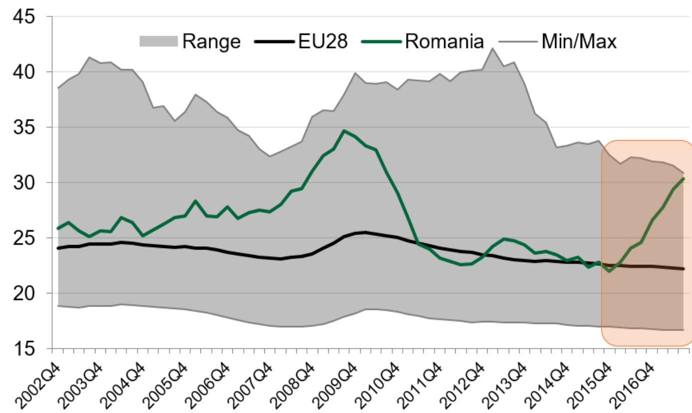
Sources: Eurostat, OTP Research

Chart 6: Compensation of employees vs. public investments (as % of GDP, 4Q rolling)



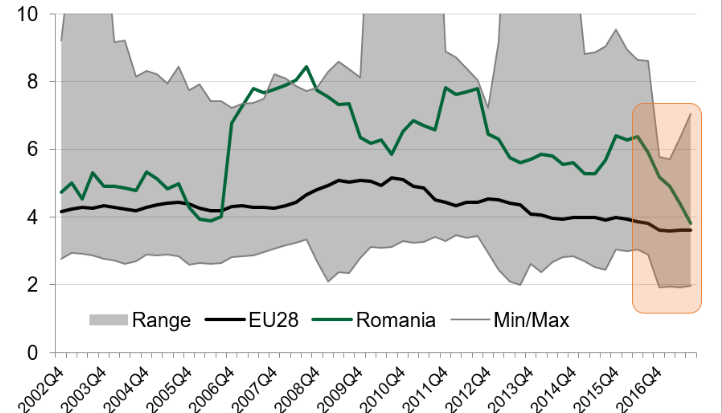
Sources: Eurostat, OTP Research

Chart 7: Compensation of employees in the EU28
(as % of general government revenue, 4Q rolling)



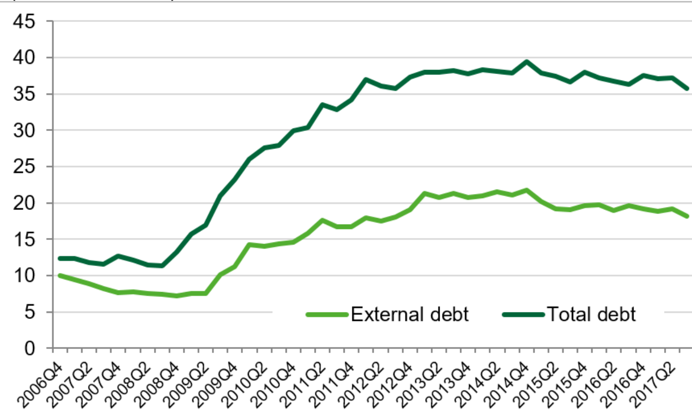
Sources: Eurostat, OTP Research

Chart 8: Total capital expenditures in the EU28
(as % of GDP, 4Q rolling)



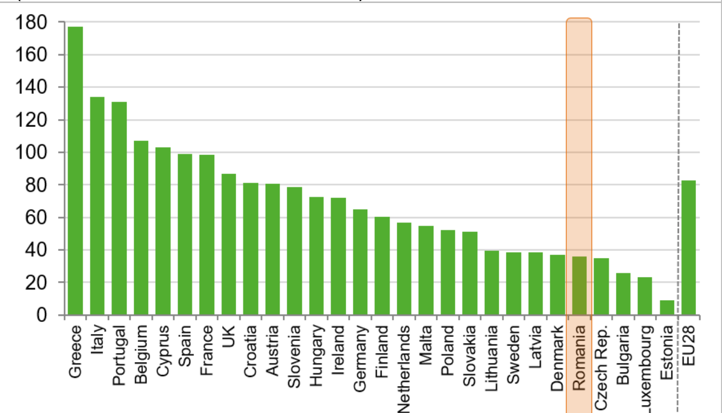
Sources: Eurostat, OTP Research

Chart 9: Romania's public debt
(as % of GDP)



Sources: Eurostat, NBR, OTP Research

Chart 10: Public debt in the EU28
(as % of GDP, as of Q3 2017)



Sources: Eurostat, OTP Research

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