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REPORT ON GOVERNMENT DEFICIT

31 July 2018

Rising public wages and social benefits put further pressure on Romania's budget balance
The 3% deficit target seems to be particularly challenging

- In the first quarter of 2018, Romania's government budget balance registered an annualised deficit of 4.2% (ESA methodology; seasonally adjusted data), according to a Eurostat report. Our in-house estimation showed a somewhat lower gap of 3.9%. However, annualised quarterly statistics can be quite volatile, particularly in the case of Romania. Nevertheless, the four-quarter rolling balance, a better indicator for identifying long-term trends, also showed 3.3% deficit, up from Q4' 2.9% (see Chart 1). This level was the highest in the EU (Chart 3). In addition, timelier cash-flow-based statistics suggest that the worrisome trend might have continued in Q2 too (Chart 1), as the rising public wage bill and increased social benefits put further pressure on the government budget. The good news is that Romania's public debt remained relatively low, slipping below the 35% threshold (Charts 2 & 4).
- Regarding the broader picture, we reiterate that owing to a series of painful austerity measures, Romania's budget deficit had been reduced remarkably after the financial crisis. Nevertheless, the deficit marked a turning point in 2015 when policy makers started to utilize the created fiscal room and cyclical revenues mainly for tax cuts and public wage hikes, while scaling back investment. Simultaneously, gross savings (the difference between current revenues and current expenditures), dipped into negative territory (Chart 5). In effect, this means that authorities have to seek financing not only for investment but even for a portion of operational expenditures and social transfers, a rather unusual occurrence at the expansion stage of the economic cycle. Due to the budget's strongly pro-cyclical feature and its unfavourable structure, fiscal policy remains the main macroeconomic risk in Romania.
- After hitting a multi-year record low in the second half of 2017, general government revenues picked up in Q1 (by around 0.4 percentage points; see Chart 6), primarily bolstered by the tight labour market. However, it is important to underscore that the revenue side of the budget remained a weak point, particularly compared to revenue ratios seen elsewhere in the EU (Chart 7).
- In Q1, net social contributions continued to increase, reaching 9.8% of GDP, up from 9.3% in the previous quarter. On the one hand, this advance was supported by higher salaries. We note that the growth pace of average net wages in the economy lost some momentum in Q1 (11.6% YoY vs. 12.9% YoY in Q4), but still exceeded that of nominal GDP (around 10%). Meanwhile, the number of employees kept rising too, with a positive effect on budget revenues. At the same time, the latest tax changes also provided a boost for social contributions. The modification of the fiscal code was close to a zero-sum game, but it caused shifts in the structure of revenues. As of January 2018, the burden of social contributions was transferred, almost entirely, from employers to employees and the personal income tax (PIT) was lowered from 16% to 10%. In order to offset the negative effect of the sudden jump in households' social contribution ratio and keep net salaries at least flat, employers were urged to raise gross wages by around 20%. The increased base for tax calculation purposes resulted in higher revenues from social contributions (Chart 8). On the other hand, the lowered PIT rate contained revenues from income taxes.
- At the beginning of 2018, levies on production and trade decreased too, as VAT revenues dipped by 0.1 pp, to 6.1% of GDP. This could be the result of low efficiency of collection and a deceleration in households' consumption expenditures. The other key lines of the revenue side were broadly unchanged.
- The expenditure side of the budget became even more worrisome as expenditures pointed to a sizeable upswing (+0.8 pps), exceeding 34% of GDP (Chart 6). The pick-up was mainly due to the rising compensation of employees and to higher social transfers. We reiterate that as a share of GDP, public wages are broadly in line with EU standards (close to 10%), however compared to budget revenues they are out of the range by a wide margin (Chart 10). We also recall that in the past few years reducing public investments was the key instrument to counteract the increasing bill of wages and social benefits. However, this was not the case in Q1 (Chart 9) when total capital expenditures remained flat, first of all owing to the acquisition of a Patriot missile system. It should be also added that public investment, measured as a share of GDP, remained below the EU average (Chart 11). This is expected to limit Romania's potential economic growth rate over the long term.

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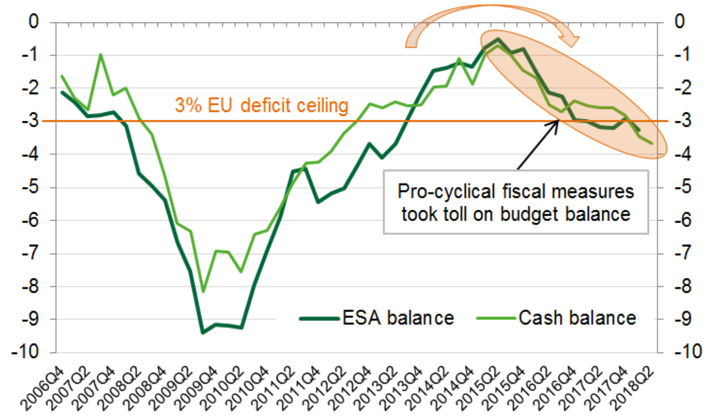
- Timelier Q2's cash-flow-based budget statistics provided a warning sign too, with the gap hitting 1.6% of GDP in the period of January-June 2018 (Chart 12). This widening was again due to the increasing wage bill and social benefits, while higher borrowing costs also started to weigh. With another 10% pension hike on 1 July, the outlook seems to be even more challenging.
- Summing it up, we think that in the absence of adjustment actions, this year's budget deficit could reach around 3.8% of GDP. However, implementing correction measures is quite likely in order to keep the gap close to the 3% target. We recall that policy makers scaled back public investment, re-introduced the special duty on fuels, while asking for extra dividends from majority-state-owned companies also helped in the second half of 2017. Nonetheless, the latest statistics indicated that this year's job is more challenging, therefore we see higher risk of a deviation from the target.

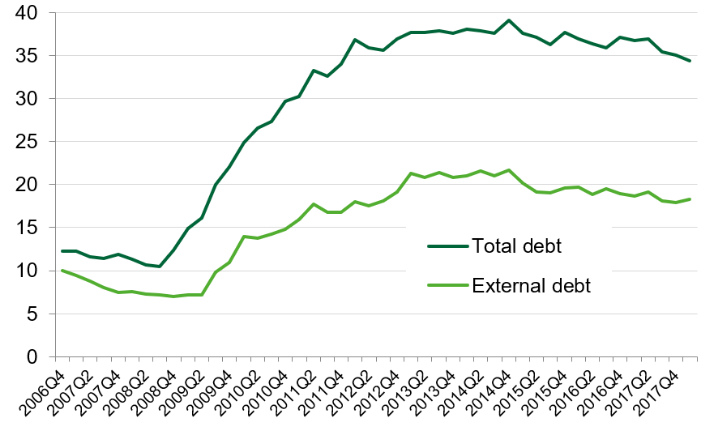
Chart set:

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



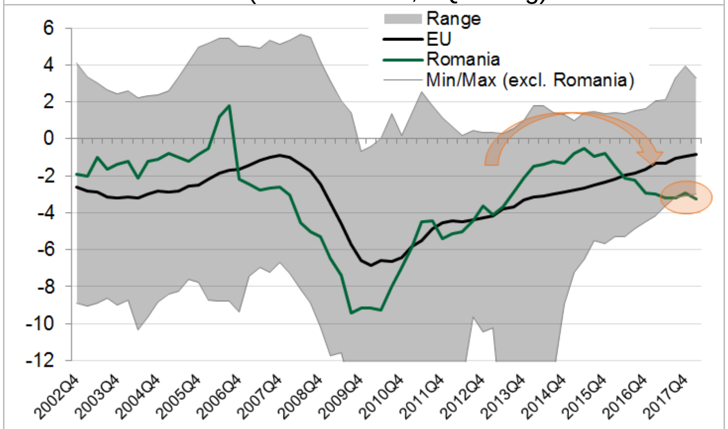
Sources: Eurostat, Ministry of Finance, OTP Research

Chart 2: Romania's public debt
(as % of GDP)



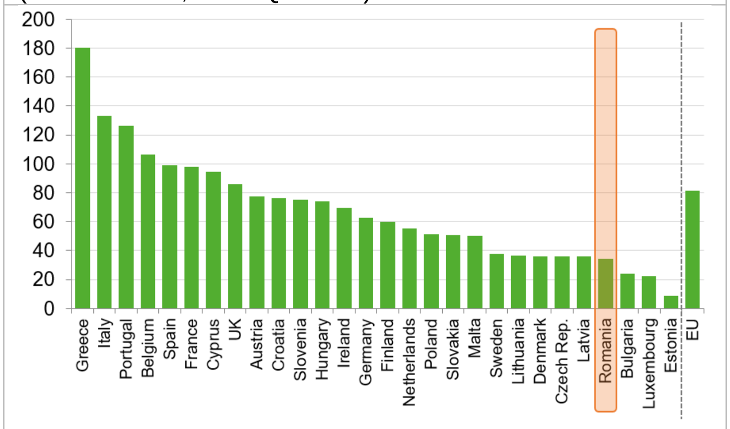
Sources: Eurostat, NBR, OTP Research
Note: external debt data based on BPM5 methodology until 2012 Q4

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



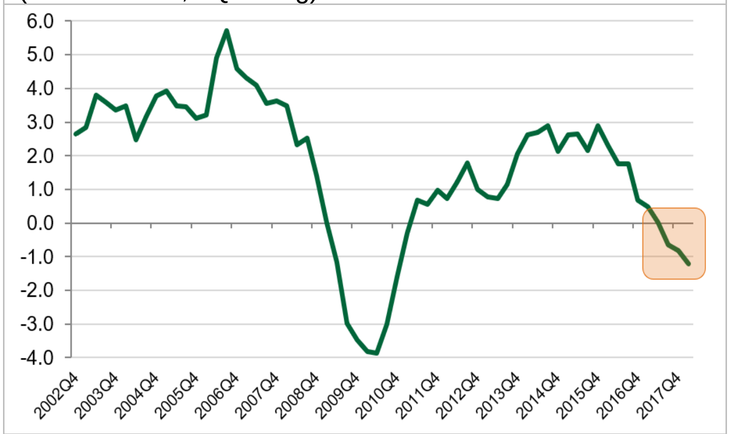
Sources: Eurostat, OTP Research

Chart 4: Public debt in the EU
(as % of GDP, as of Q4 2017)



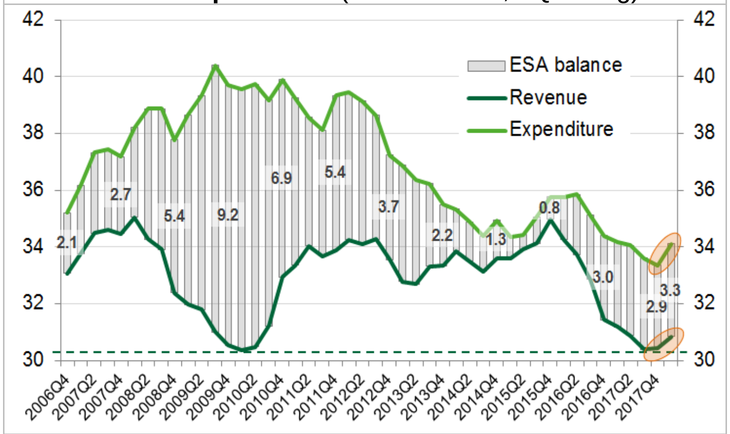
Sources: Eurostat, OTP Research

Chart 5: Gross savings
(as % of GDP, 4Q rolling)



Sources: Eurostat, OTP Research

Chart 6: Consolidated general government balance, revenue and expenditure (as % of GDP, 4Q rolling)



Sources: Eurostat, OTP Research

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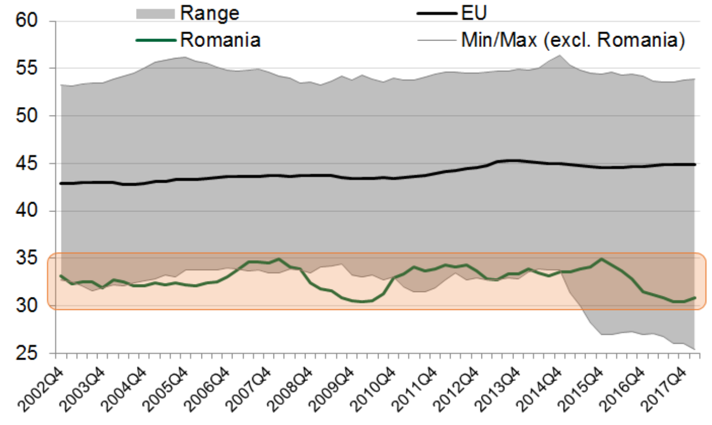
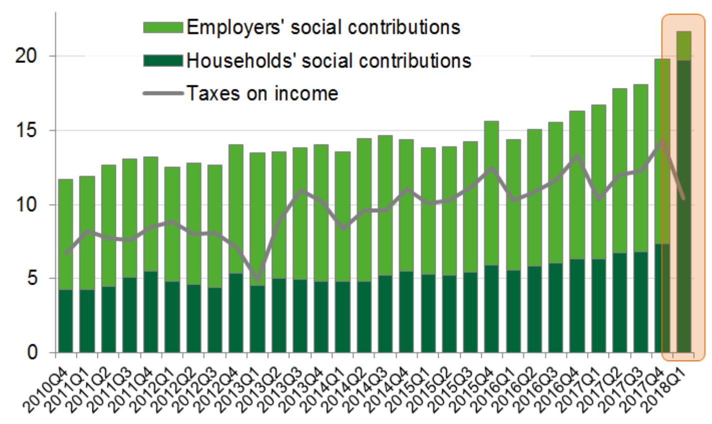
Chart 7: Consolidated general government revenue in the EU (as % of GDP, 4Q rolling)



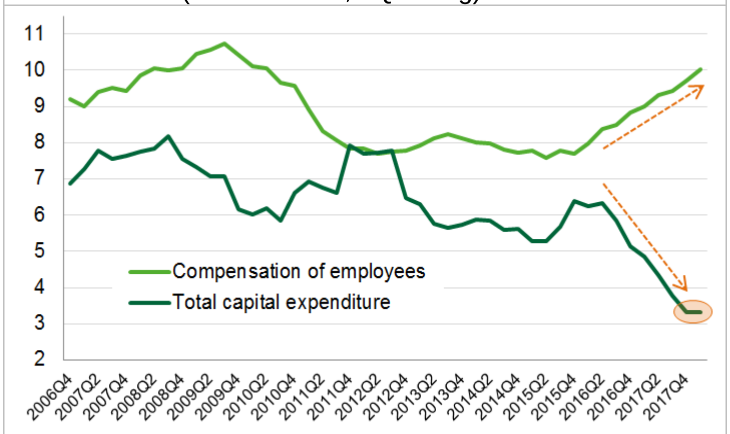
Sources: Eurostat, OTP Research

Chart 8: Net social contributions and taxes on income (RON bn)



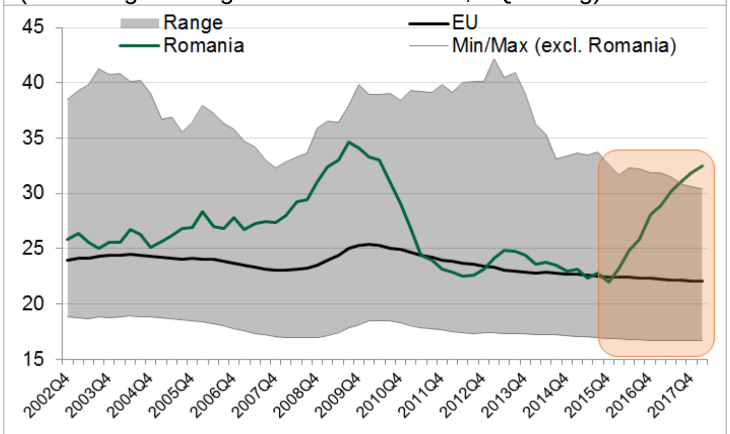
Sources: Eurostat, OTP Research

Chart 9: Compensation of employees vs. public investments (as % of GDP, 4Q rolling)



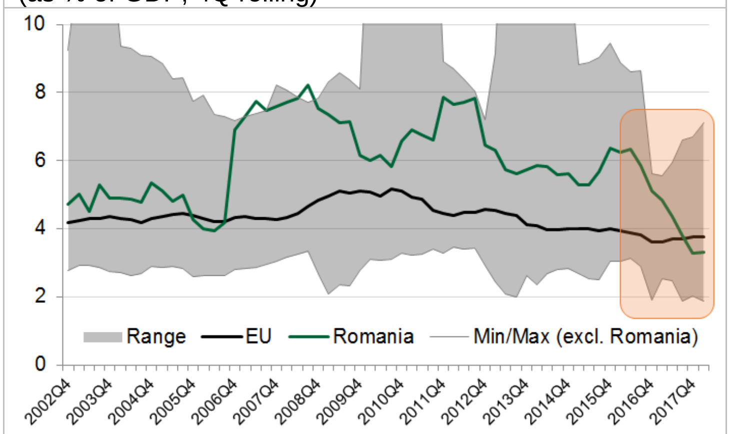
Sources: Eurostat, OTP Research

Chart 10: Compensation of employees in the EU (as % of general government revenue, 4Q rolling)



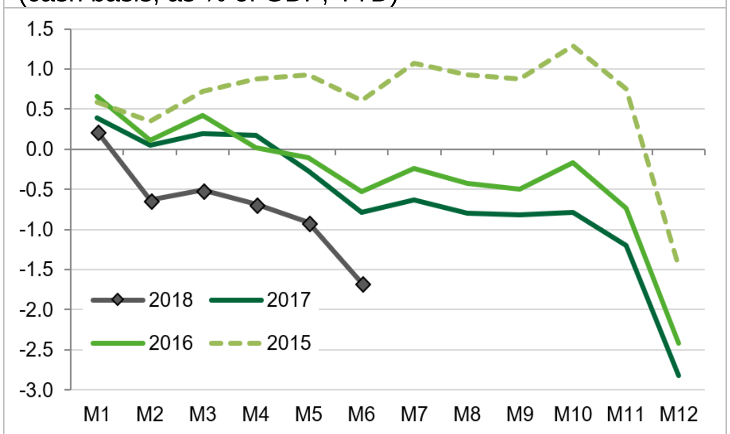
Sources: Eurostat, OTP Research

Chart 11: Total capital expenditures in the EU (as % of GDP, 4Q rolling)



Sources: Eurostat, OTP Research

Chart 12: Consolidated general government balance (cash basis, as % of GDP, YTD)



Sources: Ministry of Finance, OTP Research

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