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Focus Notes: Romania

Romania: Fiscal deficit widened further in the first seven months of 2010

- ✓ The consolidated budget deficit climbed to RON 20 billion in the first seven months of 2010, rising by 13.9% yoy. As a percentage of (projected) full-year GDP, the consolidated government deficit stood at 3.9% in July, compared to 3.6% in June and 3.5% in the same month of last year and against a full year target of 6.8%-of-GDP.

- ✓ Total revenues were up by only 1.4% yoy against a targeted increase of 4.6% yoy over the corresponding period Although the year-to-July growth of tax revenues was slightly stronger than in the same period a year earlier, tax collection was still problematic. Receipts from income tax and social contributions were also lower (by -6.3% yoy and -5.3% yoy, respectively), reflecting the impact of the weak labor market conditions.

- ✓ VAT revenues also underperformed despite the 5pps VAT rate hike (from 19% to 24% effective from July 1st). VAT revenues were lower by 0.8% yoy in January-July, against -3.7% yoy in H1. In our previous (June 2010) issue of *New Europe Economic& Strategy*, we suggested that the risk of the VAT rate hike falling short of generating the expected results was not minimal. The data released so far appear to have corroborated the latter view. That is because higher tax rates in a recessionary environment generates additional tax evasion, lower economic activity and thus, lower tax revenues. This is particularly the case in Romania where a large part of the economic activity is not yet properly recorded -grey economy.

- ✓ On the expenditures side, total budget outlays were modestly higher (by 3.2% yoy) year-to-July. This was the combined result of a massive cut backs in capital spending (-23.2% yoy) and increased social security expenditure for unemployment benefits (+11.2% yoy). On a more positive note, we anticipate that the fiscal data for August will look better, as they will incorporate the impact of the 25% public wage cut and some further improvement in VAT revenue collection.

- ✓ In our view, the 6.8%-of-GDP (revised) fiscal target looks more attainable than the previous ones, yet its fulfillment continues to be a Herculean task. The attainment of the target would require

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monthly budget deficits of approximately RON 2.9 bn. Given the progress on budget execution in the first seven months, the latter does not seem improbable. However, there are still significant uncertainties and downside risks. The first one is coming from negative surprises in the growth outlook. The impact of the looming double-dip recession on the domestic demand could turn out to be more-pronounced-than-currently-anticipated, affecting negatively tax collection. If such a risk materializes, additional fiscal adjustment on the spending side may be required.

- ✓ Secondly, there is less room for fiscal policy maneuvering from the accumulation of arrears towards the private sector compared to last year. IMF cannot be as lenient even though the government is asking for a waiver, as the integrity of the program has to be maintained until the end (due in May 2011). In that respect, IMF has asked the government to pay off RON 2bn in arrears before the disbursement of the next tranche.

- ✓ Furthermore, the government has committed to implement a range of harsh and highly-unpopular spending cuts. The total public sector wage bill ought to be cut by around 2 pps of GDP on a permanent basis. The press has repeatedly mentioned that this would necessitate significant layoffs in the public sector. Presumably, lay offs could reach 100,000-250,000, which is indeed horrifying. Yet, there has so far been no official announcement on how to implement these layoffs or whether the 25% public wage cut, introduced temporarily to generate the required public sector saving, will be extended after January 1, 2011. Finally, those cuts may encounter significant resistance from trade unions and also test the cohesion of the government coalition. The political risk is high given the thin majority in the parliament-by only 4 seats. As such, the possibility of having early parliamentary elections that would derail the IMF program cannot be ruled out entirely.

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