Walking a thin line

2017 Romanian budget

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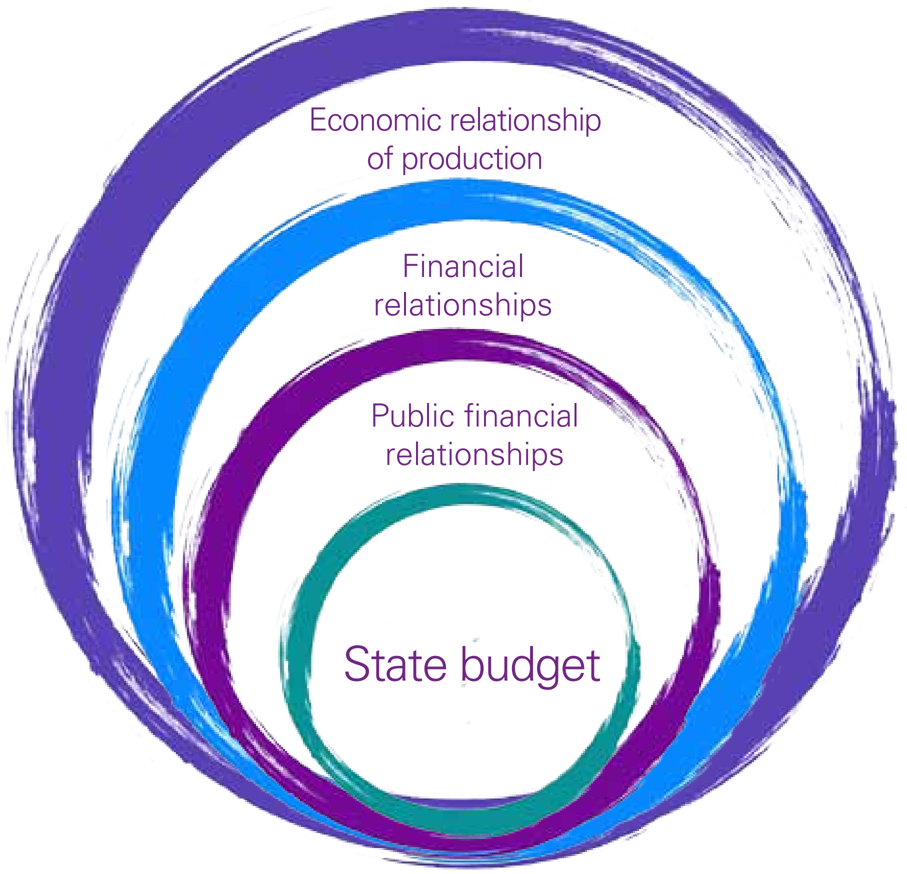
Economics

Introduction

Each year the Government announces the draft state budget. Apart from being one of the most important tasks of the executive, it is also an opportunity for numerous and sometimes fierce debates between political decision makers. In parallel, this exercise is widely covered by the media and the reverberations are propagated extensively at social and business levels. Traditionally, governmental budgets embody several functions, beside the relatively obvious one of monitoring the Government's overall revenues and expenditures. One of the most important functions is to ensure economic stability and avoid fluctuations, as much as possible. This is achieved by stabilizing prices in the economy, using policies of budget deficit/surplus as the main tool. Another similarly important function is to ensure economic growth. Here the government juggles with two budgetary elements; savings and investments, and so it must ensure through the relevant budgetary policies that there are sufficient resources for investments to be made in the economy. Last but not least, the budget is designed to achieve an effective allocation of resources by taking into account economic and social considerations (this also fulfils a secondary role of reducing possible disparities or inequalities). Figure 1 below summarizes the state budget's position within the framework of a functional national economy.

Figure 1 - National economy's functional components



> *"The national budget is built through an attempt to strike a balance between the intensity of policy interventions and the predictability of the resulting outcomes*

In western democracies, the government budget is perceived by the business environment more as a strategic document rather than a bureaucratic exercise. Part of this perception is due to the intrinsic assumption that the national budget is built through an attempt to strike a balance between the intensity of policy interventions and the predictability of the resulting outcomes. (This conception is, of course, supported by years of similar experiences). As such, the budget provides important hints as to the strategies to be pursued by the government at macroeconomic level, as well as the tools and measures to be used to implement them. In Romania these hints are to be found in the macroeconomic reports that accompany the proposed budget document. The relevance and possible implications for business reside in the fact that this information may then be turned into strategic, decision making inputs at corporate level.

Nevertheless, the budget is still a planning exercise, and similarly to a household or corporate budget it is built on forecasts, predictions are made, and the possibility of changes occurring is rather high. Consequently, when discussing budget predictability one should keep this in mind.

Coming back to the annual governmental budget, not everybody is a government budget expert, and the time required to go through all the relevant data would be significant. The abundance of technical information surrounding the budgeting exercise may prove overwhelming and difficult to decipher. In this context, the *Economics* series has undertaken the task of analyzing some of the Government's most important budgeting projections for 2017 with the aim of further providing a simplified overview of the relevant implications which have an impact on businesses and individuals alike, thus helping to make sense of the budget.

What has the government put together in this year's budget, and what are the main economic assumptions used? Who are the winners and losers according to the projections, and what impact is this exercise going to have on the business environment? We invite you to explore the answers to some of these important questions in our analysis below.

A brief explanation

The 2017 State Budget

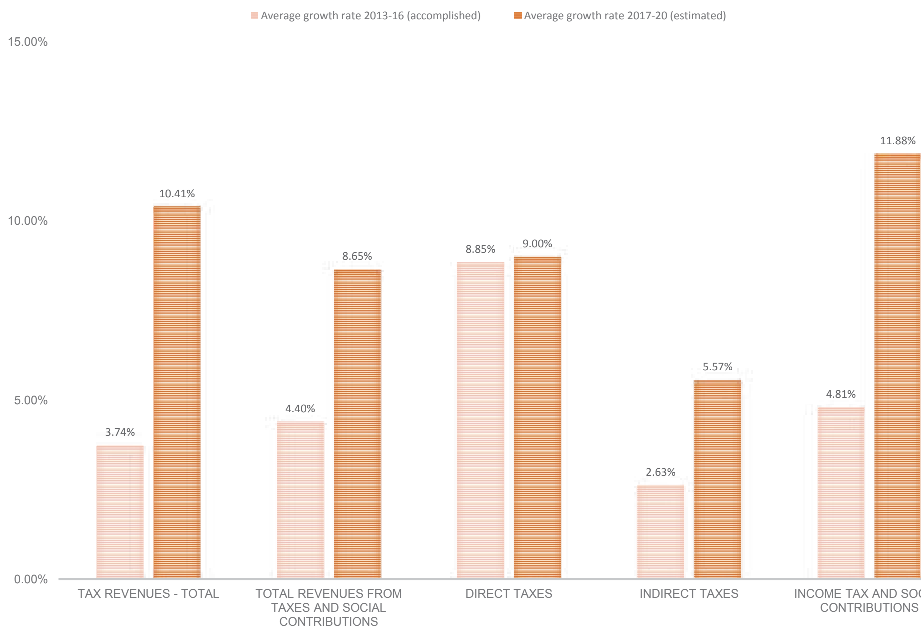
The analysis has been made based on budget projections for the period 2017 - 2020, which reveal some conclusions below:

1. **Economic growth is expected to be based on consumption**
   The projected development of the economy in the period under review is based on consumption, as demonstrated by the decreasing tendency of the average annual growth rate during the period 2017-2020 of revenue from indirect taxes (i.e. 5.57%), as compared with the increased rate of revenue from direct taxes in the same period (i.e. 9.0%).

2. **Consumption will also be encouraged by the following budgetary measures:**

a) The minimum gross salary will be increased to 1,450 lei / month.
b) Salaries for staff in health and education sectors will be increased by 15%.
c) Salaries for staff paid from public funds in public institutions and authorities of local public administration will be increased by 20%.
d) The pension point will increase to 1,000 lei, starting from 1 July 2017.
e) Pensions of less than or equal to 2,000 lei will be made tax-exempt.
f) The social allowance for pensioners will be increased to 520 lei, starting from 1 March 2017.

Figure 2 - Average annual growth rate of tax revenues



Source: Draft of Law of Budget for 2017

We expect an increase in the quality of public services provided by these institutions of local government, as well as a change in the attitude and mentality of public servants, who can be expected to show a greater commitment to executing their duties for the good of the community.

Economic development based on consumption, concomitant with the decrease in indirect taxes, creates opportunities for growth in the consumer goods sector, as well as in the associated distribution and sales networks.

However, long-term economic growth based only on consumption does not create the premises for sustainable and durable economic development, because this type of economic growth can only last as long as consumption continues.

3. Some sectors of the economy will be supported by the following fiscal incentives:

a) Tax exemption for reinvested profit. This measure supports companies with fiscal profit which reinvest the profit in technological equipment (machines, equipment and work installations), as well as in computers and peripherals. The most likely beneficiaries of this measure will be companies in the extractive and manufacturing industry, the chemical industry, the construction sector and the construction materials industry.

b) Exemption from corporate income tax for 10 years, starting from 2017, for taxpayers which carry out business innovation, research and development. The likely beneficiaries will be companies that act as centers for research, development and innovation, as well as former research and development institutes. The automotive industry, telecommunications and pharmaceutical industries are also expected to gain from this measure.

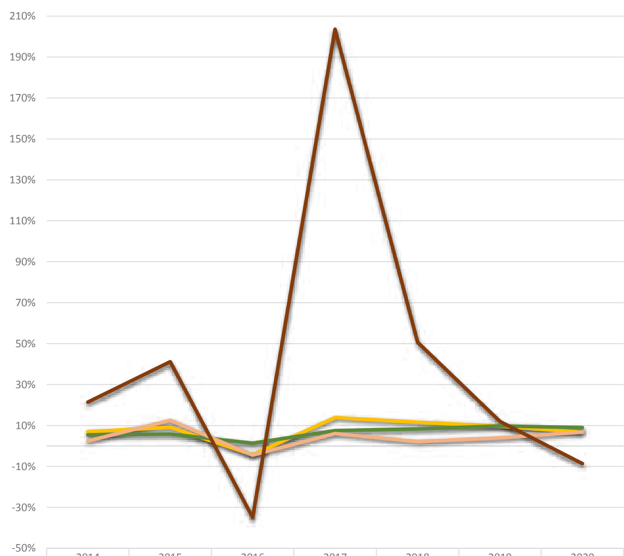
c) Reduction of the tax rate from 3% to 1% for microenterprises that earn the types of revenue stated by law, up to the equivalent of 500,000 euros, and which have at least one employee. This measure is meant to encourage small investors who are setting up their own businesses.

4. However, labor costs will increase:

a) In the private sector, because the minimum gross salary will rise to 1,450 lei / month.

b) In public institutions, because salaries will be raised by 15% in the health and education sectors, and by 20% for the staff of public institutions and authorities of local public administration. Because of these salary increases for public servants, we expect an increase in the quality of public services provided by these institutions of local government, as well as a change in the attitude and mentality of public servants, who can be expected to show a greater commitment to executing their duties for the good of the community.

Figure 3 - The growing rate of tax revenues (%)



	2014	2015	2016	2017	2018	2019	2020
TAX REVENUES -TOTAL	6.96%	9.09%	-4.31%	13.85%	11.62%	9.62%	6.66%
Total revenues from taxes and social contributions	5.45%	5.81%	1.35%	7.54%	8.36%	9.79%	8.93%
Revenues, others than taxes	2.42%	12.50%	-4.45%	6.05%	2.12%	3.96%	6.80%
Effective EU payments	21.39%	41.19%	-34.93%	203.62%	50.69%	11.93%	-8.66%

Source: Draft Law of Budget for 2017

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If the committed funds from the European Union are absorbed as projected, it is expected that the objectives set for public investments may be achieved and this would lead to an economic re-launch.

5. European funds and public investment

The rate of the General Consolidated Budget revenue growth of 10.41% is significantly exceeded by the projected average growth rate of revenues provided by funds received from the European Union of 47.06%. This projection appears to be extremely optimistic and its credibility may be in doubt, given the average annual rate of absorbing European funds during the period 2013-2016, which was significantly lower than projected.

However, if the committed funds from the European Union are absorbed as projected, it is expected that the objectives set for public investments may be achieved and this would lead to an economic re-launch (multiplication) which would benefit companies in the construction sector, as well as those which produce construction materials, together with those providing utilities and services for these public investment projects. At the same time, employment in these sectors would grow.

However, the realization of investment projects from public funds depends on achieving a high absorption rate of European grants. Taking into account the data available from past periods, when the absorption rate was below the projection, there is a risk that there may be a similarly low take-up of EU funds in future. This risk may be reduced by the effective involvement of the state authorities in developing eligible projects, so as to make better use of available EU funding.

Conclusions and recommendations

In the context presented above, one can note that the 2017 state budget is built on both sound economic forecasts, but also on less circumstantiated elements (e.g. the EU funds component). This has the potential to raise concerns with respect to the solidity of the premises upon which projections were made.

However, as already discussed, the budget is a planning exercise, and plans may be revisited. With economic growth usually being the main objective of each administration, we trust that the Government will promote and implement tailored, sustainable fiscal tools, as well as deploy balanced economic policies, in order to mitigate recurrent risks, such as the rise of the budget deficit.

As always, there will be winners and there will be less favored areas in terms of the budgetary impact. The real challenge however, and also an aspect to monitor in the up-coming months, is that the outcomes are not achieved at the expense of two core components of any sound economy, i.e. the business environment and the society in general.