ECONOMY

The Public Budget Draft for the Year 2002. Ambitions and Limitations

In a context of economic recovery and of the signing of a new *stand by* agreement with the International Monetary Fund, the Romanian Government sent the consolidated draft budget for next year to the Parliament, last October. This very early submission is a remarkable event in itself; it was also *a sine qua non-prior action* required by the IMF. What stands out in this budget and to what extent does it support the main targets of economic policy for next year? The comments underneath try to address these questions.

Features of the budget draft

Several issues can be raised concerning the structure and level of revenues and expenditure in the consolidated draft budget. The most obvious one is the simultaneous reduction of revenues and expenditures, which makes the proposed budget a restrictive one. Revenues are forecast to decrease to 31.8% of GDP, from 32.7% this year; and expenditures to 34.8% of GDP as against 36.2% this year (Fig. 1 and Fig. 2). This brings question as to the implications the budget retrenchment on economic activity.

The cause of the decrease in revenues is to be sought in changes occurred in tax regulations (such as the introduction of the global income tax and trade/fiscal facilities granted to small and medium sized firms early this year) and in the disappearance of some “special funds” (linked with social security contributions), both of which are not offset by better tax collection. As a matter of fact, and despite the commitments made at the beginning of this year, tax collection continues to be the Achille’s heel of the budget.

Fig. 1. Consolidated budget revenues and expenditure (% of GDP)

	2000	2001*	2002**
Revenues	31.5	32.7	31.8
- fiscal	29.5	30.5	30.0
- non-fiscal	1.9	2.1	1.8
Expenditure	35.5	36.2	34.8

Fig. 2. Budget revenues in more detail (% of GDP)

	2001*	2002**
Fiscal revenues	32.7	31.8
- direct taxes:	18.7	18.3
profit taxes	2.3	2.3
income taxes	3.4	3.1
contributions	11.9	12.1
other	1.1	0.8
- indirect taxes	11.9	11.7
VAT	6.5	6.5
custom duties	0.8	0.7
excises	2.6	2.7
other	1.9	1.9
Non-fiscal revenues	2.1	1.8

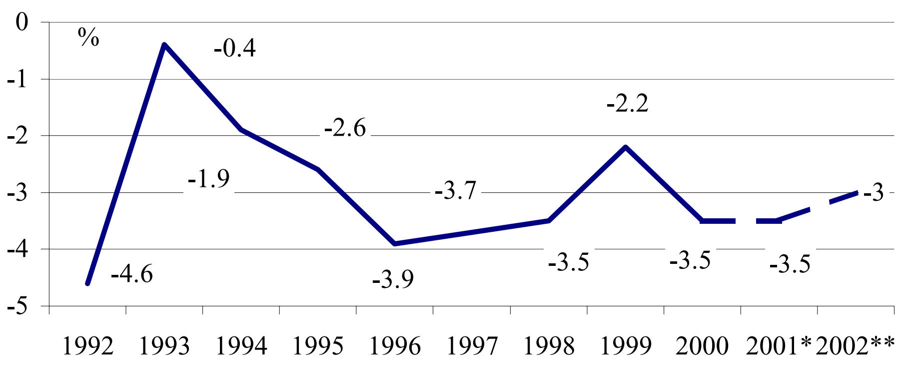
*** estimated**
**** forecast**

Furthermore, the decrease in budget revenues should be considered in conjunction with the lower budget deficit target – of 3% of GDP[21], down from 3.5% this year (Fig. 3). The 3% target is set in order to control domestic absorption and, consequently, reduce the current account deficit of the balance of payments. The lower budget deficit, therefore, would arguably accentuate the restrictive nature of next year's budget. But is there anything that could mitigate this restrictive impact?

One hypothesis is that less state expenditure is the outcome of public administration reform and better use of funds, which is an undeniable part of the story. Likewise, it can be argued that less taxation and less expenditure by the government leaves more resources for the non-government sector – which would be a compensating factor. But, one can hardly deny that, all things unchanged, the budget would be less supportive of overall economic activity. Equally, the budget is restrictive on the funds assigned to priority sectors, such as education and health – each will receive around 4 % of GDP, similarly to this year – or agriculture, for which funding will actually decrease (Fig. 4).

[21] It is not accurate, as some official documents assert, that next year's budget would be the first to comply with the EU convergence criterion for the budget deficit. It should be noted that in 1999, when an exceptional fiscal and balance of payments adjustment took place (the current account deficit went down from over 7.5% to 3.8% of GDP), the budget deficit – with privatization revenues included – went below 3% of GDP.

Fig. 3. Consolidated budget deficit, % GDP



Source: BNR data

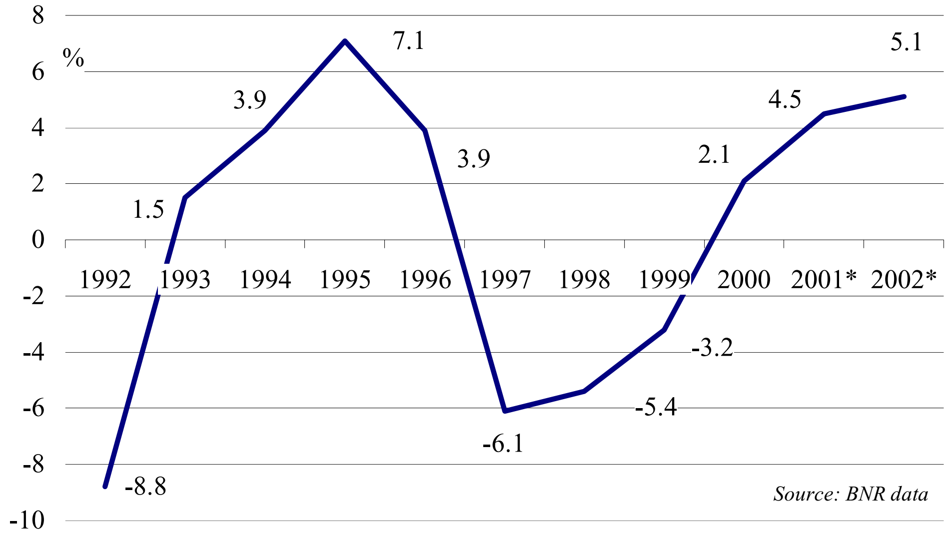
*** estimate, ** target**

Fig. 4. Consolidated budget expenditure – functional structure (% of GDP)

	2001*	2002**
Total expenditure	36.2	34.8
-public administration	1.8	1.5
-defence	1.5	1.5
-internal security and public order	1.9	1.8
-education	4.0	4.1
-health care	4.0	3.9
-social security	10.4	11
-public works and services	2.1	1.5
-environment	0.3	0.2
-culture and sports	0.5	0.6
-industry	0.9	0.8
-agriculture and forestry	1.1	0.9
-transportation and communication	2.8	2.7
-scientific research	0.2	0.2
-debt service	3.7	3.3

Note: not all items are showed in the above structure, which explains why the numbers do not add up to the total expenditure.
*** estimated**
**** forecast**

Fig. 5. GDP change (% from previous year) 1992-2002



** projected*

There is an attempt to increase the focus of budget expenditures on projects, but this effort has still a long way to go. The basic configuration of the budget does not bring substantial changes, which is not surprising, since its structural inertia is huge. On the other hand, one has to look more into detail, in order to assess the quality of budgetary efforts. Some changes in revenues (taxation) may have a positive impact on saving, particularly in a period of disinflation. This is the case with the faster reduction of direct taxes (-0.4% of GDP) as compared to indirect taxes (-0.2% of GDP) – Fig. 2. Equally, the cut in public administration expenditures (-0.3% of GDP) would mirror the reform under way in this field, which is also related to the drive for fiscal decentralization.

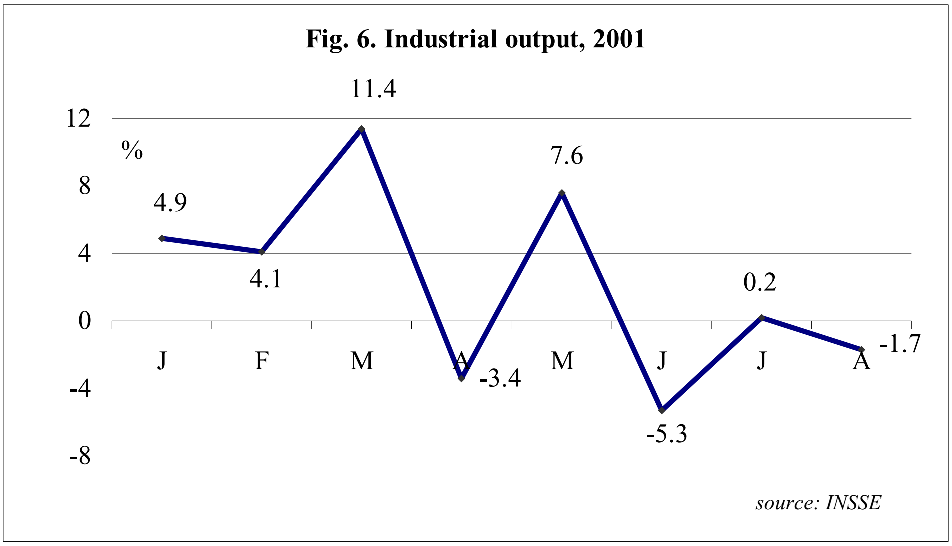
The draft budget and main goals of economic policy

Some of the comments above refer to the restrictive nature of the budget and its impact on economic activity (economic growth). It is suggested as well that the lower budget deficit would help disinflation and would also help reducing the trade imbalance and the current account deficit of the balance of payments.

In a previous report[22], a puzzle was highlighted: what is the rationale for forecasting a higher growth rate of the GDP in 2002 (5.1%, as compared to 4.5% this year), given the worsening international environment, the slowdown of domestic industrial output in recent months, and the need for

[22] EWR no.5, which dealt with official forecasts for 2002

corrective measures to deal with financial indiscipline[23] and the external disequilibrium? The budget figures do not clarify this puzzle.



For one thing, exports cannot be expected to be the primary driving engine for the economy in 2002, as they were in 2000, given the worsening international outlook. Equally, capital expenditures in the draft budget amount to 3.5% of GDP, which is comparable to what has been estimated for this year. What can then make a difference for GDP growth? Maybe higher investment?

Could loans from multilateral creditors (IFIs, including the European Investment Bank) play a more important role in supporting investment? Definitely yes, but this role would have to be factored in the structure of the budget. In addition, such loans would have to be complemented by domestic resources (co-financing), which would imply either cutting other provisioned expenditure, in order to maintain the same deficit, or a higher budget deficit – which seems to be out of question.

What is then left for filling in "the slot"? Naturally, investment undertaken by the non-government sector should be considered. However, official figures anticipate gross fixed capital formation (which refers to both public and private investment) to reach 19.7% of GDP next year – which implies only a modest rise in the volume of investment, compared to this year. There is also the possibility of substantial productivity gains, which have operated in several industrial sectors this year; such gains could make up for a slower rise in investment. But productivity gains are hard to anticipate, and to rely on them in constructing a budget, is quite risky.

For reasons such as those mentioned above, the forecast of a 5.1% GDP growth seems too optimistic, under current and foreseeable circumstances.

[23] Arrears have grown to 40% of GDP (asa against 35% at the end of 2001)

Vulnerabilities

Wage pressures can become of much nuisance on the expenditure side unless the criteria for their advance are well spelled out and an effective dialogue is carried on with trade unions. Recently, the Government promised a wage increase for state employees starting with next January; but this increase is not enshrined in the current draft budget. Where would the resources for this increase (over 7,000 Billion ROL) come from? Obviously, demands by trade unions can be substantiated by hard data, and it is no secret, that many people live below the poverty line, but there are limits to what the Government can do without jeopardizing the stability of the economy and the sustainability of its growth.

On the revenues side, a precarious tax collection can easily backfire. For instance, this year's poor results in tax collection will very likely force the Government to freeze some expenditure items in order not to miss the 3.5% deficit target. According to recent statements made by Ministry of Finance officials, a prime candidate for such cuts is capital expenditure, which runs counter to the objective of spurring growth next year.

Finally, one should be more cautious about the prospects for increasing the revenues from social security contributions – from 11.9% this year to 12.1% next year. It may be that the new rules on the employment of individuals with civil contracts would broaden the scope of the underground sector. In the end, revenues may, instead, come down. As a matter of fact, social security contributions (SSC) represent the most worrisome aspects of fiscal policy in Romania. The SSC ratio[24] is above 60% in Romania, whereas in none of the Central European countries does it go beyond 50%. At the same time, the share of these taxes in the GDP is the lowest in Romania: 11.1%.[25] Obviously, something is amiss here, and fiscal policy has to address this situation, which increases the propensity of firms and individuals to operate in the underground economy.

Policy recommendations

Although Romania's economy is less connected with the outer environment, both trade- and financial markets-wise, the growing uncertainties in the world economy and the worldwide economic slowdown will take their toll; this impact seems to be underestimated by current official forecasts. In any case, nonetheless, the Romanian economy is poised to continue its growth next year.

In view of domestic and external constraints, however, investment should increase substantially in order to sustain rapid growth, which is a questionable

---

[24] Which is defined in relation to the total wage bill of a company and what individuals pay out of their wages.

[25] I thank Valentin Lazea, from the NBR, for these data.

premise of the budget. There are also vulnerabilities in the budget construction which cast further doubts on some of its premises.

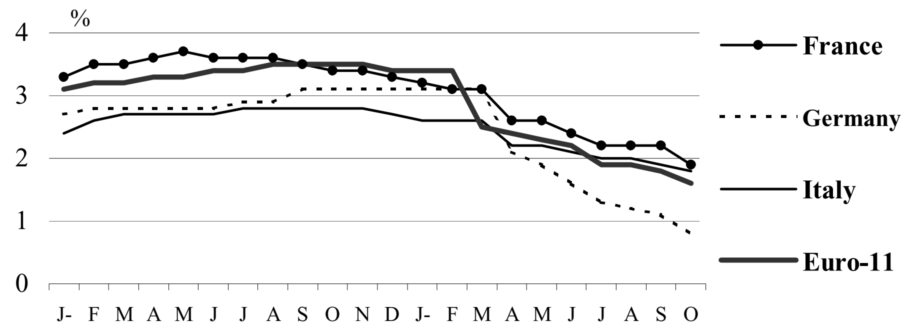
Assuming that it sticks to its current forecasts, the Government should also consider an alternative scenario for its economic program and the public budget; these should assume a slower GDP growth rate (4%), and a smaller increase in exports next year. At the same time, the Government should watch closely the vulnerable links in the budget **(which may imply fewer revenues, or higher expenditure)** and be ready with back-up solutions. With regard to the external financing of the budget deficit, and in view of a possibly severe fallout from an Argentinian financial debacle, the Government should consider an early external bond issue following the agreement with the IMF.

The Government equally needs to explain better its goals and constraints at a time of extreme uncertainty in the world economy and growing domestic wage pressures; this exercise in public persuasion is badly needed in order to avert major policy slippages.

International Economic Climate

Most of the commentators cut down substantially their growth forecasts in the aftermath of the terrorist attacks in the USA in early September. The biggest downgrade is for America, where GDP is now expected to grow by only 1%, rather than the 2.6% forecasted before the attacks. More important for Romania, our main trading partners' economies are also likely to slow down, even more than previously expected. **Italy** and **France** are likely to fall below 2% GDP growth, according to the monthly panel survey published by *The Economist* (Fig. 7). **Germany**, the largest European economy, and target of a sizable portion of the Romanian exports, has come close to a halt, with only 0.8% forecasted growth this year.

Fig. 7. GDP growth projections for the current year, Euro area



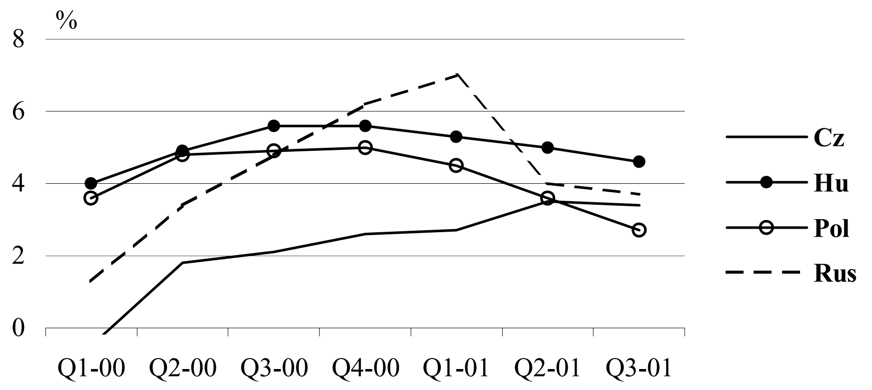
Source: The Economist monthly survey

Moreover, this is not just a short-term adjustment, as many people had hoped until recently: with the exception of Germany, the EU zone is expected to grow even less in 2002. The only question seems now to be if the current downturn is V-shaped or U-shaped – that is, if the recovery will be fast or sluggish. Morgan Stanley, an investment bank, believes that the thrust will be reached during the 4th quarter of 2001, when the European economies will contract, and that we shall see growth again at the beginning of 2002.

The **non-EU** trading partners of Romania have also seen their growth forecasts slashed for this year and the next (Fig. 8). Poland is falling below 2% – which in the post-communist countries, where the need to grow fast in order to catch up with the EU is stringent, equals almost to a recession. The delays in restructuring and privatizing the heavy industry take their toll now, and show that nobody can remain a star performer in Central and Eastern Europe unless the adjustment effort is a long-term commitment. This is a lesson that the Romanian Government should not forget, especially this year when Romania is likely to be the top performer in the region in terms of GDP growth. Russia's economy remains as volatile as ever, relying too much on the totally unpredictable price of commodities. Only Hungary looks a bit more resilient, which is a good thing for Romania, since our western neighbor is also our main regional trading partner, and hence a source of stability for our own economy.

Not all signs are bad, however. The latest *Outlook* of the IMF, published after the terrorist attacks, noted that the Fund does not expect a world recession, in spite of the recent turbulence. Unlike in the case of national economies, where recession means a period of time with negative growth (usually two successive quarters), at the world level there has been no negative growth since the '30s. Therefore, world recession is defined as global growth below 2%. Even by these high standards, as the IMF analysts pointed out, a recession is unlikely this year, while for the next they expect a slight recovery.

Fig. 8. GDP growth projections for the current year, CEE



Source: The Economist quarterly survey

Focus: Is This Year's Growth Explained by a Rise in Stocks of Finished Goods?

Since last spring, when it became clear that the industrial output was going to increase this year above the most optimistic forecasts ten months ago, a heated discussion has been going on about the sources of this growth. On the one hand, the Government says that the growth is real and healthy – and admits tacitly that it is at least in part due to the supply side policies implemented in 2000 by the previous Isarescu cabinet. On the other hand, the independent analysts fear that the surge of the industrial output was achieved mostly by artificially stimulating the economy with state acquisitions, cheap energy and soft budget constraints. As a result, the stocks of finished goods that the producers are not able to sell may be on the rise.

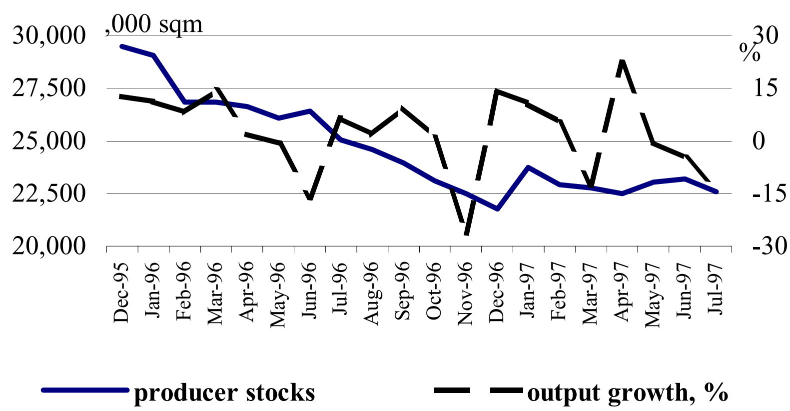
In order to see who is right and who is wrong, we took a closer look at the output and inventories data available, by industry. **Overall, we found little support for the skeptics' position: with a few exceptions, the stocks of**

finished goods have not risen in the fastest growing industries in 2001. However, since the Romanian economy is still full of distortions, this only means that the problem may be hidden somewhere else. The paradoxical accumulation of stocks in sluggish industries is a case in point.

The sectors that grew most rapidly in the first eight months of 2001 were the **consumer goods** (18.7% against the same period of the last year) and the **manufacturing industry** (10.7%). But in consumer goods there is no single case of increased stocks to producers – on the contrary, they decreased in absolute terms for many products or remained constant (which means they decreased relative to production).

In the manufacturing sector, the textile industry, one of the main Romanian exporters and a growth performer this year, has actually maintained a two-year trend of decreasing inventories (Fig. 9). Metallurgy, an industry that traditionally creates problems and where an artificial stimulation is felt very quickly, has also seen a steady reduction of stocks over the last two years, in spite of the fluctuations of output (Fig. 10). The only substantial accumulation of stocks in the manufacturing sector is in the paper industry (Fig. 11), and we do not yet have an explanation of why this happened. But whatever the reason, it is unlikely that one single industry can reverse the positive trend of the rest of the intermediate products sector. Moreover, the paper industry's output is going down, and therefore it does not contribute to growth this year.

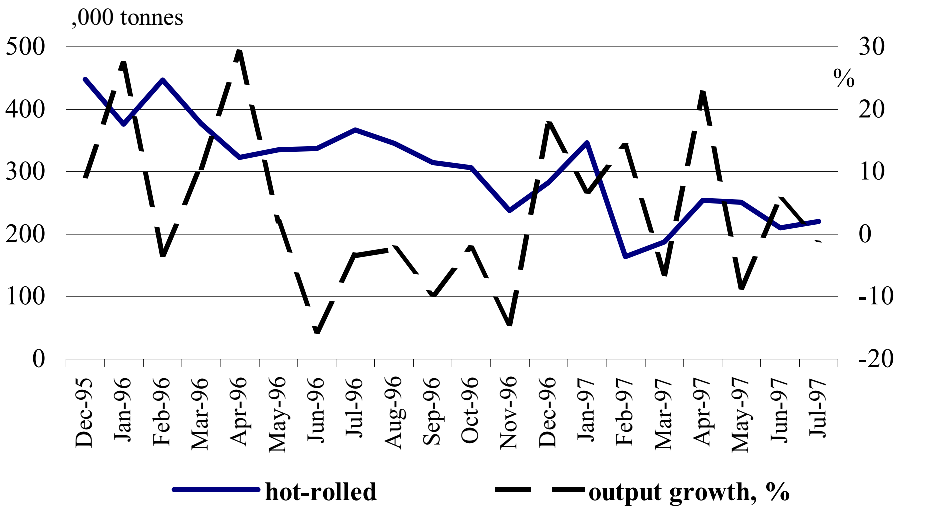
Fig. 9. Textiles inventories and output growth, 2000-01



Another sector that, like the paper industry, went against the general trend this year and decreased its output is **durable goods** (-3.6% on the first eight months of 2001, compared with the similar period of 2000): household goods, TV sets and other house appliances. Paradoxically, it is exactly in this sector that most stocks of finished goods are recorded (Fig. 12). Since most of these producers are private and no state intervention in this sector was reported, the most likely explanation for the accumulation of unsold goods is a miscalculation of the producers or a drop in demand – or both. Another, more subtle explanation might be that the domestic durable goods producers, especially in the refrigerators and washing machines industry, bought on soft credit cold-rolled steel sheets from Sidex Galati, which otherwise would have appeared on the books of the steel plant as unsold inventories. In other words, the stocks were transferred from metallurgy to the durable goods sector. In this particular case, however, the explanation is unconvincing: the steel sheets of the kind used in house appliances represent just a small fraction of the metallurgical output in Romania, so they wouldn't have been able to contribute much to the general reduction of stocks showed in Fig. 10. However, the soft inter-industry commercial credits (actually, arrears of payments) represent a real problem, which makes the interpretation of data regarding industrial output and inventories more difficult.

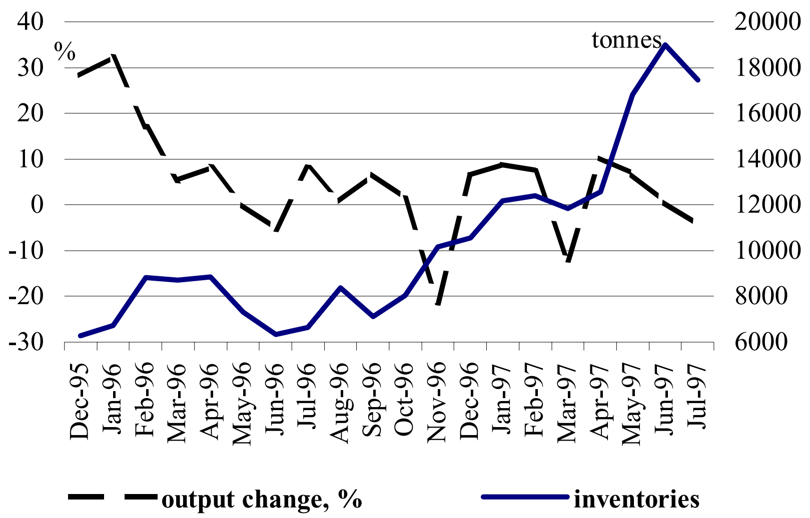
The stocks of **fossil fuels** have increased even though the sector grew below the average over the first eight months of this year (Fig. 13). In these state-owned industries it is notoriously difficult to correlate production with the market demand – which is one more reason why their restructuring and privatization should de speeded up. This is specially the case with the national company Petrom, the main oil producer, who last year spent exuberantly on sponsoring, advertising and investments, encouraged by the high price of oil. This year brought a harsh correction in the world price for oil (from 32 USD last autumn to 22 USD currently), and, as a consequence, Petrom's profits have already been cut in half and the company has come recently under attack in the Romanian Parliament.

Fig. 10. Metallurgical goods inventories and output, 2000-01



The lesson here is that the good times should be used for implementing difficult but necessary reforms, like the selling of Petrom to a foreign strategic investor. Otherwise a minor regional player Petrom will not be able to protect itself against the volatility of the world commodities market. Coal industry is still far from being turned around, too. Fig 13 shows that this year it has been unable to sell what it produced, even at a slower pace. While the Government has no business in meddling into the durable goods industry, where the private companies should deal themselves with the piles of finished products, it has every reason to be concerned about the stocks of energy goods produced in the public sector, which, although subsidized, still cannot be sold.

Fig. 11. Paper industrial output and inventories, 2000-01



The real problem in this respect is Romania's muddled **energy policy** – or the lack of it. (See also our previous issue, EWR 5, for a discussion of this topic.) On the one hand, since the world price for oil has decreased, an increase in domestic consumption is all but natural. The question here for the Government is: how come that Romania's imports of fuels have increased over the first eight months of 2001, while the stocks of oil and coal to domestic producers have also risen? Is it something wrong with the price or quality of these goods, since domestic consumers prefer to buy them from abroad? On the other hand, the irrational subsidization of the price of electricity to industrial users (the price has decreased in real terms this year – see also EWR 5) is anything but natural and makes for a poor preparation of the Romanian firms for the EU open market.

Fig. 12. Durable goods inventories and output growth, 2000-01

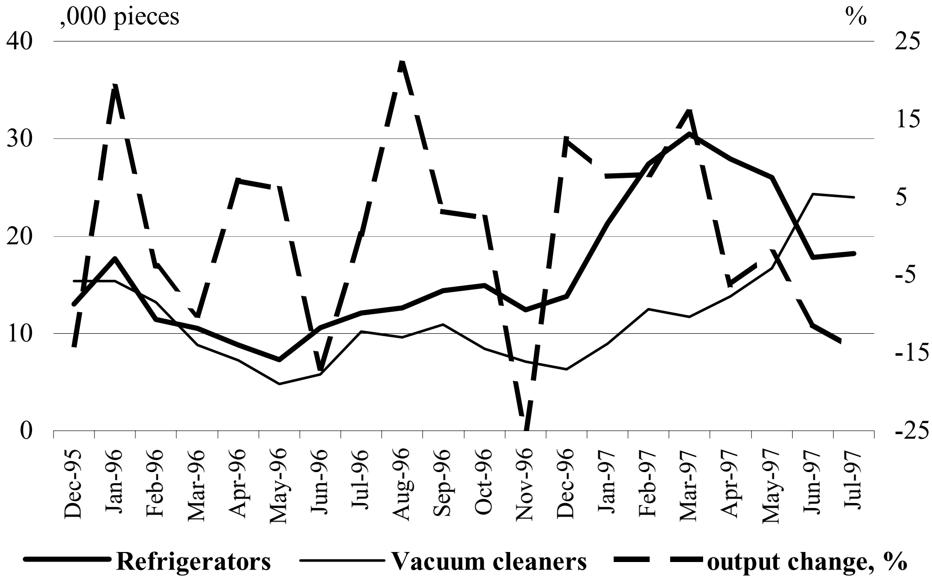
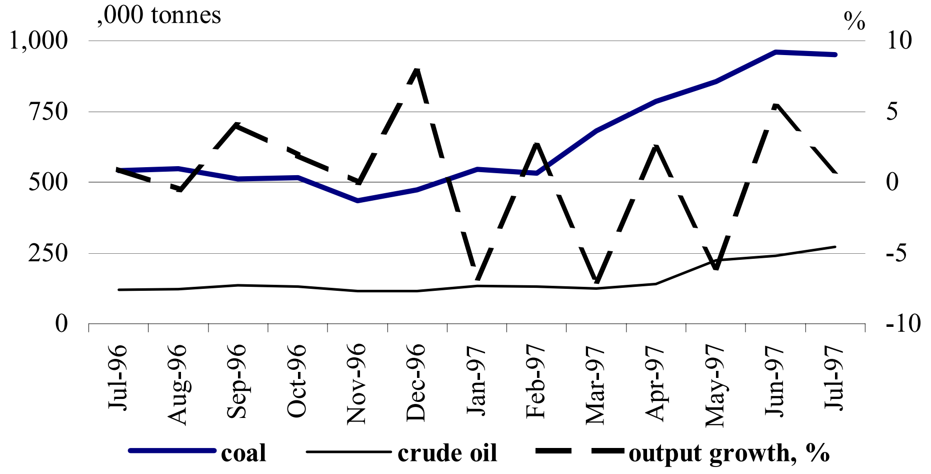


Fig. 13. Fossil fuels stocks and output, 2000-01



Conclusion

The widespread belief that all of the industrial growth in 2001 was artificial and that we are now awashed in finished goods that cannot be sold, does not seem to be supported by the data available. The economic growth looks real and healthy, provided the information coming from INSSE is accurate. This does not mean there are no increases of stocks, like those in the durable goods of paper industries. But these are no reason for public concern.

More important and threatening is the distinct possibility that many goods and services would not have been sold if their producers and buyers had not faced soft financial constraints. The **arrears** both inter-enterprise and to the public budget, have risen from 30 to 40% of GDP since 2000. They represent indeed the equivalent of a huge quantity of stocks immobilized on the books of producers – and one of the most urgent problems on the agenda of the Romanian Government. The next issue of the EWR will explore this matter more in detail.

ANNEX 1- Determinants of subjective ethnic conflict; path model

Chi-square= 172.158; df= 43; p= 0