Romania: Potential implications of new fiscal code

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Introduction

Ignoring both the IMF and European Commission's recommendations to not rush to cut VAT to 19%, the Parliament in late June adopted the new Fiscal Code by a vast majority. Apart from the VAT reduction to 19% from 24%, the tax on special construction facilities as well as the 7 eurocents excise on fuels has been removed from the new Fiscal Code (coming into effect as of 2016). The tax for dividends will drop from 16% to 5%, applicable as of January 2016.

The impact on budget revenues is estimated at around RON 17bn for FY16. While the cabinet will struggle to keep the nominal fiscal deficit under 3% of GDP next year, the structural budget deficit is expected to depart from the target agreed under the Fiscal Compact (1% of GDP + 0.25pp for projects co-funded by the EU).

President Iohannis recently used his prerogative to reject the amended Fiscal Code once, arguing that it generates unpredictability and undermines fiscal consolidation. He cited recent analyses by the EC and IMF that point to a significant departure from the structural budget deficit target (MTO) assumed under the Stability and Growth Pact, the Convergence Program and Fiscal & Budget Strategy.

More recently, the interim head of the Social Democrat Party, which leads the governmental coalition, confirmed that, on August 24-25, an amended version of the Fiscal Code would be voted on again by the Parliament in a special session. According to his statements, reinforced by the minister of finance, the Fiscal Code provisions will be explicitly discussed with central bank representatives (they have already expressed critical opinions on the aggressive fiscal relaxation proposed by the government and voted for by a large majority in the Parliament, including the center-right opposition at the end of June).

Current fiscal backdrop

- Romania ranks last in the EU in terms of revenue collection to the state budget (31.9% of GDP in 2014).

- Public money squandering and fiscal evasion are still, after years of reform, major weaknesses of the country's public finances (tax fraud is estimated at more than 16% of GDP, mostly VAT).

- Although it kept a close eye on state company arrears, the government has slackened the pace of restructuring public companies over the last three years.

- In January 2015, a strong disagreement over state company restructuring broke into the open between the government and the IMF; the current precautionary arrangement has been suspended for almost a year now.

- EU funds absorption is largely a wildcard; EU funds take-up has been slow and the cabinet has so far failed to address some of the key weaknesses signaled by the European Commission: weak management, control systems and procurement practices, inadequate planning and prioritization of objectives, and last but not least corruption and frequent conflicts of interest.

Opportunities and threats from the implementation of a loose Fiscal Code

Opportunities	Threats
More disposable income - More savings - More consumption Higher credit eligibility More cash available to companies - Larger bank accounts - More private investments - Better credit quality Economic growth acceleration More sovereign bond issuance available for banks, if country retains its 'investment grade' status	Unsustainable fiscal policy breaching EU deficit commitments Downgrade of country rating by major agencies Deteriorating relationship with international donors Increased risk profile with impact on cost of funding Risk of overheating as potential output remains low Short-term adjustments made by sacrificing public investments (which would have pushed potential output higher) Medium-term adjustments having opposite economic effect plus fiscal unpredictability

Estimated macro impact on GDP 2016-19

	2015	2016	2017	2018	2019	2016-19 AVG
GDP baseline, % y/y	3.2	3.5	3.8	4.1	4.3	**3.9**
GDP new, % y/y	-	4.2	4.4	4.5	4.6	**4.4**
Private consumption baseline, % y/y	3.7	3.6	3.5	3.4	3.4	**3.5**
Private consumption new, % y/y	-	4.7	4.6	4.4	4.2	**4.5**
Investments baseline, % y/y	3.0	4.5	5.5	6.5	6.5	**5.8**
Investments new, % y/y	-	4.8	6.0	7.3	7.5	**6.4**
Inflation, baseline, % y/y average	0.0	1.0	1.9	2.1	2.1	**1.8**
Inflation, new, % y/y average		-0.2	1.9	2.1	2.1	**1.5**
Budget balance, % of GDP*	-1.6	-1.2	-1.1	-1.1	-1.1	**-1.1**
Budget balance new, % of GDP	-	-3.5	-3.0	-2.6	-2.3	**-2.9**

Source: BCR Research

Additional risks:

- The government intends to perform a significant hike in public wages in 2016, according to the new legal framework (estimated impact 1.3% of GDP).

- Increased military expenditures of 1% of GDP as of 2017.

- The Parliament on June 30 reinstated legislation regarding preferential pensions for military retirees, which will put additional pressure on the expenditure side of the budget.

Inflation and monetary policy

The central bank has left the monetary policy rate unchanged at 1.75% and Governor Isarescu made it clear that one of the reasons for prudent reconsideration of the rate cycle was the government fiscal program. He added that negotiations with the EU and IMF are central in pushing forward with the reforms. He explained that Romania should stick to the IMF/EU deal, even though the arrangement could be in a different form. Following the planned VAT cut to 19%, we have lowered our headline inflation forecast to 0.7% y/y for December 2016, while the average CPI is likely to become slightly negative (-0.3% y/y). The reduced VAT will largely obscure the inflation pressures in 2016, while we do not rule out the economy showing signs of overheating. With increased prospects of the budget policy turning pro-cyclical in the election year 2016 and the local economy shifting to a positive output gap for the first time in eight years, the central bank’s monetary stance could turn less accommodative.

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