

## The effects of fiscal policies on the economic growth in Romania

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**Abstract:** *This paper intends to examine the results of fiscal policy implementation in Romania, their impact on economic growth and how fiscal policies have influenced the growth of budgetary deficits. Our objective is to highlight and explore efficient fiscal consolidation strategies that can ensure a stable economic growth through sustainable public finances. The methodology consists in analysing the information provided by national and international financial institutions, comparing it to past, proposed and assumed values, and examining the efforts and results. The conclusion we reached was that, in order to restore the sustainability of public finances, the need arises for considerable fiscal consolidation effort, as well as for deep structural reforms, with a view to creating favourable conditions for sustainable economic growth. Indeed, by implementing suitable fiscal policies, Romania exited the excessive deficit procedure in 2011.*

**Key-words:** *fiscal policies, budgetary deficit, economic growth*

### 1. Introduction

As public finances form a field of research that deals with public revenue and expenditure problems in particular, the importance of the topic is reflected through the macroeconomic imbalances and lack of economic stability that Romania has faced in recent years.

We chose to approach this subject because fiscal consolidation policies play a very big role in the economic growth and welfare of society. Fiscal policies aim to reduce fluctuations and economic instability, protect consumer incomes and stimulate development. The importance of this tool is visible to everyone, even to people without direct involvement in the economic system. The moment of such a study is suitable. Over the last 12 years, economy experienced an ascending trend, followed by recession, while economic growth has resumed in recent years. Lately,

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due to the increase of unsustainable economy growth between 2004 and 2008, the great importance of applied fiscal policies is obvious.

The section entitled “The necessity of agreements with the European financial institutions” presents the context in which Romania ratified agreements with the International Monetary Fund, European Commission and the World Bank. These agreements materialize in economic consolidation programs and loans from international financial institutions at a low interest rate. The next section, entitled “Fiscal policy measures applied in Romania before the financial crisis” provides an analysis of the pro-cyclical measures implemented in Romania before the financial crisis emerged and shows how this effected the sustainability of economy. The section “Fiscal consolidation measures implemented in Romania and their effects” presents a study on the degree of efficiency of fiscal consolidation measures implemented in Romania between 2008 and 2015. The last section presents the conclusions regarding the effects of the fiscal consolidation measures implemented in Romania on economic growth and budgetary deficit decrease.

## **2. Literature review**

The interventionist role of the state was shaped as a result of the development process of society, which led to the emergence of new tasks and economic, social and political factors. The measures taken in this respect led to the passage of certain categories of activities under state control, including economic activities that were considered to have public interest (Neagu, 2009).

Mishkin (1991) defined the crisis as a disruption of financial markets, in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities.

In her scientific research, Margit Molnar (2012) concluded that, if fiscal adjustment is based more on growth than on spending tax debt, stabilization is more likely to occur and this stabilization is sustainable.

Clinton, et al. (2011) concluded that, if a fiscal package is very well-designed, then pain only arises if the package suffers from an initial lack of credibility, and the length of the period of pain closely corresponds to the length of the period during which credibility needs to be established. If a fiscal package is designed, the long-run gain could be much lower or even non-existent, as higher distortions and/or productivity offset the gains from lower real interest rates.

Huidumac Petrescu and Pop (2015) noted that the banking sector plays an important role in economy by supporting savings, capital accumulation and targeting resources towards profitable investment projects. Economic development is closely connected to the development of the banking sector in an economy. Expanding and

developing economic activities require additional funding, which most often, and especially in Romania, comes from the banking sector.

Anghelache, Manole and Anghel (2015) analysed Romania's GDP by using multiple regression models and concluded that GDP is significantly influenced by changes in final consumption and gross investment.

Emerging markets need to continue adapting their policies to take advantage of this "real existing globalization". This means making their economies more attractive for foreign investment, by streamlining bureaucracy and imparting labour skills. It means continuing to run sound and stable monetary, fiscal and debt management policies in good times, so that they have space to deploy those policies in bad times (Eichengreen, 2010).

### **3. Objectives**

The research objectives proposed in this paper are: finding how fiscal policies acted over the economic cycle phases (before, during and after the economic crisis); determining the impact of fiscal policy on economic growth and the percentage changing of GDP component and users; identifying those policies that ensure fiscal sustainability and long term sustainable economic growth.

### **4. Methodology**

Using the data from Eurostat and NIS, the study focuses on comparing economic growth and budgetary deficit fluctuations to past, proposed and assumed values. Analysing the fiscal policies implemented by Romania, we reviewed the efforts and results that materialised in changes of GDP components, economic growth and overcoming high budgetary deficits.

### **5. The necessity of agreements with the European financial institutions**

At the end of 2008, Romania entered the excessive deficit procedures, as it recorded a 5.6% budgetary deficit. In this context, according to the Maastricht Treaty, Romania had to reduce its budgetary deficit below 3% of GDP. Due to measures taken between 2005 and 2008 as regards the increase in unsustainable government spending without ensuring their funding, Romania had to implement a comprehensive program to adjust budgetary spending. The pro-cyclical fiscal policies implemented during the economic boom between 2005 and 2008 rose the budgetary deficit from 1.2% of GDP in 2005 to 9.1% of GDP in 2008. The incorrect

budgetary planning and implementation avoided a strong fiscal consolidation that could be achieved when economic conditions were favourable.

In order to implement an effective program for consolidating Romania's economy in 2009, an agreement was ratified with the International Monetary Fund, European Commission and the World Bank, which included a financial package consisting of technical assistance and a loan of 20 billion euros to sustain the exchange rate and finance the budget deficit at a low cost. The loan agreements negotiated in 2009 were followed by financial support for the Government's economic program to strengthen macroeconomic and financial stability. The program was aimed directly at the adjustment of the external deficit, having positive direct effects on the exchange rate and, consequently, the financial position of companies and the public and banking sector. These agreements had a strong preventive character, ensuring, along with financial resources, the ability to correct macroeconomic imbalances and increase the Government's economic program credibility.

The Stand-by agreement ratified between Romania and the International Monetary Fund in 2011 was aimed at the continuation of fiscal consolidation and structural reforms previously initiated, envisaging the stimulation of economic growth and private sector participation in the economy.

Due to economic imbalances that occurred before the financial crisis, the first program was focused on restoring macroeconomic stability. The second program was directed towards structural reforms focusing primarily on the energy and transport sectors, as both are essential for increasing the economic growth potential.

## **6. Fiscal policies measures applied in Romania before the financial crisis**

Fiscal policies affect aggregate demand, the distribution of wealth, and the economy's capacity to produce goods and services. In the short run, changes in spending or taxing can alter the magnitude and the pattern of demand for goods and services. In time, this aggregate demand affects the allocation of resources and the productive capacity of an economy through its influence on the returns to factors of production, the development of human capital, the allocation of capital spending, and investment in technological innovations (Kopcke, Tootell and Triest, 2006).

Between 2000 and 2008, the government debt in Romania increased considerably, in 2008 being 3 times higher than 2000. The first substantial increase in government debt was in 2007, when the Ministry of Finance borrowed money to finance the budgetary deficit and refinance public debt. In late 2009, public government debt increased to 19.5% of GDP, due to a shortage of funding needed to finance an excessive budgetary deficit of 5.6% of GDP built on consumption instead of investment, surpassing for the first time limit of 3% set by the Maastricht Treaty.

The fiscal policies applied in Romania before the financial crisis played a decisive role in increasing the public debt. The financial crisis contributed to the explosion of budgetary deficits and debt. Fiscal policies had been expansionary and lacked a credible and predictable medium-term framework. The falling external demand and capital inflows also contributed to the accumulation of budgetary deficit, determining an increase of public debt. Romania's budgetary deficit of 5.6% in 2008, higher than the 3% threshold, was a reflection of the fact that the fiscal policies implemented since 2006 had been pro-cyclical, not providing a fiscal space to avoid an excessive deficit in a downturn. If between 2005 and 2008 Romanian implemented a countercyclical fiscal policy, in 2009 it had a safety margin, and harsh economic measures that affected consumption and, consequently, the population would not have been necessary. Since 2006, the structural balance deteriorated rapidly and the government did not have a structural adjustment plan even if the economy in Romania grew.

The systematic budgetary slippages were due to weak budgetary planning and execution and lack of fiscal predictability and discipline. Driven by a significant increase in wages and real estate investments, and by a boom in private credit consumption, Romania's GDP grew with an impressive pace between 2003 and 2007. General government expenditure rose from 33.5% of GDP in 2004 to 34.9% of GDP in 2007 and 38.5% of GDP in 2008.

Maintaining macroeconomic stability is essential to prevent sudden fluctuations, which can bring about negative effects. Macroeconomic stability means first of all to constantly maintain a relatively high degree of confidence (Filip, 2009).

The economic growth pattern must be reconsidered, given the experience of the past years, when the growth in our country was based on consumption, which did not allow sustainable economic growth to be achieved, and it should target investment in sectors with high added value (Molănescu and Aceleanu, 2011).

## **7. Fiscal consolidation measures implemented in Romania and their effects**

Before the economic crisis, Romania registered an unsustainable economic growth. In this period, prior to the economic crisis (2005-2008), the implemented fiscal policies were pro-cyclical, the budgetary deficit rose from 1.2% of GDP in 2004 to 5.6% of GDP in 2008. The implementation of wrong budgetary policies before the crisis was partly due to the lack of independent monitoring of budgetary developments, the absence of mechanisms that would ensure compliance with budgetary targets, wrong budgetary multiannual planning. The precarious condition of the institutional framework contributed to the existence of budgetary slippages, especially in the spending levels registered in that period.

Romania suffered the most drastic fiscal adjustments during these years as compared to similar countries in the region. The budgetary deficit improved by 5.9 percentage points of GDP in 2009-2012. Romania had the weakest starting position,

an unsustainable budgetary deficit of 9.1 % of GDP in 2009, generated highly by pro-cyclical fiscal policies implemented during the years of economic growth from 2004 to 2008. However, all these drastic fiscal adjustments hallmarked Romania's economic activities. The population consumption decreased as the wage drop measures were implemented alongside with the value added tax increase by 5 percentage points from 19% to 24%.

The most important fiscal consolidation measures implemented since 2009 were: the 25% reduction of public sector wages (2010); the 15% reduction of all social benefits except pensions (2010); the pension freeze at 2009 levels (2010); the freeze of early retirements (2010); the accelerating layoffs in the public sector (2010); the increase of the VAT from 19% to 24% (2010); the revision, in 2013, of the income tax of agricultural activities, by widening the tax base, changing the way of establishing the taxable income and the income tax; the introduction of a special construction tax and the 7 eurocents excise per fuel litre (2014); the reduction of social security contributions by 5 percentage points for the employer (2014); the reduction of the value added tax from 24% to 9% for food, drinks, seeds, plants and ingredients for food preparation (2015); the decrease of the standard VAT from 24% to 20%, for certain supplies of goods and services, a reduced VAT of 9% or even 5% being applied (2016); the reduction of excises (2016).

Starting with 2009, budgetary consolidation measures aimed at reducing the budgetary deficit below 3% of GDP, while fiscal governance changes aimed at creating more sustainable public finances in Romania and remedy the deficiencies that led to earlier slippages. Since the implementation of the austerity measures, Romania achieved positive results in terms of deficit targets of the program of consolidation and budget deficit adjusted fulfilment. The prudent fiscal policies are reflected in the fact that incomes rose faster than spending during the crisis.

For a better view of the extent to which the fiscal consolidation measures affected macroeconomic indicators, the following indicator analysis is required:

Year	Budgetary deficit	Economic growth	GDP (million euros)	Final consumption	Gross capital formation	Inventories	Net export
2007	-2.90%	6.90%	125403.4	82.90%	30.20%	0.80%	-13.90%
2008	-5.60%	8.50%	142396.3	81.70%	31.90%	-0.60%	-13%
2009	-9.10%	-7.10%	120409.2	80.90%	25.60%	-0.60%	-5.90%
2010	-6.90%	-0.80%	126746.4	79.70%	22.50%	3.50%	-5.70%
2011	-5.40%	1.10%	133305.9	78.40%	26%	1%	-5.40%
2012	-3.20%	0.60%	133511.4	78.80%	26.30%	-0.30%	-4.80%
2013	-2.20%	3.50%	144253.5	76.20%	23.80%	0.70%	-0.70%
2014	-1.40%	3%	150230.1	76.90%	22%	1%	0.10%

Table 1. *Evolution of budgetary deficit, economic growth and GDP formation between 2007 and 2014* (Data source: Eurostat, NIS)

Starting with 2009, the fiscal consolidation measures began to reduce the rigidity of government expenditure structure. The cyclically-adjusted spending as a percentage of GDP decreased from 41.1% in 2009 to 38.9% in 2011, 35.5% in 2012 and 34.5% in 2013. The share of public personnel expenses in GDP fell from 10.9% in 2009 to 7.9% in 2011 reaching 7.4% of GDP in 2013.

The budgetary fiscal strategy 2011-2013 aimed to restructure public expenditure, rationalizing it, placing it on efficiency principles, establishing consistent and predictable policies based on sectoral strategic priorities. The policy regarding the drop in public sector wages was accompanied by a reduction in employment in the public sector through redundancies and the introduction of a rule that for every 7 people who leave a public institution a single job can be created. The rule was first applied similarly in all ministries, but has become more flexible in 2012 to cover staff shortages in some sectors, such as health care. Therefore, employment in the public sector was reduced by 189573 occupied posts (14%) between December 2009 and December 2012, most of the reductions concerning local governments, i.e. education and healthcare.

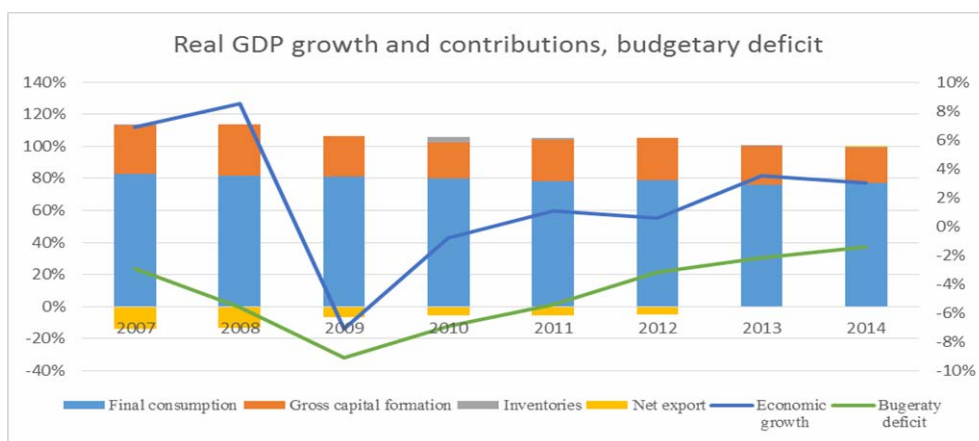


Fig. 1. *Evolution of the budgetary deficit, economic growth and GDP formation between 2007 and 2014* (Data source: Eurostat, NIS)

In 2008, the main sources of economic growth came from the agriculture, forestry and construction sectors. The final consumption had a role of 8% and the gross capital formation of 7.5% concerning the GDP growth. The final consumption expenditure of households was 9.2%, due to the increase of wages and the social spending, and it had a major contribution to the growth of the final consumption. Another major contributor to the growth of gross capital formation in Romania was represented by investments in economy, positively influenced by the construction sector. A negative influence on Romania's economic growth in 2008 was held by the net exports, due to increased imports caused by consumption. Unfortunately for

the economy, consumption growth in 2008 was mainly determined by imports and not by domestic supply. Net exports recovered in the last quarter of 2008 due to the reduction of massive imports and a slight increase in exports.

One important thing to note in 2008 is the evolution of the GDP resource categories and user categories. For example, the agriculture and construction sectors, although they had a positive contribution to the GDP growth in the fourth quarter of 2008, there was a slowdown of growth as compared to the nine months of that year (the most drastic reduction in the fourth quarter was recorded by the industry sector, which decreased by 7.7%, and the real estate activities, which decreased by 1.5%). Also, in the fourth quarter of 2008, the domestic demand registered a slowdown in growth as compared to the first nine months of that year and a decrease of 1.3% as compared to the same period the previous year. It results that starting with the fourth quarter, a series of very important signals occurred in terms of Romania's economic activity reduction, having negative effects on household income and resulting in an increase of unemployment.

In 2009, the GDP contributions resources and their use reduced as compared with the fourth quarter of 2008. Among the sources of GDP formation, the biggest reductions were registered by the construction sector - 13.6%, and the commerce sector - 11.2%. Resources forming GDP registered a significant decrease, mainly due to reduced final consumption expenditure, as final consumption of households decreased by 10.8%. A significant reduction of the gross fixed capital formation was recorded due to the decrease of investments in the economy and public investment. However, in the fourth quarter of 2009, the formation sources made a positive contribution to GDP.

In 2009, the construction activity decreased greatly due to the significant reduction in the loans granted beginning with the fourth quarter of 2008. In the fourth quarter of 2009, the agriculture sector increased by 0.7% and the industry sector by 4%, which caused a slowdown in the economy contraction. Also, in this quarter, a positive net exports indicator was recorded due to the increase in exports by 2.9% and the lowering of the volume of imports by 11.1%. If the Romanian government had taken measures to support business in 2009, the reduction volume in the economic activity would have been lower than the effective reduction. For example, a measure would have been represented by the implementation of measures to boost exporters' activity.

In 2010, the pace of economic contraction was greatly reduced as compared to 2009. For example, construction activities decreased by 10.7%, trade by 4% and other services by 2.8%. In return, the industry sector increased by 5.1%, the real estate activities and renting and business services increased by 0.8%. The "first home program" had a positive effect on the construction activities. Among the categories of GDP users, a significant decrease of gross fixed capital formation was registered (13.1%) and consumption saw a decrease of 2.1%. Although the measures took in 2010, materialized in a reduction in wages and an increase in the VAT, had the desired effect of reducing the budget deficit, they had a negative influence both on



investments and consumption. All economic activities except construction, which registered a significant reduction, had a positive contribution to economic growth. Agriculture activities increased by 0.8%, the industry sector by 0.1%, trade activities by 0.2%, the financial intermediation sector by 0.3% and professional activities by 1.3%.

In 2010, consumption in Romania recorded positive figures. Consumption increased by 1% due to a 1.6% contribution from final consumption expenditure of households. An important role to Romania's overcoming the recession was played by gross fixed capital formation, which increased by 7.7%.

In 2011, Romania overcame the recession, recording an economic growth of 1.1% of GDP. Budgetary measures taken in 2011 and the allocation of large sums from the state budget for investments had positive effects on Romania's overcoming the recession. Changes in the contribution to the GDP growth in 2011 were recorded in individual consumption of households (1%) and gross fixed capital (1.9%).

The gross domestic product in 2012 was, in real terms, 0.6 % higher as compared to 2011. In 2012, the sources of economic growth were investments, which managed to alleviate the impact of the macroeconomic international context. In terms of domestic supply, the services sector was the main engine of economic growth. Agriculture contributed negatively to economic growth, due to drought, since this sector registered the highest reduction in production in the last 20 years.

Due to the continued fiscal consolidation between 2009 and 2010, according to ESA methodology, Romania achieved in 2013 the lowest budget deficit since 2007; furthermore, the foreign market borrowing costs were the lowest in history.

Net exports were the main engine of economic growth. Their contribution to the 4.4% real GDP growth was due to increased external demand, which led to an increase by 13.5 in the exports of goods and services, while the imports of goods and services increased by 2.4%. The contribution of final consumption was reduced by only 0.6% in terms of accelerating private consumption in the second half of 2013. The large agricultural production boosted the farm and self-consumption market, an important component of household consumption in Romania.

In 2014, Romania's real GDP growth was 3%, while in the European Union GDP growth was 1.4%. The main engine of economic growth was domestic demand, whose contribution to real GDP growth was of 2.7%, calculated as an increase by 4.5% in the private consumption in real terms, while gross fixed capital formation decreased by 3.5%. The contribution of private consumption was 2.8%, due to an acceleration of purchases of goods in the second half of 2014.

## 8. Conclusions

The evolution of public debt was marked by stages that sometimes proved to be true tragedies for countries having big debts, accumulated from the mismanagement of public funds or by the creditors themselves. Generally, large amounts of public debt from EU countries have increased significantly in recent years, thus raising

questions about the health of public finances and the sustainability of European fiscal and budgetary policies.

Romania has had to rethink the approach of policies makers and pursue a prudent public debt policy on a sustainable level. Another important problem is that the debt generated will have to be born by future generations, which will generate low rates of employment and will lead to an aging population. The European Commission highlighted priorities, including fiscal responsibility. Most EU states have a medium-term objective target of 0.5% of GDP for the structural budget deficit.

The pro-cyclical measures implemented before the economic crisis led to high budgetary deficits and thus the accumulation of public debt. Also, the unsustainable investments and government expenditures contributed to the increase of budgetary deficits. After changing the fiscal policies implemented, in 2011 Romania overcame the recession, recording a growth of 1.1% of GDP. The budgetary measures taken and the allocation of large sums from the state budget for investments had positive effects on Romania's overcoming the recession.

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