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About Opportunity of Fiscal Relaxation and Wage Increase in Romania or What is Like to be Caught on the Wrong Foot

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Abstract

Monetary and fiscal policies are intervention tools in economy, but the manner and the magnitude of the intervention must be ensured with a technical analysis, close to what really happens, in order to prevent shocks that may be higher than for the one who makes the intervention. It is logical that the need of fiscal policy relaxation should be identified depending on the phases of the economic cycle. Fiscal policy in Romania saw a major change starting with 2016: Romania passed to tax reduction, while increasing the expenses at the same time. In other words, the fiscal policy was massively relaxed, the budget deficit in the ESA definition increased from 0.8% of the GDP in 2015, to 2.8% of the GDP in 2016. There were several analyses on this relaxed policy, especially regarding its sustainability, and few analyses regarding the efficiency of this policy in fulfilling the main goal, namely economic growth. Moreover, the new Government committed itself to following an economic agenda based on the vision of "intelligent, sustainable and inclusive" economic growth, anchored by implementation of a growth strategy based on the wage led growth.

Keywords: budget execution, current account, fiscal relaxation, economic cycle, GDP, potential, economic growth

JEL Codes: E03, E60, H30, H60, O11

1. Introduction and Literature review

Professional economists all over the world are publicly discussing the "fiscality peak" in certain states and the "austerity measures" in other states (Murphy, 2013). Economists warn that Romania is close to, if it hasn't passed already, the peak of the economic cycle, and the operating space in anti-cyclic policies has been dangerously narrowed by the recent measures of fiscal relaxation. "Fragmentation and insufficient social cohesion are reflected at political level in the absence of substantial medium term and long term governing programs, with goals widely shared and followed up beyond the electoral cycle" (Barbu, 2016). Moreover, domestic economy evolved, during the last quarters, at a pace above its potential, and an analysis of the dynamics of macroeconomic indicators reflects assumptions of deceleration in the Romanian economy in the following quarters, especially in the absence of positive economic shocks, especially domestic, given the maturity signs of the post-crisis global economic cycle.

On 4 January 2017, a new government came to Romania, supported mainly by the Social Democrat Party (PSD), the winner by a big majority of the general elections of 11 December 2016. In its electoral program, that became, with slight changes, the Governing Program, PSD and the new government committed to follow an economic agenda based on the vision of "intelligent, sustainable and inclusive" economic growth, anchored by implementation of a growth strategy based on the wage led growth (Socol, 2017, in press). Explained in a figurative but rather technical manner, this implies that the drive given to the aggregated demand through wage increase (leading to an increased weight, in the overall income, of the remuneration of the labour force and of the amplified consumption), together with the encouraged capital investment, especially in value added sectors and sectors with high trigger capacity, would allow a mutation of the equilibrium of the long term economic growth ("steady-state growth path") at higher level, by stimulating productivity, which attracts a positive response from the aggregated supply. Consequently, according to the view of the authors of the Governing Program, an annual growth of over 5% of the GDP seems achievable and sustainable for several years.

With all the attractive aspects of the above presented growth vision, we believe that the implementation of such a scenario implies taking into account longer time for the implementation and manifestation of the economic multipliers, and for the possibility of potential internal or external shocks.

In addition, if we take into account the fiscal impulse in 2016 (definitely, the expansion of the budget deficit from 1.35% to 2.4% had a cyclic effect), and the very low interests rates on the monetary market, the very fast expansion of the available income, and the recent progress of the European economy, we believe that the Romanian economy is in a more advanced stage of the economic cycle. This seems to be actually the assessment included in the latest Report on Inflation written by the National Bank of Romania (February 2017), indicating an excess of demand which became positive since the beginning of 2016. Given the fiscal and budgetary measures entered into force at the beginning of 2017 (some of them included in the Fiscal Code, some voted by the former Parliament and some recently adopted by the new

Government), including wages increases and pensions increases, and tax reductions, we believe there are reasons to assume that, in short term, the demand excess will expand. Even if (and this is a big IF), the productive sector and the potential GDP will follow the drive given through such measures to the aggregated demand, this adaptive process needs some temporal resources. Meanwhile, the Romanian economy, being small and open, the impact of the demand impulse on the GDP will be partially eroded through the expansion of the trade deficit, while imports may absorb the demand supplement quicker than the domestic production can. A positive demand excess implies, according to empirical studies (Caggiano, Castelnuovo, Colombo, & Nodari, 2015; Mittnik & Semmler, 2012; Auerbach & Gorodnitchenko, 2011; Baum, Poplawski-Ribeiro, & Weber, 2012), weakened efficacy of the fiscal and budgetary measures to drive the GDP growth.

Expansion of the demand excess, of the trade deficit and current account deficit, together with narrowed fiscal space, while the budget deficit is almost 3% in 2016 and susceptible to exceed this level in 2017, and the low short term interest rates increase the vulnerability of the Romanian economy, in the sense of lower capacity of public policies to counteract the impact of potential shocks. Such shocks may be caused, for instance, by the slowing down of the global economy as a result of emerging protectionist policies in the USA or other parts of the world, or oversized appreciation of the US dollar. If we look at the last year, we have clear proof that singular political events (Brexit vote or Donald Trump's becoming president of the USA) have the potential to derail the estimated evolution of economy and markets agreed by analysts. 2017 does not lack such "opportunities".

Although the macroeconomic effects of the fiscal policy enjoy more attention in international public and academic debates, compared to the monetary policy, the specialized economic literature is richer in studies on the effects of the monetary policy upon the economic activity.

In academic literature, the circumstances that followed the economic and financial crisis of 2008 reveal fundamental differences regarding the effects of fiscal policy, both theoretical and empirical. Consequently, the controversy about the effects of the fiscal policy distorted, to a large extent, the decisions taken by the economic and political decision-makers regarding the implementation of appropriate fiscal measures to stabilize the economic cycle and re-launch the economic activity. Thus, the economic policy oscillated between adopting Keynesian measures to stimulate the financial sector and aggressive reduction of governmental expenses, and tax increase (Mencinger, Aristovnik, & Verbič, 2017).

After the burst of the economic and financial crisis in 2008, in the attempt to stabilize economies, many governments of industrialized countries adopted expansionist fiscal policies, based on the idea that fiscal policy can be an efficient instrument to stabilize business cycles. Consequently, Afonso and Sousa (2011) investigated the macroeconomic effects of the fiscal policy upon the composition of the GDP, upon the private consumption and private investments, and real estate prices, share stock prices, price level, and average cost of debt re-financing (interest rate).

The specialised literature also includes studies on the effect on fiscal consolidation that are implemented through reduction of governmental expenses, reduction of transfers or fiscal increase. The consolidation episodes between 2009 – 2014 have been analysed, an interesting period to study the ”austerity” plans adopted by the governments of several European countries (Alesina, Barbiero, Favero, Giavazzi, & Paradisi, 2017). Some studies show that there is a considerable heterogeneity among fiscal multipliers in various countries (Baum, Poplawski-Ribeiro, & Weber, 2012).

An assessment of the short and medium term effects of the transmission mechanism of fiscal policies in the EU and OCDE countries and their dependency upon the fiscal behaviour and the status of the economy causes misleading effects of fiscal multiplication, which leads to adopting inappropriate fiscal measures that aggravate the economic status of a country (Mencinger, Aristovnik, & Verbič, 2017).

The specialized literature, theoretical and empirical, reveal that the fiscal position of each country has a direct impact upon the deficit and governmental debt, and the transmission rate of the effects of fiscal policy is lower when the fiscal position is weak, because pro-cyclic fiscal policy measures have been adopted at a expansion moment, and the other way round (Spilimbergo, Symansky, & Schindler, 2009; Nickel & Tudyka, 2014). Pro-cyclic measures of fiscal behaviour that have been adopted coincided with the process of prudence reduction in the public and private sectors, which aggravated later on the fiscal position of most countries, and had negative implications upon economic growth (in 't Veld, 2013).

Regarding the identification of fiscal policy shocks for Romania, Ioana Boiciuc’s results (2015) are compatible with other studies on emerging economies, the impact of fiscal shocks upon macroeconomic variables is low, and fiscal multipliers are few.

The findings of another study shows that public expense in Romania respond better to shocks caused by income structural changes, compared to the opposite case, and preserving the fiscal sustainability is vital for macroeconomic stability and financial capability of the country (Dornean & Oanea, 2015).

2. X-ray of Romania’s Macroeconomic Status at the end of 2016 and Beginning of 2017

2.1 Budget Execution in 2016

The general consolidated budget ended 2016 with a deficit on cash execution of -2.41% (about -18.3 billion lei, - 4 billion euro) of the GDP estimated to 169 billion euro, according to data published by the Ministry of Public Finance. The result is weaker than for the 2 previous years, but close to 2012 and 2013, when Romania managed to stay under -3% din GDP after the first years of economic crisis.

The notable difference, however, is the value significantly lower as against the previous 10 years, both in income, where Romania went under the threshold of 30% of the GDP, and expenses, with a minimal record, under 32% of the GDP. The average values across the EU in 2015 were around 45.0% of the GDP for income and 47.4% for expenses, which shows, in absolute numbers, that Romania’s deficit in 2016 resembles very well the EU average for 2015. Except that in Romania the income covered the expenses with 92.5%, while in the EU it was 95%, because the amounts of money available for the state place Romania at the lower end of the EU practices. Moreover, Romania suddenly passed from the highest income as against the GDP over the last 10 years to the lowest, which caused strong shock in public money management, where the income had to be adjusted (paradoxically, even at times of robust economic growth, assumed to be 4.8% in 2016) to accommodate the fiscal deficit target. The starting data indicate that we have a weak state that simply does not possess enough means in terms of social policies and investments undertaken according to a European model. Which we already know, but 2016 showed a deepening of this logical dead end to promise more and more with less and less money.

Table 1. Evolution of Budget Execution between 2006-2016

Year	Income (% of GDP)	Expenses (% of GDP)	Deficit (% of GDP)
2006	31.8	33.5	-1.68
2007	32.5	34.9	-2.4
2008	32.0	36.9	-4.8
2009	31.0	38.2	-7.2
2010	32.8	39.4	-6.51
2011	32.7	37.0	-4.29
2012	32.9	35.4	-2.51
2013	31.3	33.8	-2.47
2014	31.7	33.6	-1.85
2015	33.1	34.6	-1.47
2016	29.5	31.9	-2.41

Source: Ministry of Public Finance

To note that the results of the budget execution, both absolute and as against the estimated GDP, were given based on the official estimation of 758.5 billion lei, used by the Ministry of Public Finance to calculate the deficit. To keep in mind, the state budget means 45.4% of the general consolidated budget, in terms of income, and 53.4% in terms of expenses, that is less than half of the total public budget.

Social insurance budget covered the expenses with its own collected income (without money transferred from the state budget) with 71.5%, which means an increase from 66.4% in 2015 (in 2014 it was 74.2%). Briefly, it means that for every 5 lei collected from taxes as payment for pensions, the state spent 2 more lei for the payment of pensions, the difference coming from other taxes such as tax on revenue or VAT, paid also by the retired people.

The health budget covered its expenses with its own collected income with 86.8%, which is more than 82.7 % in 2015 and 2014, when it was only 76.5%. The explanation is the increase of taxable incomes, including taxes collected by the state, without reflecting this additional money in better health services.

Table 2. Results of the Budget Execution in 2016

Budget	Income		Expenses		Deficit	
	Million lei	% of the GDP	Million lei	% of the GDP	Million lei	% of the GDP
General consolidated budget, Out of which:	223,721.9	29.5	242,016.3	31.9	-18, 94	-2.41
- State budget	101,476.4	13.4	130,083.1	17.2	-28,606.7	-3.77
- Local budgets	68,315.2	9.0	67,793.5	8.9	+521.7	+0.07
- Social insurance budget	52,428.3	6.9	52,196.4	6.9	+231.9	+0.03
- National fund for health insurance	24,950.2	3.3	26,106.0	3.4	-1,155.8	-0.15

Source: Ministry of Public Finance

Although it's about half of the total funds managed by the state, the public budget deficit was higher than the deficit of the general consolidated budget, which we see more often in comments for the public. Unlike the previous year, when the deficit of both budgets was below the threshold of 3% of the GDP, in 2016, the minus in the public budget exceeded a bit this limit (-3.77%) and it was only partially compensated by several small pluses in other budgets.

Table 3. Results of the General Consolidated Budget Execution and of the Public Budget in 2015 and 2016

Budget	Income		Expenses		Deficit	
	Million lei	% of the GDP	Million lei	% of the GDP	Million lei	% of the GDP
General consolidated budget in 2015	233,554.3	33.1	243,915.5	34.6	-10,361.3	-1.47
General consolidated budget in 2016	223,721.9	29.5	242,016.3	31.9	-18,294	-2.41
Public budget in2015	105,705.6	15.0	125,215.8	17.8	-19,510.3	-2.77
Public budget in 2016	101,476.4	13.4	130,083.1	17.2	-28,606.7	-3.77

Source: Ministry of Public Finance

Regarding the income, it is to note the reduced collected VAT, from 8.0% of the GDP to 6.8% of the GDP, after reducing the VAT from 24% to 20% starting with de la 1 January 2016, and to 19% starting with 1 January 2017. The weight of the excise also decreased slightly, from 3.7% to 3.6% of the GDP. The slight increase in taxes on profit (from 1.9% to 2.0% of the GDP) was not accompanied by a similar increase of the tax on wages and income (remained at 3.7% of the GDP). The most important component of the revenue of the state, insurance contributions, remained at 8.1% of the GDP. The funds received from the EU for the payments effected decreased dramatically, from 17.2 billion lei (2.4% of the GDP) to only 0.95 billion lei, which is a reduction of almost 95%. At the same time, expenses with projects financed from non-reimbursable foreign funds for 2014 – 2020 increased from 0.1% of the GDP to 0.8% of the GDP, with a nominal increase from 0.50 billion lei to 6.35 billion lei.

Regarding expenses, most important was the stagnation of capital expenses equal to 2.5% of the GDP. After increasing with 5 billion lei, the staff allocations increased also in relative terms (from 7.3% to 7.5% of the GDP), which consecrated the abandon of the total wage-fund for public servants of 7% negotiated with the IMF a few years ago.

Table 4. Budget Expenses in 2015 and 2016

Category	2015		2016	
	Billion lei	% of the GDP	Billion lei	% of the GDP
Total expenses, out of which:	243.43	34.2	242.02	31.9
- Staff expenses	52.07	7.3	57.04	7.5
- Goods and services	40.46	5.7	40.95	5.4
- Interests	9.57	1.3	10.01	1.3
- Subventions	6.28	0.9	6.60	0.9
- Projects with non-reimbursable foreign funds	24.26	3.4	4.02	0.5
- Social assistance	75.96	10.7	81.84	10.8
- Capital expenses	18.04	2.5	19.02	2.5

Source: Ministry of Public Finance

The amounts paid to the account of interests to public debt were about 10 billion lei, the amount for goods and services decreased as percentage of the GDP, although they remained significant in nominal terms, and the most important component of public expenses, social assistance, had almost 6 additional billion lei. Its weight in the GDP increased with 0.1% from 10.7% to 10.8%, which meant improved social protection.

2.2 Budget Execution in the 1st Quarter in 2017

The execution of the general consolidated budget for the first 3 months in 2017 resulted into a surplus of 1.52 billion lei, 0.19% of the GDP estimated for 2017, according to the data published by the Ministry of Public Finance. The income of the general consolidated budget, of 59.53 billion lei, representing 7.3% of the GDP, was 7.1% higher, in nominal terms, as against the same period of time in 2016.

What increased was the collection of the tax on wage and tax on income (+15.8%), social contributions (+14.8%), tax on foreign trade and international transactions (+18.2%) and capital income (+12.7).

Collection of other taxes on goods and services increased with 60.2% as against the same period of the previous year, due, mainly to the evolution of the collection of the contribution for medicine, and for the contracts funded from the budget of the National Unique Fund of Health Insurance.

The VAT decreased with 9.1% as against the first 3 months of 2016, due to the reduction of the standard rate from 24% to 20%, starting with 1 January 2016, a measure that caused effects starting with February 2016. Starting with February 2017, the effects of the reduced VAT from 20% to 19% started. However, VAT collection increased with 2.5% in February 2017 as against February 2016, and with 8.9% in March 2017 as against March 2016. The increase announced by the Ministry of Finance is based on a harsh reality: the postponing the VAT reimbursements to companies (especially exporters) returned into economy, so that the so-called increased collection is actually based on increased VAT debts of the state to economy and on the creation of difficulties for private companies. Thus, in February 2017, the state reimbursed private companies 32% less VAT than in February 2016, and in March 2017 43% less than in March 2016. All this money will have to be paid in the future, when it will be a problem for the government to ”make ends meet” with the collection rate, when it will have to reimburse what it postponed in February and March. The problems caused to companies because of this postponing shall add up.

21.2% increase in taxes on property collected by local administrations into the state budget has been also achieved, as against the previous year. 2.9 billion lei have been allocated, out of which 2.7 billion lei is the money corresponding to projects in agriculture, which will be deducted from the funds received from the EU.

The expenses of the general consolidated budget, 58 billion lei, increased in nominal terms with 10.4% as against the same period of time of the previous year, and staff expenses increased with 16.4%, as a result of increased wages in health and education sectors, in local administration and in public institutions for shows and concerts.

Expenses with social assistance increased with 9.7% as against the previous year, being influenced mainly by the increase of the pension point with 5.25% up to 917.5 lei, the increased compensation given to the adults with serious visual impairment by increasing with 25% the net wages of the beginner social assistants with pre-university education, the compensation for child-rearing and incentives for insertion.

Expenses with goods and services decreased with 3.1% as against the same period of the previous year, with reductions in the state budget (2.6%), and in local administrations (2.5%).

Subventions increased with 114.0% as against the same period of time of the previous year, the main growth comes from the subventions of agricultural producers. 1.7 billion lei, 0.2% of the GDP were allocated for investments, including capital expenses and programs of development funded from internal and external sources.

2.3 Current Account in 2016

The current account of the payment balance had a deficit of 4.118 million euro, twice weaker than -1.943 million euro for the same period of time in 2015. Due to significant increase of the income of the population and fiscal reductions on consumption, the deficit in trade with goods worsened with 20%, from -7.8 billion euro in 2015 to 9.3 billion euro in 2016. Part of this lack of equilibrium of the trade balance improved in the service sector, significantly (+11%) as against the previous year and improved the total balance with more than 7.5 billion euro. This positive balance covered more than 80% of the negative balance in the goods sector, otherwise we would have faced a serious problem.

Table 5. Current Account in 2015 and 2016 (million euro)

	2015			2016		
	Credit	Debt	Net	Credit	Debt	Net
Goods	49,099	56,893	- 7,794	52,101	61,400	- 9,299
Services, out of which:	16,642	9,848	+ 6,794	17,629	10,073	+ 7,556
- Processing services	2,567	172	+ 2,395	2,628	190	+ 2,438
- Transport services	5,204	1,796	+ 3,408	5,478	1,892	+ 3,586
- Tourism-trips	1,542	1,855	- 313	1,562	1,923	- 361
- Other services	7,329	6,025	+ 1,304	7,961	6,068	+ 1,893
Primary income	2,353	6,091	- 3,738	2,758	7,583	- 4,825
Secondary income	5,701	2,906	+ 2,795	5,097	2,647	+ 2,450
Total current account	73,795	75,738	- 1,943	77,585	81,703	- 4,118

Source: National Bank of Romania

Confirming once again the importance of this sector for the national economy, almost half of the net money in the service current account comes from transport. In net balance, these services brought last year about 3.6 billion euro, followed by goods processing services as temporary import of 2.4 billion euro.

To note, capital exports as a result of investments previously made in Romania practically annulled the net amounts sent into the country by the Romanians who work abroad, and the processing services for goods possessed by third parties, with 4.8 billion euro in each sense.

Per total, the forced economic growth based on domestic consumption minus the increased imports rather than exports resulted into a minus of about 2.45% of the GDP.

Long term deposits of non-residents went down with 22% last year, from about 4.9 billion euro at the end of 2015 to about 3.8 billion at the end of 2016. The payments into these deposits were 1.56 billion euro, 38% of the current account deficit.

The payment balance was supported by direct investments of non-residents, 4,081 million euro in 2016. It came from participations in capital of 3,889 million euro and the balance of intragroup loans, 182 million euro.

Medium term and long term foreign debt decreased for the 4th consecutive year, reaching 69.11 billion euro. However, the total foreign debt increased in 2016 with more than 2 billion euro reaching 92.5 billion euro. The payments for the foreign debt were 53.85 billion euro. Short term foreign debt increased with almost 3 billion euro, reaching 23.42 billion euro.

Medium- and long-term external debt service ratio was only 25.2% between January-December 2016, compared with 38.5% in 2015, while the coverage rate for goods and services imports was 6.4 months of imports, comparable with the coverage at the end of last year.

Table 6. Evolution of Foreign Debt per Components between 2011-2016 (million euro)

	2011	2012	2013	2014	2015	2016
Medium and long term foreign debt	75,929	78,760	76,591	75,725	70,558	69,116
Short tern foreign debt	22,795	20,921	19,491	18,577	19,876	23,416
Total foreign debt	98,724	99,681	96,442	94,302	90,034	92,532

Source: National Bank of Romania

To note, as a warning, the coverage of the short term foreign debt with foreign currency reserves of the NBR decreased at the end of 2016 to 90%, compared to approx. 98% on 31 December 2015. This fact reflects a worrying evolution, as we are going away from the theoretical recommendation of 100%.

3. Risk of Pro-Cyclic Policies in Romania

Stabilizing the economic conditions and positioning within the business cycle is a challenge for decision-makers in charge with the relief of economic fluctuations (Ţiţan & Georgescu, 2013). Monetary and fiscal policies are intervention tools in economy, but the manner and the magnitude of the intervention (by increasing the interest rate with 0.75%, by reducing the tax on profit with 6%, by reducing the VAT with 4% etc.), must be ensured with a technical analysis, close to what really happens, in order to prevent shocks that may be higher than for the one who makes the intervention. The difficulty is even higher if the interest variable is not noticeable and needs filtering or assessment.

As un-noticeable macroeconomic indicator, the potential GDP is useful in the analysis and projection of macroeconomic policies, not directly, but through output-gap in whose calculation formula can be found. The potential GDP represents the healthy sustainable economic growth, without affecting other macroeconomic indicators (inflation, foreign deficit, public debt) that a country can dream of, based on the three production factors existing at a certain moment that make up the GDP: capital, labour force, and productivity (total of the factors). Output gap is defined as the difference between the effective GDP and the potential GDP expressed in percentages, reflecting the deviation of economy from the level that implies equilibrium.

Output gap is defined as the difference between the effective GDP and the potential GDP expressed in percentages of the potential GDP, thus reflecting the deviation of the economy from the level of equilibrium (Ţiţan & Georgescu, 2013). In other words, output gap is the percentage deviation of the effective GDP from its potential value and has the following calculation formula: Output gap = (effective GDP – potential GDP) / potential GDP x 100. Depending on the sign of the difference (effective GDP – potential GDP) output gap can be: Output gap or expansionist gap (effective GDP – potential GDP < 0) and Output gap or recessionist gap (effective GDP – potential GDP > 0). There are 2 main categories of methods to determine the potential GDP. One – decomposition of the GDP according to the main features of the time series, and two – based on the economic theory, looking for those economic variables that are connected to the potential GDP.

Table 7. Evolution of the Real GDP, Potential GDP and Output Gap in Romania between 2008-2016

Indicator	Year								
	2008	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
Real GDP	8.5%	-7.1%	-0.8%	1.1%	0.6%	3.5%	3.1%	3.9% *	4.8% **
Potential GDP	4.5%	-4.7%	2.1%	2.1%	1.7%	2.0%	2.0%	3.3%	3.9%
Absolute output gap (effective GDP – potential GDP)	40%	-2.4%	-2.9%	-1.0%	-1.1%	1.5%	1.1%	0.6%	0.9%
Relative output gap (effective GDP – potential GDP) / potential GDP x 100	88.88%	-51.06%	-138.1%	-47.62%	-64.71%	75.00%	55.00%	18.18%	23.08%

* Semi-final data

**Estimated GDP for 2016

Source: calculation of the author based on data on the real GDP and the potential GDP in the Convergence Programs of the Romanian Government, approved annually between 2009-2017, made public on the website of the Romanian Ministry of Public Finance, http://www.mfinante.gov.ro/programDeConvergenta.html?pagina=programConvergenta

It is logical that the need of fiscal policy relaxation should be identified depending on the phases of the economic cycle. In theory and experience, the economic cycle can be understood as having 2 phases: a ”normal” phase, where the monetary policy interests are significantly positive, and a ”abnormal” phase, where the interests are zero or even negative. During each such phase, expansion times alternate with recession times. Depending on some macroeconomic indicators and their correlations, and on the behaviour of the economic system upon the impact of endogenous and exogenous factors, economy can be in one of the following 4 phases: normal-expansionist; normal-recessionist; abnormal-recessionist and abnormal-expansionist. In the phases normal-expansionist and normal-recessionist, the central role is played by the monetary policy, although fiscal policy can help removing the recession if it hadn't been pro-cyclic during the boom stage. The only case where fiscal policy relaxation should play the central role in stimulating economy is during the abnormal-recessionist stage. If the fiscal policy were used at the right time and to the appropriate extent during the abnormal-recessionist phase, the abnormal-expansionist stage would not exist. Unlike the developed countries, in Romania, the 2008 crisis did not lead to an abnormal-recessionist phase. If there was a moment when Romania needed to use the fiscal policy to stimulate economy (not necessarily major role), it was the time when the effective GDP was below the potential GDP. This means that the entire normal-recessionist time and part of the normal-expansionist time (return to recession), until the moment when the current GDP became equal to its potential (the GDP gap becomes positive). However, the excessive relaxation of the fiscal policy before the crisis made impossible its relaxation after the recession. The actual relaxation began in 2016. If, in 2016, production had been below its potential, relaxation would have been justified. Most estimations show that the production gap closed since the beginning of 2016, which meant that a certain relaxation of the fiscal policy had been justified in 2014 and 2015, when the budget deficit in the ESA definition went down to 0.8% of the GDP, from 2.1% in 2013. Unfortunately, this restrained deficit was achieved through non-execution of expenses planned for investments.

In order to analyse to what extent the relaxation of the fiscal policy in 2016, an election year, stimulated economic growth, we must remind the circumstances where fiscal policy can be efficient. Among these circumstances, the superior rank of the capital mobility. In Romania, which has a relatively small and open economy, capital mobility is relatively high, but far from perfect. A perfect substitution of assets would mean that the domestic interest rate is equal to the international interest rate. This equality did now show up neither before the crisis, or after. The second aspect is the exchange rate. It's obvious that in Romania the regime of the exchange rate is the controlled floating. This means that, in short term, the exchange rate can float freely between certain limits, relatively restrained, and not necessarily symmetric, but appreciation or depreciation beyond these limits are counteracted by the Central Bank. Given these aspects, an appropriate framework of analysis of the fiscal policy in Romania for 2016-2017 is the one in which capital is relatively mobile and the exchange rate is flexible within certain limits. To see what effects the expanded deficit caused, we consider that there are no other influences from other factors, that is we temporarily neglect the capital income attracted from EU funds, the capital outcome for debt payment etc. In this framework, omitting the other factors, we can identify a benchmark result that can produce an increase of the budget deficit: an increase of the current account deficit; an appreciation of the Leu, in actual terms; an increase of the interest rate; an increase of production and an uncertain result of prices. The higher the capital mobility, the higher the capital income. Therefore, the higher the current account deficit (not necessarily the part determined by the expanded budget deficit), increase of production and actual appreciation of the Leu. As against this benchmark result, depending on the methods to increase the budget deficit, we can identify however the trend of prices and their effects.

In Romania's case, during the years when the structural budget deficit increased, especially due to VAT reduction, the consumption prices decreased. This did not cause additional appreciation of the Leu as against the benchmark result, but an actual increase of the wages. A more appreciated Leu and higher actual wages led to increased consumption, especially of imported goods, and gradual increase of the current account deficit. The deterioration of the current account deficit equaled with the placing abroad of a part of the increased additional domestic demand of consumption goods, as the increased demand could not attenuate the deflation produced by the government. Consequently, ceteris paribus, the inflation target could not be achieved. Between 2014-2016, the actual wage increase was not determined only by the deflation induced by the government, but also by a nominal increase of wages in the public sector, especially in 2015-2016. The wage increase in the public sector influenced also the private sector, to a certain extent, through an imitation/demonstration effect. In industry (producing approx. 25% of the gross added value in economy, employing approx. 30% of the labour force and selling over 50% of production on the foreign markets), a 10% wage increase in the public sector adds 3.5 percentage points to the dynamics of the average wage in one year (NBR – Report on inflation, February 2016, p. 27). The increase resulted from the nominal wage increase added up to the actual wage increase caused by price reduction generated by the VAT cut, thus stimulating consumption furthermore. The increased consumption caused a certain growth on private investments. It is likely that the positive influence of investments on the potential production be more than compensated by the negative effects that result from eroded competitiveness of the companies. While stimulating consumption, the increased wages however decreased the production incentives. The wage increase was reflected in the increased production prices, leading to an appreciation of the actual exchange rate of producers, indicating Romania's reduced international competitiveness in this regard. For instance, the consumption goods industry, in the 3rd quarter of 2016, the effective actual exchange rate increased with 5% as against the 3rd quarter of 2013 and 2.13% as against the 4th quarter of 2015. The combination between bigger consumption and fewer incentives for production initially resulted into accelerated economic growth, from 3.9% in 2015 to 4.8% in 2016. Short term, as expected, the combination led to increased production. However, starting with the 2nd part of 2016, signs appeared that the positive effects for economic growth of consumption are overtaken by negative effects of the increased wage costs, which reduce the incentives for production. Increased wages in certain industries, determined by several factors, could be compensated, until recently, by cost reduction, including as a result of lower oil price. In 2016, however, the wage increase in industry overlapped the trend appeared in January 2016 and continued until present day, of increased prices in raw materials at the global level. This means that for companies, the costs generated by the wage increase can no longer be compensated by other cost reductions, which will be reflected in the accelerated price increase with producers.

Thus, the wage increase in industry induced through the demonstration effect in the public sector added a heavy burden for producers, namely it reduced furthermore the incentives for production. Repeated and relatively low increases of the minimal wage per economy particularly could not be compensated by small and medium companies through similarly frequent and high increases in productivity. Consequently, in the 2nd half of 2016, productivity growth lagged behind the wage increase. In 2017, the 15% wage increase in education and health (approx. 700,000 people) and 20% wage increase in local administrations (approx. 120,000 beneficiaries), will put more pressure to continue the wage growth in the private sector, thus reducing furthermore the producers' incentives.

In the boom years, such as in 2016, consumption (given its share in GDP by 70-80%, respectively 84.6% in 2014, 82.2% in 2015 and 82% in 2016) sustained the economic growth. Between 2004 and the economic crisis of 2008-2009, consumption grew annually with more than 7%, with a peak of 11.7% in 2007 which coincided with the explosion of loans. In 2008, the year of the maximal economic growth before the crisis (8.5%), consumption meant 418 billion lei, meaning double as against 4 years before, which was 201 billion lei in 2004. Eight years later, in 2016, total consumption was 574 billion lei, only 37% higher than in 2008.

Consumption had an extremely modest evolution after the crisis, 3 years of decline, 2 years of 1% growth and resuming after the Government approved the massive fiscal incentives. However the incentives could be seen only in consumption, not in the evolution of the second engine of economy – investments. While the level of consumption in current prices these days exceeded the one in 2008, which is normal, following the GDP evolution, we cannot say the same about investments (brut formation of fixed capital). No year after the crisis, investments saw again the level of 2008, 201 billion lei. In 2016, investments were 180 billion lei (like in 2015), with almost 12% below 2008. For zero growth, the contribution of investments to economic growth in 2016 was zero.

Between 2004 and the beginning of the crisis, the growth of investments was never below 10% (with a peak of 50% in 2007). After the crisis, the progress of investments was modest, with 3 years decline, 3 years with growth below 3%, and a peak year, 2015, with 8.8% growth and 2016 with zero growth. Let us only think that today's investments ensure tomorrow's economic growth.

Official estimations show that in 2017, while the employment in the public sector remains constant, the average wage will increase with approx. 13.6%. This means that in industry, the increase rate of the average wage will be higher with almost 4.7 percentage points per year than the rate that would have appeared if the wage growth in the public sector didn't exist. Comparatively, in industry, labour productivity increased between the 4th quarter of 2014 - the 3rd quarter of 2016 with a quarterly rate of 0.04%.

Starting with 2017, a significant increase of wages in the public sector is intended. In 2017, their weight will be 8.4% of the GDP, and estimations show they will be 10% of the GDP in 2020 and 12% in 2022, the highest allocation ever in Romania and the highest in Europe (the European average of the total public sector wages as percentage of the GDP is 10%). At 8.4% of the GDP, it means that we allocate to the wages in the public sector 32% of the collected revenue. In 2022, half of the collected revenue would go to the public sector wages, which would be the highest percentage and totally unsustainable, not realistic, because there were be no more resources left for anything else.

Romania has seen this before! Record increases when consumption reached the ceiling. We have seen, however, that the Romanian economy has a high volatility. We had record growth numbers but also record recession numbers. Romania had a high economic growth in 2008, a year when the prospects of recession were clear and the crisis received its birth certificate in September 2008 when Lehman Brothers, the big American investment bank, went bankrupt. The GDP growth in 2008 was an impressive 8.5%, but it was followed by a deep plummeting of 7.1%. Minus 7,1%. In 2008, just like last year, radical measures to make public sector wage grow were taken, which were followed by drastic cuts and dramatic austerity measures.

4. Conclusions

The VAT reduction in 2016 was not enough studied, it was tardive and did not have the expected outcome, namely to cause a sustainable economic growth, but generated an accelerated consumption reflected especially in imports.

In a country like Romania, where capital is mobile, but not perfectly mobile (the interest rate is not equal to the one in Eurozone), the Leu does not float freely, and theory says that when you make a sudden move of fiscal policy in the sense of relaxation, a high current account deficit appears, the currency appreciates in actual terms, production increases, interest rates increase and the effect upon prices is uncertain. In Romania, the VAT reduction led to price reduction, a deflation not linked to the demand, an increase of actual wages in economy, and these increased actual wages led to more consumption and an increased current account deficit, controllable for the moment. Part of our demand was placed abroad, that is why we did not see it in prices.

The increased budget deficit due to tax cuts, together with increased current expenses in 2016 and 2017, came too late and has more disadvantages than advantages. The increased budget deficit caused an appreciation of the exchange rate, thus reducing the foreign competitiveness of economy. The VAT cuts induced increased imports, that is a loss of a part of the domestic market by the local producers, and placed inflation beyond the target intended by the NBR. The increased budget deficit due to VAT cut and increased wages in 2016 contributed first to increased consumption, accelerating economic growth in the election year. However, the increased wages in the public sector led, through the demonstration effect, to rapid growth of wages in the private sector, compared to the labour productivity. The new wage growth in the public sector in 2017 will have the same effect. With higher wages, production incentives diminish, which will affect the economic growth and implicitly the wage growth in the future.

Budget deficit growth through increased public investments in infrastructure would be a better option which would have led to increased efficiency in the private sector. During the last 8 years, the weight of private investments in the GDP has had a descending trend. That is why for more than 8 years the private sector has a savings surplus which in its turn has had a descending trend. The savings surplus produced is used to fund the public budget deficit. The public budget deficit is not generated by public investments but by current expenses (material, wages and social expenses). It finally results that during the last 8 years, our society has used the savings surplus of the private sector not to fund investments but to fund current public expenses. It means that our production potential is deeply affected, which will result into long-term slowing down of the economic growth.

“Under these circumstances, the fiscal-budgetary environment is altered in terms of political decision. We lack basic correlation between priorities of the fiscal policy, on the one hand, and priorities of the budget policy, on the other hand. Fiscal policy intends to take taxes down, and budget policy intends to take expenses up. With low taxes and high expenses, as stipulated by the law of uniformed wages, we shall have an ill-fated explosive combination. Hence, excessive deficit and expanded public debt” (Barbu & Căpuşneanu, 2015).

Pro-cyclicity is a historical feature of the Romanian economic policies, and the issue is the exhaustion of fiscal incentives for the moment when we may need them most. Pro-cyclic policies stimulate growth beyond its potential, risking a higher amplitude than a recession.

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