A Critical Decision

By Andrea Schaechter and Guillermo Tolosa[1]

Romania has made significant strides over the last seven years to fix its embattled public finances. We are concerned that the Fiscal Code in its current form would put these achievements at risk. It would entail a yearly loss of revenues of about 2.2 percent of GDP and an increase in the fiscal deficit to at least 3 percent of GDP, putting public debt on an upward trajectory. Alternatively, to keep the deficit in check it would require a downsizing of government expenditure as well as forgoing new spending initiatives, including for infrastructure, defense, wages, health or education.

Is there an alternative third way that would allow Romania to gradually lower its public debt, alleviate the tax burden, and fund new projects? We believe there is, if the scope and speed of tax policy measures as well as new spending plans are more moderate. Below we put forward some arguments for adjusting the Fiscal Code with such an option in mind.

Fiscal policy should be sustainable. After many years of belt-tightening, Romania reached a sustainable structural deficit in 2014, and will not require further deficit reductions in 2015 or 2016. Public debt, which is now nearly two and a half times higher than before the crisis, when measured as a share of the economy, would stabilize. In the eyes of investors this can be a significant strength, in particular given the remaining uncertainty surrounding countries in the region.

Fiscal stimulus measures should be well-timed. While the economic situation is still very difficult for many Romanians, the country is now growing at full speed and wages have risen this year by more than 7 percent. It is not evident that further stimulus is desirable at this point, if financed with more debt. Austerity would inevitably be needed when cheap and abundant financing stops and debt has reached higher levels. Romania has gone through such an unfortunate cycle of excessive stimulus in good times and strict austerity in bad times in the past decade. It should not be repeated.

Targeted tax cuts achieve the best results. The current proposed tax package is almost exclusively directed to spur consumption, which is already the fastest growing part of the economy. The benefits of consumption-boosting tax policy initiatives are likely to be short-lived if there is little growth in investment.

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This is not to say that Romania cannot benefit from lower tax rates. However to create fiscal space for prudent tax cuts requires more concrete actions, more time, and close coordination by all line ministries and ANAF, in particular: (i) better tax collection, (ii) more efficient public spending, and (iii) shifts from nationally financed investment toward EU-funded projects. In all three areas progress is under way, but when assessing the actual numbers they do not yet add up to the sizeable amounts needed to finance the Fiscal Code proposals.

In summary, revisiting the Fiscal Code in Parliament is an opportunity to clarify the medium-term fiscal priorities, assess realistically the size of fiscal space and the speed at which it can be created, and rescale the proposed tax cuts accordingly. It will be a critical decision to preserve the hard-won achievements of macroeconomic stability.