

ROMANIA'S FISCAL REFORM REGARDING THE ADJUSTMENT OF THE BUDGET DEFICIT THROUGH THE CONVERGENCE PROGRAM AND THE IMPORTANCE OF ABSORBING INVESTMENTS FROM EUROPEAN FUNDS

Camelia Mădălina BELDIMAN*

Abstract: *This paper aims to highlight the importance of the convergence program for the period 2023-2026, with the goal of coordinating economic and budgetary policies unlike other EU member states. Romania has been subject to the Excessive Deficit Procedure (EDP) since 2020, receiving a recommendation from the European Commission to increase the budget deficit by more than 3% of GDP. According to this recommendation, Romania must rigorously implement fiscal measures to correct the excessive budget deficit by the end of 2024 in order to maintain macroeconomic stability. The scientific purpose of our approach is to emphasize the importance of creating a budgetary space to allocate funds for supporting public investments and implementing projects financed from European funds in an efficient, professional, and transparent manner, with a multiplier effect and a direct contribution to gross fixed capital formation. The main objectives of the long-term fiscal-budgetary policy aim to reduce the budget deficit from 8% of GDP in 2021 to 6.2% of GDP for 2022 and 4.4% of GDP for 2023, achieving a decrease of 2.9% of GDP in 2024, through a sustainable and balanced consolidation effort that does not affect the economy's capacity to sustain and promote investments, targeting a more limited increase in current expenditures and continued efforts to improve revenue collection. Failure to adopt measures to limit budget expenditures would result in additional financing needs in 2024, leading to an unsustainable level of the consolidated general government deficit of over 7% of GDP, which would increase public debt with the risk of tightening its financing conditions. Considering the aforementioned issues, which concern Romania's public and strategic interest in ensuring the sustainability of public finances, fiscal consolidation, and the management of European funds, an extraordinary situation arises whose regulation cannot be postponed, requiring the adoption of immediate measures through an emergency ordinance.*

* Senior Lecturer, PhD, "Dunărea de Jos" University of Galați, Faculty of Law and Administrative Sciences, Romania, Corresponding author: madi.beldiman@gmail.com.



Copyright: © 2024 by the authors.
Open access publication under the terms and
conditions of the Creative Commons
Attribution (CC BY) license
(<https://creativecommons.org/licenses/by/4.0/>)

Keywords: *convergence program; budget deficit adjustment; reduction of macroeconomic imbalances; inflation rate; fiscal measures*

1. Introduction

This paper aims to highlight the importance of implementing the convergence program, analyzing the realities and challenges currently facing Romania, in order to find the optimal solution for adjusting the long-term budget deficit that will lead to reducing macroeconomic imbalances and, at the same time, creating the fiscal space necessary for implementing investments financed from the European funds available to Romania.

Given Romania's current situation, the adjustment will reflect a reduction in the share of permanent expenditures in GDP, primarily at the expense of maintaining prudent wage and social assistance policies in the public sector. Additionally, the increase in the share of budget revenues will be supported by the accelerated absorption of European funds, concurrently with improving tax collection, in the context of implementing the reforms and investments included in the National Recovery and Resilience Plan.

The involvement of the National Bank of Romania (BNR) in the economy aims primarily to ensure and maintain price stability, representing the best contribution that monetary policy can make to sustainable economic growth. BNR formulates and implements monetary policy within the framework of the inflation maintenance strategy, aiming to bring the annual inflation rate back to 2.5% \pm 1 percentage point in the medium term and to lower it over the longer term to a level compatible with the quantitative definition of price stability adopted by the European Central Bank.

The annual inflation rate has sharply accelerated its rise in June 2022, reaching 16.37% in December, well above the projected range, with the main effect being the increase in prices of processed foods, as well as the rise in fuel prices, electricity, and natural gas prices, flattening in the second half of the year with the base effect resulting in downward corrections in the prices of certain goods.

At the same time, the unit labor cost in industry has significantly accelerated its double-digit annual growth in the second half of 2022, resulting in a further deterioration in labor productivity, amid the energy crisis and production chain blockages. Moreover, the current account deficit continued to increase sharply throughout the year, but also under the influence of the worsening exchange rate and the significant increase in reinvested profits and redistributed dividends.

According to evaluations in the second half of 2022, economic growth is expected to slow significantly in 2023 and to recover only slightly in 2024, a perspective that makes the relatively rapid narrowing of the GDP gap likely and its descent into negative territory starting in the fourth quarter of 2023, implying the rapid exhaustion of inflationary pressures on the demand side.

High uncertainties and risks have arisen from the sharp rise in inflation in Europe and globally, prompting central banks in the region to accelerate or continue raising representative interest rates.

Accordingly, BNR raised the key interest rate 9 times consecutively from January 2022 to January 2023, by a total of 5.25 percentage points, to 7.0%. Correspondingly, the interest rate for the lending facility was raised to 8.0%, and the rate for the deposit facility to 6.0%. At the same time, BNR maintained firm control over liquidity in the money market and maintained the current levels of minimum reserve requirements for liabilities in RON and foreign currency of credit institutions. These measures aimed to anchor medium-term inflation expectations and stimulate savings, with the aim of sustainably bringing the annual inflation rate back in line with the stationary target of 2.5% \pm 1 percentage point, in a manner that contributes to achieving sustainable economic growth.

Furthermore, the exchange rate of the leu/euro remained relatively stable in the first part of the year, including in the context of BNR's actions in managing liquidity, and subsequently, the national currency tended to appreciate against the euro and significantly strengthen against the US dollar, thus substantially recovering from the depreciation suffered in the first three quarters of the year.

2. Economic Perspectives in Romania and Global Economic Evolution

The International Monetary Fund estimates global economic growth at 2.8% for 2023 and 3.0% for 2024, as restrictive monetary policies continue to temper inflation, financial market deterioration, ongoing Russian aggression against Ukraine, and the expansion of geo-economic fragmentation. Advanced economies are expected to achieve an average economic growth of 1.3% in 2023 and 1.4% in 2024, while developing countries are projected to experience more pronounced growth, at 3.9% in 2023 and 4.2% in 2024¹. For the Eurozone countries, a growth rate of 0.8% is estimated for 2023 (0.1 percentage points above winter estimates and 0.3 percentage

¹ According to EUROSTAT communique no. 47 of April 21, 2023

points above estimates from last fall), mainly due to adjusted economic growth forecasts for Spain (+0.4 percentage points to 1.5%) and Italy (0.1 percentage points to 0.7%). A slight recession is forecasted for the German economy (-0.1%) in 2023, followed by growth of 1.1% in 2024. In 2024, Eurozone economies could advance by 1.4%¹.

A 2.7% economic growth is expected for the region in 2024. Compared to January projections for this year, the growth perspective for the region has improved by 1.3 percentage points, while economic growth for 2024 has been slightly revised downward by 0.1 percentage point. For the countries in the Central Europe region (Bulgaria, Croatia, Hungary, Poland, and Romania), economic growth for 2023, compared to the previous forecast, has been maintained at 1.1% and adjusted upward by 0.2 percentage points for 2024 (2.9%)². The impact of tightening financial conditions is likely to be felt over time throughout the economy, particularly on private investments. Growth in the euro area is also expected to be slow in 2023, but the benefits of lower energy prices and lower inflation should support a gradual improvement in economic activity, with average annual growth in 2024 expected to be nearly double (1.5%) compared to 2023 (0.8%), with the economy's growth being driven by services and construction, while industry and agriculture have tempered economic growth levels due to negative developments.

The services sector, amid the return to normalcy of all activities and considerable performances in high-value-added sectors, recorded an increase of 7.7%, resulting in a contribution of 4.5 percentage points to GDP dynamics, representing over 90% of the economic growth level. Within this sector, the "information and communication" branch was the most dynamic in the economy, with significant growth (20.0%), continuing the good results from recent years. This sector's contribution to GDP growth was 1.3 percentage points. In the construction sector, the results in 2022 exceeded expectations, with gross value added increasing by 11.2%, a consequence of spectacular developments in the second half of the year, despite the challenges facing this sector due to high material prices and labor shortages. The contribution to real GDP growth was 0.7 percentage points. The industry continued to experience exacerbated supply difficulties and rising prices for energy products. Thus, in 2022, gross value added in industry decreased by 2.3%, reducing economic growth by 0.5 percentage points³.

¹ CNSP- Projection of the main macroeconomic indicators, spring forecast, May 5, 2023.

² The 2023-2026 Convergence Program carried out by the Government of Romania in May 2023

³ <http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/>

The agricultural sector was affected in 2022, on one hand, by adverse weather conditions (mainly in the field of cereal crops), and on the other hand, by price increases (fuel, fertilizers, etc.), leading to a 11.6% decrease in activity volume and a 0.5 percentage point decrease in economic growth.

In 2022, the evolution of consumer prices globally, as well as the prices of goods and services in Romania, followed an upward trend. In December, an annual rate of 16.4% was recorded, the highest increase in the last 20 years. Internal inflationary pressures were mainly generated by price increases in energy goods, which were passed on to production costs, as well as by increases in food prices. On an annual average, inflation remained at a high plateau, with an annual rate of 13.8%. Above-average increases were observed in the prices of food products (15.7%), followed by non-food items (14.7%), while service tariffs increased at a slower pace, by 7.8%. On average, the first quarter of 2023 ended with an inflation rate of 15.04%, with the most significant increase recorded in food prices (22.12%), followed by non-food items (11.88%) and services (10.49%)¹.

Romania managed to maintain a relatively stable economic balance, including in terms of the labor market, which was supported by measures to support employees and employers, improved workplace flexibility, and the redirection of human resources to sectors less affected by the crisis and with growth prospects in the coming years.

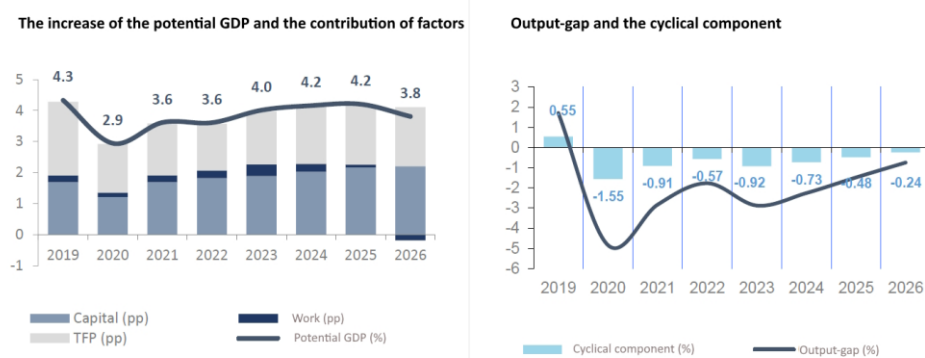
3. Romanian Economic Developments in the Period 2023-2026

Potential economic growth is rebounding as a result of investments in the economy. For the year 2023, potential growth is estimated at 4%, and as the implementation of investments from the National Recovery and Resilience Plan (PNRR) progresses, the potential of the Romanian economy approaches pre-pandemic levels.

Regarding the contribution of the labor factor to potential growth, it is negatively affected by demographic trends, but on average remains positive due to structural improvements in the labor market, given the slight upward trend in the activity rate

¹ <http://www.prouniversitaria.ro/carte/managementul-proiectelor-finantate-din-fonduri-europene-pentru-perioada-2014-2020>

of the population aged 15-74 and the increasing influx of workers from abroad under efficient integration into the Romanian labor market¹.



Source: The National Commission for Strategy and Forecasting

As shown in the above graph, the output gap has a decreasing trend, recording negative values, from -2.9% of potential GDP in 2023 to 0.7% of potential GDP in 2026. Against the backdrop of the estimated economic growth for the period 2023-2026, a favorable evolution in the labor market is expected, creating conditions for increasing the number of jobs and improving employment for the population aged 20-64 (by 5.3 percentage points by 2026, reaching a level of 73.9%)².

Economic growth is based on the continuation of the investment process starting from the second half of 2022, primarily supported by funds allocated from European funds (PNRR and the Multiannual Financial Framework 2021-2027), as well as from governmental sources, estimating a growth in gross fixed capital formation by 6.8%, materializing in productive and efficient investments with a multiplier effect throughout the economy. Less favorable economic prospects, maintaining high price levels, as well as the increase in interest rates on loans, will significantly influence the dynamics of private consumption, with only a 2.7% growth expected in 2023. The positive contribution of domestic demand (+3.4 percentage points) to real GDP growth will be offset by the negative contribution of net exports (-0.6 percentage

¹ The 2023-2026 Convergence Program carried out by the Government of Romania in May 2023

² CNSP- Projection of the main macroeconomic indicators, spring forecast, May 5, 2023

points), with the real growth in exports of goods and services (+4.0%) being lower than that of imports of goods and services (+4.7%)¹.

Table 1. Components of GDP - Economic growth

	2022	2023	2024	2025	2026
Real GDP	4.7	2.8	4.8	5.0	4.6
Nominal GDP	18.7	12.9	10.5	8.8	8.0
Components of real GDP - supply side					
Industry	-2.3	-0.2	4.0	4.9	4.4
Agriculture, forestry, and fishing	-11.6	10.6	5.3	1.8	1.6
Construction	11.2	7.0	9.6	10.0	8.0
Services	7.7	3.1	4.6	4.8	4.4
Contributions to GDP growth - expenditure method (percentages)					
Final domestic demand	6.1	3.7	5.7	5.7	5.1
Change in inventories	-0.6	-0.2	-0.1	0.0	0.0
Net exports	-0.7	-0.6	-0.7	-0.6	-0.5
Contributions to GDP growth - supply side (percentages)					
Industry	-0.5	0.0	0.9	1.1	1.0
Agriculture, forestry, and fishing	-0.5	0.5	0.3	0.1	0.1
Construction	0.7	0.4	0.6	0.7	0.6
Services	4.5	1.8	2.6	2.7	2.5

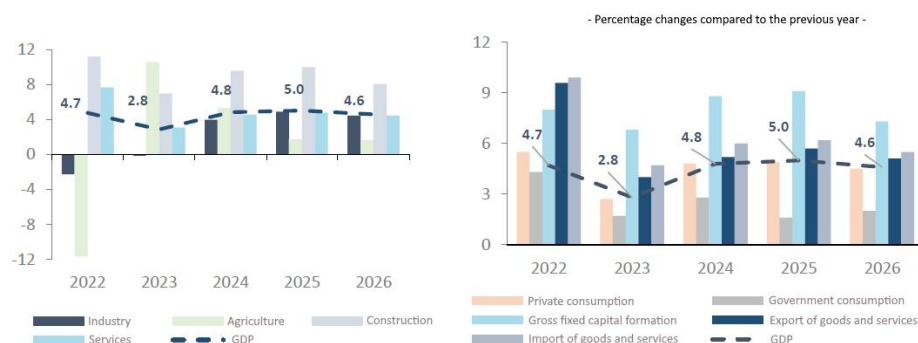
Source: National Institute of Statistics (INS) and National Commission for Strategy and Prognosis

During the period 2024-2026, the average annual growth rate is forecasted at 4.8%. The scenario is based on the recovery of the industry, after the decline in previous years, against the backdrop of economic recovery, thus estimating an average annual evolution of 4.4%. Investments will continue to play a fundamental role, their development being supported by the use of European funds from the PNRR and the Multiannual Financial Framework. Under these conditions, a construction sector with an average annual growth rate of 9.2% higher than that of GDP is foreseen. The services sector will also perform with an average annual growth of 4.6%, highlighting modern activities with high value added².

¹ The 2023-2026 Convergence Program carried out by the Government of Romania in May 2023

² Ministry of European Investments and Projects <https://mfe.gov.ro/pnrr/>

The evolution of the Gross Domestic Product by components

**Figure 1. The evolution of the GDP by components**

Source: National Institute of Statistics (INS) and National Commission for Strategy and Forecast

Domestic demand, with an average annual growth rate of 5.1%, will continue to represent the engine of economic growth, based on both the investment and consumption components. Meanwhile, the average annual growth rate of private consumption will be moderate (+4.7%), and government consumption will increase by an average of 2.1%. Exports of goods and services will increase at an average annual rate of 5.3%, while imports of goods and services will increase by an average of 5.9%. Their evolution will result in a gradual decrease in the negative contribution of net exports to the real GDP growth rate, reaching 0.5 percentage points at the end of the forecast period.

In 2023, it is estimated that inflation will rise to an average annual level of 10.7% and end the year at 7.4%. From 2024 to 2026, a downward trend in inflation is expected as the effects of supply shocks diminish, so that the forecasted inflation at the end of 2026 will reach 2.6%, respectively 2.9%, as an annual average¹.

Table 2. The prospects for inflation

%	2022	2023	2024	2025	2026
end of the year	16.4	7.4	3.9	2.9	2.6
annual average	13.8	10.7	5.4	3.2	2.9

Source: National Commission for Strategy and Prognosis

¹ Horizon 2020 <https://ec.europa.eu/programmes/horizon2020/h2020-sections>

In 2022, Romania's exports and imports increased by 23.1% and 28.1%, respectively, compared to 2021, with the increases in values expressed in euros having a significant price component. Under these conditions, the trade deficit was 44.0% higher than the level in 2021. In the first two months of 2023, international trade lost intensity compared to the same period of the previous year, but the evolution was positive in the sense that the growth rate of exports was 3.6 percentage points higher than that of imports (9.0% compared to 5.4%). In January-February 2023, the trade balance reached a negative value of 4.4 billion euros, mainly fueled by the petrochemical sector (pharmaceutical products, fertilizers, plastics, etc.), which generated 47.0% of the external loss level, and the energy sector (12.7%)¹.

For 2023, exports of goods are expected to increase by 10.6% compared to 2022, reaching 101.7 billion euros, concurrently with a 9.3% increase in imports, up to 137.8 billion euros. For the 2024-2026 period, average annual increases of 7.4% for exports of goods and 7.5% for imports are forecasted, with the dynamics of export indicators correlated with those of industrial production and the agricultural sector.

The current account of the balance of payments recorded a deficit in 2022 that was 52.1% higher than the level in the previous year, reaching a share of 9.3% of GDP.

The financing of the current account deficit was carried out to over 40% from foreign direct investments, representing the highest level recorded since the financial crisis of 2008. In the first two months of 2023, the current account balance had a negative value of 2.61 billion euros, 17.1% less than in the same period of the previous year, due to a reduction of 130 million euros in the goods deficit and an increase of 48.3% in the surplus in services, especially in telecommunications, IT and information services, and road freight transport.

For the whole of 2023, the current account deficit is expected to reach 26.2 billion euros, representing 8.1% of GDP. In the medium term, the level of the current account deficit will remain at an average annual value of 27.3 billion euros, with a share in GDP of 7.7% in 2024 and 6.7% in 2026.

During the period 2023-2026, the share of the net balance with the rest of the world in GDP, taking into account the capital account, will remain negative, with a decreasing trend, given the higher contribution of the capital account (De Mooij, et.alii., 2020).

¹ According to EUROSTAT communique no. 47 of April 21, 2023

4. Romania's Obligation to Respect the Specifications Regarding the Implementation of the National Recovery and Resilience Plan (PNRR)

Romania's National Recovery and Resilience Plan (PNRR) must ensure an optimal balance between the priorities of the European Union and Romania's development needs, by implementing major reforms and key investments that support resilience, crisis adaptation capacity, and growth potential, thereby facilitating the green and digital transition. The structure of the plan focuses on 15 components integrated into the 6 pillars of the Recovery and Resilience Mechanism, with a clear concentration on the green transition pillar, to address challenges related to climate and environmental changes as much as possible.

Fiscal adjustment combined with structural reforms and investments represent the approach to addressing macroeconomic vulnerabilities. Romanian fiscal legislation will undergo thorough analysis, benefiting from technical assistance, especially in the field of taxes and social contributions on income earned by individuals, corporate income tax, property taxes, and green tax. The revision of fiscal legislation aims for a positive impact of 0.5% on GDP starting in 2025 through the gradual withdrawal of excessive fiscal incentives, avoiding the expansion of reduced VAT rates, using a tax base linked to market value, eliminating distortions that allow taxpayers to minimize tax liabilities, and taxing labor and corporate profits.

The fiscal reform aims to ensure the long-term sustainability of public finances, aiming to increase the share of budget revenues in GDP (by 2.5 percentage points by Q4 2025 compared to 2019) and reduce the VAT gap. The PNRR presents a unique opportunity for the digital development of the tax administration, implementing new, innovative concepts to modify or influence the functioning paradigm of the institution and facilitate the transition to predominantly digital interaction, both in processes involving external interactions of the institution and in its internal processes.

Romania aims to take measures to combat corruption and increase the quality and efficiency of the customs system. The reform objective is to improve the administrative and operational capacity of the Romanian Customs Authority and create favorable conditions for transitioning customs activities to a fully electronic environment and simplifying customs procedures, with €62 million allocated. The reform targets EU citizens, the business environment, and economic operators who will benefit from a unified methodology to guide them through customs procedures, reducing bureaucracy and waiting times for customs formalities, thereby facilitating the legitimate flow of trade.

Under the Recovery and Resilience Mechanism, Romania benefits from funds totaling €29.2 billion, of which €14.24 billion are non-repayable financing and €14.94 billion represent support in the form of loans (Dobrescu & Pavel, 2014).

In Romania's case, the long-term sustainability of public finances will be influenced by the implementation of reforms regarding the revision of the fiscal framework and the pension system, included in the National Recovery and Resilience Plan (PNRR). This will be evaluated this year based on the 2024 Ageing Report at the European Union level. In recent years, assessments of the long-term sustainability of Romania's public finances have been significantly influenced by consistent ad hoc increases in the pension point value.

Demographic changes will alter Romania's population structure and have implications for labor market dynamics and pension expenditures. In this context, pressure on the public pension system will increase, as it will have fewer resources compared to expenditures, putting pressure on the budget balance and the long-term sustainability of public finances.

The digital transformation of the National Tax Administration Agency (ANAF), through comprehensive digital solutions, provides a positive experience in terms of accessing digital services by taxpayers, by transforming the Single Public Portal into the main mode of interaction between taxpayers and ANAF. Using digitization for the functional areas of tax administration leads to the optimization of existing IT applications and increased automation of ANAF's operational functions (efficient tax services for administration and citizens - SFERA; redesign and optimization of the Value Added Tax Information Exchange System, etc.).

5. Conclusion

All in all, I believe that the research issue has been sufficiently debated with solid arguments regarding the adjustment of the budget deficit within the reference value of 3% of GDP, as the implementation of European investment projects is difficult due to the efforts made to improve revenue collection from taxes and taxes which do not materialize. The long-term sustainability of public finances will be influenced by the implementation of reforms regarding the revision of the fiscal framework and undoubtedly represents a current research topic, especially in the context of the acceleration of the globalization and digitalization processes. Limiting salary increases in the public sector over the medium term will be reflected in a reduced contribution to deficit adjustment (expressed as a share of GDP), in the context of

the forecasted slowdown in nominal GDP dynamics, against the backdrop of inflation deceleration. In the scenario of maintaining tax revenues at approximately 28% of GDP, to achieve fiscal consolidation within the assumed parameters (reducing the budget deficit by 3.2 percentage points by 2024 and maintaining it at 3% of GDP until 2026), a significant adjustment of current expenditure growth would continue to be necessary (from 33.4% of GDP in 2022 to 29% of GDP in 2026).

For the implementation of investment projects included in the loan component of the PNRR (approximately 15 billion euros) until 2026, it is necessary to create additional fiscal space. These investment projects generate an additional average annual impact on expenditure of nearly 1% of GDP over the next 3 years.

Furthermore, by reforming the economic governance framework at the European level (revising fiscal rules) currently under discussion, with implementation starting in 2024, there is a proposal for strict limitation of the growth of net primary expenditure for states presenting high risks regarding the sustainability of public debt, ensuring a significant reduction in the deficit below the reference level of 3% of GDP. In conclusion, investigating inappropriate fiscal behaviors will undoubtedly bring increased efficiency in terms of revenue collection for the consolidated general budget.

5. References

- Anghelache, G.; Belean, P. & Vasile, B. (2003). *Finanțele publice ale României/ Romania's public finances*. Bucharest: Ed. Economică.
- Bistriceanu, Ghe. (2007). *Mica enciclopedie de finanțe, monedă, asigurări – Literele D-O/ Small encyclopedia of finance, currency, insurance – Letters D-O*. Bucharest: Ed. Universitară.
- Chelan (Trandafir), A. (2011). *Concurența fiscală și impactul său asupra României în contextul globalizării/ Fiscal competition and its impact on Romania in the context of globalization*. PhD Thesis. Bucharest: Academia de Studii Economice
- Dascălu, E.D. (2006). *Sistemul Bugetar în România/The Budget System in Romania*. Bucharest: Ed. Didactică și Pedagogică.
- Filip, Gheorghe (2009-2010). *Finanțe Publice/ Public Finance*, Course support, 2nd year, Finance-Banking. Iasi: Universitatea "Al.I. Cuza" Iasi.
- Matei, Ghe.; Drăcea, M.; Drăcea, R. & Mitu, N.E. (2007). *Finanțe publice/Public Finance*. Craiova: Ed. Sitech.
- De Mooij, R.A.; Prihardini, D.; Pflugbeil, A. & Stavrev, E. (2020). *International Taxation and Luxembourg's Economy. IMF Working Paper 20/264*, International Monetary Fund, Washington, DC

Lieberman, M. & Hall, R.E. (2010). *Principles & Applications of Economics*, 5th edition. South-Western: Cengage Learning.

Mara, E.R. (2011). *Finanțele publice și fiscalitatea între teorie și practică/ Public finances and taxation between theory and practice*. Cluj-Napoca: Ed. Risoprint.

Dobrescu, A. & Pavel, E. (2014). *Managementul proiectelor finantate din fonduri Europene pentru perioada 2014-2020/ Management of projects financed from European funds for the period 2014-2020*. Bucharest: Pro Universitaria.

Moșteanu, T. (coord.). *Finanțe publice note de curs și aplicații pentru seminar/ Public Finance Course Notes and Seminar Applications*. Bucharest.

Văcărel I. (coord.). (2006). *Finanțe publice/Public Finance*. 5th Edition. Bucharest: Ed. Didactică și Pedagogică.

<http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/>

CNSP- Projection of the main macroeconomic indicators, Spring Forecast, May 5, 2023.

The 2023-2026 Convergence Program carried out by the Government of Romania in May 2023

EUROSTAT communique no. 47 of April 21, 2023.

Ministry of European Investments and Projects <https://mfe.gov.ro/pnrr/>.

<http://www.prouniversitaria.ro/carte/managementul-proiectelor-finantate-din-fonduri-europene-pentru-perioada-2014-2020>.

Horizon 2020, <https://ec.europa.eu/programmes/horizon2020/h2020-sections>.