

Romania: Complications with implementing the austerity package

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On 25 June, the Romanian Constitutional Court challenged the legality of some parts of the austerity programme agreed by the centre-right government led by Emil Boc and the International Monetary Fund. The Court found that one of the essential elements of the programme, namely the 15-percent reduction of pensions to come into force on 1 July, was unconstitutional. The award has adversely affected the economic situation (the stock exchange indices and the national currency exchange rate have fallen) and will prevent Romania from the timely fulfilment of the conditions of its agreement with the IMF. Despite serious concern on the financial markets, no threat seems to exist to the continuation of reforms. The government has a stable majority, which enables the modification of the savings programme. The confusion regarding its adoption and the form of the changes introduced (VAT increase) will however seriously impede Romania's recovery from recession.

Harsh austerity programme

As a consequence of the deep economic crisis (GDP in 2009 fell by 7.1%), Romania received in May 2009 a stand-by loan of 20 billion euros from the IMF, the World Bank and the European Union. The availability of further tranches of the loan was made dependent on the reduction of the budget deficit (the maximum level for 2010 was set at 6.8% of GDP), the carrying out of a pension system reform and a reduction in employment in the public sector (1.36 million employees). The reform programme has been in the process of being gradually introduced since last May. However, its main part involving radical budget cuts was to come into effect at the beginning of July 2010.

The details of the programme had been known for a year or so, yet austerity measures were adopted by parliament practically at the last moment (mid June). The government coalition - which consists of the Democratic Liberal Party (PDL), the Democratic Union of Hungarians in Romania (UDMR) and independent MPs - was delaying the vote on the package as it was under strong pressure from the trade unions and public protests. The adopted package of laws provides for a 25 per cent reduction of wages in the public sector, a 15 per cent reduction of social benefits, a recalculation of pensions for retired law enforcement officers and a 15 per cent reduction in pensions (which was later rejected by the Constitutional Court). The programme also introduces changes into the tax system; it broadens the income tax base and introduces a tax on capital gains.

A restless search for funds

The blocking of the pension cut by the Constitutional Court has complicated the government's plans for lowering the budget deficit. The reduction of pensions was one of the essential elements of economic reform and was expected to result in serious savings (see Appendix). Nevertheless, the other budget cuts have been deemed constitutional and will come into effect as scheduled.

Currently the government is searching for interim ways of restricting the budget deficit to meet the conditions of the agreement with the IMF. On 28 June, it issued a decree raising the VAT rate from 19% to 24%, starting on 1 July. This means a return to the solution previously recommended by the IMF. However, this urgent way in which the changes have been introduced may be challenged due to the lack of the *vacatio legis*. Additionally, the extra intakes from VAT are likely to be lower than the planned savings on pensions.

Investors are anxious

The challenging of the austerity package and the urgent decision to increase the VAT rate made financial markets anxious about the situation in Romania. A slump in all stock exchange indices (on 25 June, the main stock exchange index BET fell by 6% in one day), the sudden depreciation of the national currency (on 28 June, the value of the leu against the euro reached the lowest level in history: 4.325 RON/euro) and lowering interest in Romanian debentures were the consequences of this move. It is also uncertain whether the 900 million euro tranche of the loan granted by the IMF will be paid out. The IMF was to grant consent for the payment of the funds on 28 June but the decision was postponed (according to unconfirmed reports, it is to be taken on 2 July).

Regardless of those problems, the Romanian economy is not facing the risk of instability. Probably, a delay in the payment of the stand-by loan's tranche does not pose any threat to the stability of state finances (the public debt in 2009 did not exceed 24% of GDP). Additionally, the central bank reserves necessary to protect the value of the leu are exceptionally high. However, the confusion regarding the savings programme has worsened the investment climate and reinforced the negative image of Romania as a country with a rather unpredictable economic policy.

The government's stability and the future of reforms

The blocking of part of the savings programme is the greatest defeat sustained by the centre-right government led by Emil Boc to date. The opposition parties, the post-communist Social Democratic Party (PSD) and the liberal PNL, have promised to announce another vote of no confidence against the government. The vote will probably take place this August or September. However, the dismissal of the government seems rather unlikely because the ruling coalition enjoys a small but stable majority in parliament.

The Romanian government will continue reform because the increase in the VAT rate will not be sufficient to bring the deficit down to the level agreed with the IMF. Instead of making budget cuts, which was the preferred form of introducing savings so far, further changes aimed at increasing budget incomes will be made. For example, it is being considered to raise the flat income tax rate from 16% to 20% from 2011. However, higher taxes will slow down Romania's recovery from recession (according to forecasts, its GDP will fall by 2% in 2010).

Appendix. The Emil Boc government's savings programme

Austerity measures	Expected savings (in % of GDP) by the end of 2010
25% reduction of wages in the public sector	1%
15% reduction of pensions* and social benefits	1%
Cutting funds for local governments	0.3%
Cutting home heating subsidies	0.3%

**will not be introduced*