Fiscal Council of Romania

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Public investments and the budget deficit: the persistence of a misguided interpretation

I saw in the media a repeated interpretation of the relationship between the budget deficit and public investments, which is flawed. This interpretation has been adopted by some government officials. When the budget deficit reaches 9.28% in 2024 (according to ESA methodology), when the country faces the threat of a credit rating downgrade and major difficulties in accessing financing or refinancing, and when permanent expenditures consume a very large share of the public budget, it would be wise to show humility. I am therefore revisiting this interpretation, given the serious situation of the public budget (see my text, "Public investments and the budget deficit", Fiscal Council (FC), March 2024, and FC's documents).

The budget deficit in 2024 exceeded that of the pandemic year (2020), when it stood at 9.2% of GDP. The 9.28% deficit in 2024 is the result of imprudence in budget planning and considerable policy slippages, as well as an underestimation of the need for fiscal consolidation. The series of crises cannot justify such a high deficit, as these crises have affected not only Romania.

The idea that small deficits hinder development also gained traction, contributing, among other causes, to Romania entering the excessive deficit procedure (EDP) in 2020 — Romania being the only EU country under EDP that year. This thesis underestimated the role of European funds and the possibility of allocating resources for investments from the national budget itself. There are also opinions claiming that bringing the budget deficit down to around 6% of GDP in 2022 was evidence of fiscal consolidation after the pandemic year; however, it is overlooked that in 2021 economic output recovered and tax revenues increased, and that in 2022 the "surprise inflation" (triggered by the sharp rise in energy costs and disruptions in supply chains) significantly inflated the budget's nominal revenues. It is all the more regrettable that the pre-election and election years blocked fiscal consolidation. **And now, the deteriorating international context has caught us off guard**. Whose responsibility is this? And why do we fail to learn from other crisis episodes Romania has gone through?

Romania's budget deficit in 2024 was by far the highest in the EU; after Romania, much lower, comes Poland, with a deficit of 6.6% of GDP in 2024 — but Poland has a current account surplus, whereas Romania's current account deficit exceeded 8% of GDP in 2024. Moreover, about two-thirds of Romania's current account deficit was financed through borrowing. Those who point out that other countries also have large budget deficits fail to consider the full picture. I mentioned Poland, which has a current account surplus. Furthermore, Poland's defense spending accounted for 4.7% of GDP in 2024. If defense expenditures had not increased so significantly, Poland's budget deficit would likely have been around 4% of GDP. Slovakia also recorded a budget deficit above 5% of GDP in 2024, but it is part of the Eurozone and does not face currency risk. And examples can go on.

Let me return to the interpretation of the relationship previously mentioned. It is claimed that as long as public investments, as a percentage of GDP, are close to the budget deficit — as was allegedly the case in 2024 — the situation is not dramatic. It is also argued that the primary deficit (which excludes interest payments) was, as a share of GDP, lower than public investments. However, both comparisons are based on flawed reasoning, especially considering that European funds account for a large part of the financing of public investments. Since such financial resources appear both on the expenditure and revenue sides of the public budget, the ratio between public investments financed from domestic and borrowed resources and the budget deficit is well below one (it is subunitary); it was also below one compared to the primary deficit. This situation is indeed cause for concern, particularly when the budget deficit exceeds 9% of GDP and the share of permanent (rigid) expenditures is very high within total spending. Invoking certain "sustainability rules" allegedly being observed in public finance in Romania is meaningless. The reality is different. Moreover, at very high deficit levels, markets tend to react almost instinctively.

Moreover, investments must primarily be directed toward sectors that support the production of *tradables* (goods for export and import substitution), especially when external deficits are very large, as is the case in Romania. **Public investments cannot systematically justify very large budget deficits. Following such logic would imply that deficits could even exceed 10% of GDP — a level that markets would not finance.** The European Commission encourages the protection of public investments for development, but not through the pursuit of unsustainable budget deficits. A public budget needs adequate own revenues to allow the financing of public investments.

And a legitimate question arises: if the so-called "sustainability rules" are truly being respected, as claimed, then why is there a need for large-scale fiscal adjustment in Romania? The common-sense answer is that the invoked rules are neither properly formulated nor correctly interpreted.

Another question is why we have reached such high budget deficits. In economic policy, choices involve trade-offs; not all demands can be satisfied, and not all objectives can be achieved simultaneously. The reality is that control was lost — and not solely because of electoral years. There was a lack of a sense of priorities and urgencies, and of clear-sighted budgetary planning. It must be emphasized again: the succession of crises cannot justify the sharp rise in budget deficits in recent years.

Looking at pension reform, which placed significant pressure on the public budget in 2024 and will have a full effect in 2025, it becomes even more evident that careful budget planning was needed. The Fiscal Council, in fact, advocated for a gradual implementation of this reform. Similarly, the co-financing of investments from European funds should have been considered within budget programming, taking into account its impact on the budget deficit.

At the end of 2024, Romania's public debt stood at 54.6% of GDP, and its rate of growth is rapid if corrective measures for the budget deficit are not taken. **Those who point out that other EU countries have considerably higher public debt levels overlook the fact that Romania is not part of the Eurozone, and thus faces currency risk, while large budget deficits make access to financing more difficult and may cause nervous market reactions.**

Romania has a very shallow domestic financial market, which does not adequately support deficit financing — banks have exposure limits, and one cannot rely excessively on pension funds as financiers. Moreover, relying solely on external markets for financing is extremely dangerous, if not impossible.

The precarious state of Romania's public budget — with very low tax revenues (including social contributions), amounting to only 26-27% of GDP compared to an EU average of over 40%, and 34-35% in neighboring countries — represents a major handicap. Undertaking a large-scale fiscal correction when the international environment is highly unfavorable and when significant additional resources must be allocated to defense is an extremely difficult mission. But after the mistakes of recent years, there is no turning back. The neglect of the need for additional fiscal revenues is now revealing its full consequences.

As highlighted in documents of the Fiscal Council, fiscal consolidation cannot be achieved solely through spending cuts; an increase in tax revenues is also necessary. However, this target should have been a constant concern for successive governments.

Fiscal consolidation is further needed because Romania suffers from the "twin deficits" syndrome: a very high budget deficit combined with a very high current account deficit. Romania's current account deficit is among the largest (as a percentage of GDP) in the EU and is unique in the region; countries we traditionally compare ourselves with — the Czech Republic, Hungary, and Poland — have much lower current account deficits. The very large budget deficit largely explains the high current account deficit. **If the budget deficit is not significantly reduced, there is a risk of losing confidence in the leu, potential capital outflows, and mounting pressure toward the depreciation of the national currency.** The increasingly unfavorable international context further complicates Romania's domestic economic situation. It must be understood that the National Bank of Romania (NBR) cannot act as a *factotum* — it cannot ensure Romania's macroeconomic stability on its own.

The new derogation clause triggered by the European Commission (regarding defense expenditures) does not exempt Romania from the need for fiscal consolidation in the coming years, as some might believe. The clause does not alter the underlying economic reality.

We must increase tax revenues and reduce spending as much as possible, while ensuring maximum efficiency in expenditures. We must also make full use of European funds. Romania is currently at risk of losing many billion euros from the Recovery and Resilience Plan (PNRR). Romania must do everything possible to recover as much of the lost time as it can. The Romanian Bank for Investment and Development (BID) could play a role in the Romanian economy similar to that of the European Investment Bank (EIB) in the European Union.

An intensive absorption of European funds can mitigate the contractionary impact of the necessary fiscal correction, as well as the shock produced by the trade war and the broader worsening geopolitical context. This once again highlights the importance of Romania's membership in the European Union. A scenario in which Romania enters insolvency is inconceivable, given that it is an EU member state. However, this does not mean that a severe budgetary correction can be avoided.

The Multiannual Financial Framework (MFF) will likely allocate (percentagewise) fewer resources to Romania in the new cycle. The new MFF will change, considering the EU's challenges related to competitiveness and defense/security.

Romania has developed a “dependency” on European funds, which could backfire when these resources inevitably diminish — after 2026, the National Recovery and Resilience Plan (NRRP) ends, and funds from the MFF will decrease in the next financial cycle. A sharp decline in available European resources would impact budget execution, public investment, the balance of payments, and potential GDP. This outlook is an argument for ensuring that macroeconomic adjustment occurs within a reasonable timeframe, through credible measures.

The massive inflow of European funds calls into question the models used for assessing fiscal sustainability (debt sustainability analyses – DSA), given that these resources are not permanent; similarly, models used for evaluating economic balances, such as the balance of payments, raise concerns for the same reason.

A final thought: the public debate needs more professional honesty and less propaganda, even though economic science operates with approximations and assumptions, and often deals with controversial concepts (e.g., output gap/demand shortfall when discussing the fiscal stance).