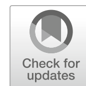
Fiscal Policy of the EU: Implications for Romania



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Abstract The economic and fiscal crisis which started in 2007–2008 triggered a significant change in the economic governance at the European Union level, particularly at the fiscal policy level. The paper analyses the evolution of the EU economic governance regulation, starting with the Maastricht Treaty from 1992, focusing on the more recent regulations outlined in the Treaty on Stability, Coordination and Governance (TSCG), particularly on the Fiscal Compact. The paper assesses the impact of the Fiscal Compact in Romania, pointing out the major consequences it has on the conduct of the fiscal policy and on the capacity to stabilize the business cycle. The study concludes that the space for maneuver of the fiscal policy in Romania will be much lower than in the past. Possible solutions to this constraint include the acceleration of the absorption of EU funds and the increase in public spending efficiency.

The key points of the chapter are the following ones:

1. to understand the main changes in the EU economic governance regulation starting with 1992
2. to understand the provisions of the Fiscal Compact
3. to understand the impact of the Fiscal Compact in Romania
4. to clarify the concept of Medium Term Objective (MTO, structural budget balance)
5. to identify solutions on how to cope with the constraints from the Fiscal Compact

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1 Introduction

It is well known that successful monetary unions in history are those that have combined the monetary union with the fiscal one (e.g. U.S., Canada, Germany and Switzerland). From this point of view, the Euro area, with a common monetary policy and no common fiscal policy is a unique and an unprecedented form of a common monetary union.

According to Bordo (2010), and Bordo et al. (2013), there are couple of required characteristics for a successful monetary union:

- a common monetary policy with an independent central bank that has the main goal price stability;
- free trade and free movement of production factors;
- a common fiscal policy, strong fiscal rules, with member states keeping some fiscal independence, but fiscal discipline driven by the markets; "no bail-out" rule of member states by the federal government;
- a strong mechanism to address asymmetric shocks (e.g. automatic stabilizers such as unemployment benefits and progressive income taxation, as well as financial transfers among members).

The European Monetary Union has a common monetary policyimplemented by ECB, but there is no fiscal union—although some authors, like Jonung (2010), argue that the EU has a fiscal union through the Stability and Growth Pact. The member states have almost the full ability to conduct their independent fiscal policy. There is a common budget, but the EU's budget is only around 1% of GDP. There are no fiscal stabilization policy tools and no fiscal transfers are made between member states to deal with asymmetric shocks.

It is also well known that the labor market in EU is more rigid and much less mobile than in federal states like the U.S. and Canada.

Consequently, it is also largely agreed in the literature that the European Monetary Union does not satisfy the optimum currency area criteria.

The economic and fiscal crisis which started in 2007–2008 led to significant economic implication at the global level, which triggered a necessary reaction at the policy making level.

Some authors (Eyraud et al. 2017) show that some of the fiscal problems faced by the European Union members, particularly by the euro area members, were driven by distorted political incentives. Using real-time data, they found evidence on fiscal policy biases (especially procyclicality), excessive deficits, and compositional distortions. Also, they argue that fiscal rules at the EU level failed to avoid these biases, more political and public support being needed to make them more successful. Moreover, the strong cross-country fiscal spillovers should be considered given the trade linkages, confidence effects, the high degree of financial market integration, and the common monetary policy of ECB (see also Georgiadis 2015 and Beck et al. 2016). For instance, a deterioration in public finances in one

member country can be translated in higher funding cost for the other member states as well.

In the European Union, and particularly in the euro zone, the crisis triggered an increasing awareness about the need to improve the economic governance framework to move closer to a fiscal union.

The economic (including fiscal) governance at the EU level has been changed and updated during the last 25 years, trying to keep the pace with the historical developments.

2 Evolution of EU Economic Governance Regulation

The discussion about common economic governance at the EU level started back in 1992, when the EU Member States signed the Maastricht Treaty, which introduced the euro as a single currency and set a limit for the public debt and budget deficit at 60% of GDP, respectively 3% of GDP.

In 1997–1998, a reinforcement of the Maastricht Treaty was done through the Stability and Growth Pact (SGP), the EU Member States agreeing to strengthen the surveillance and coordination of national fiscal and economic policies. At that point EU introduced the medium-term budgetary objective (MTO) rule—a budgetary position in medium term "close to balance or in surplus". Basically, the EU Member States committed to take corrective fiscal-budgetary measures to reach their budget objectives from the convergence programs, and to correct excessive deficits as quickly as possible. The European Commission could now decide to launch an excessive deficit procedure when the deficit of a member country exceeds 3% of GDP.

In 1999 the corrective arm of the Stability and Growth Pact (SGP) was introduced. The objective is to "deter excessive general government deficits" and, if they occur, to force their correction.[1] The excessive deficit over 3% of GDP shall be considered exceptional and temporary "when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn." Also, the excess over 3% "shall be considered temporary if budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn."[2] The severe economic downturn was considered only if there is an annual fall of real GDP of at least 2%.

The European Council recommendation was intended to "establish a deadline for the correction of the excessive deficit, which should be completed in the year

[1]COUNCIL REGULATION (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

[2]COUNCIL REGULATION (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

following its identification unless there are special circumstances."[3] Some sanctions can apply, usually as a non-interest-bearing deposit. This deposit shall comprise a fixed component equal to 0.2% of GDP, and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP (Heipertz and Verdun 2010).

In 2003, EU finance ministers rejected the European Commission's recommendation to initiate sanctions against France and Germany for breaching the Stability and Growth Pact's rules. The Commission took the European Council to the European Court of Justice.

In 2005, it was decided to end the "one-size-fits all era", as the EU lawmakers amended the Stability and Growth Pact (SGP) to better consider individual national circumstances and avoid a "one size fits all" approach. At the same time, the surveillance and coordination were strengthened, and the excessive deficit procedure was clarified and accelerated.

In 2010, the first "European Semester" exercise came in place. The goal of the European Semester is to have a better coordination of the EU member countries economic policies throughout the year and address the economic challenges facing the EU. The ultimate scope of the European Semester is to ensure sound public finances (in order to avoid excessive public debt), to prevent excessive macroeconomic imbalances, to stimulate structural reform, to create more jobs and growth, and boost investment. Every year, the European Commission elaborates an in depth analysis of the Member States budgetary, macroeconomic and structural reform plans. Then, the European Commission issues country specific recommendations for the next 12–18 months, and assesses the progresses of each country towards the "Europe 2020" targets.

In 2011, a collection of six new laws, known as the "six-pack" is agreed, being then followed by the 2-pack that further improves budgetary surveillance in the Euro area (every country using the euro must submit its draft budget to the Commission by mid-October, and if the Commission considers this may not satisfy the single currency rules, it may request it be revised).

In the "six-pack" regulations the EU Governments should:[4]

- Operate public accounting systems that comprehensively cover all areas of revenue and expenditure, which must be subject to internal control and independent audits. In particular, Member States shall publish cash-based budget data and a detailed reconciliation table showing the methodology of transition between cash-based data and data based on the ESA standard.
- Make the fiscal data publicly available. Those for central and state government and the social security sector must be supplied monthly and those for local government quarterly (Council Directive 2011/85/EU).

[3]COUNCIL REGULATION (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

[4]COUNCIL DIRECTIVE 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

- Ensure their fiscal planning is based on realistic macroeconomic and budgetary forecasts, using the most up-to-date data. These include latest European Commission forecasts and, where relevant, those from independent organizations. Member States shall specify which institution is responsible for producing macroeconomic and budgetary forecasts and shall make public the official macroeconomic and budgetary forecasts prepared for fiscal planning, including the methodologies, assumptions and relevant parameters underpinning those forecasts. At least annually, the Member States and the Commission shall engage in a technical dialogue concerning the assumptions underpinning the preparation of macroeconomic and budgetary forecasts (Council Directive 2011/85/EU).
- Operate specific fiscal rules to help ensure the overall government budget complies with European rules. The aim is to avoid excessive public deficit or debt. Independent organizations carefully monitor compliance with the rules (Council Directive 2011/85/EU).
- Establish a credible, effective medium-term budgetary framework that includes a 3 year fiscal planning horizon. This contains multiannual budgetary objectives, projections of major expenditure and revenue items and assessment of the long-term sustainability of public finances (Council Directive 2011/85/EU).
- Ensure consistency and coordination of all accounting rules and procedures across all areas of government activity (Council Directive 2011/85/EU).

In March 2012 a significant change in the EU economic governance was approved, the Fiscal Compact act being passed. The Euro zone Member States agreed to make the goal of balanced budgets part of their national constitutions and future euro area members agreed to do so once they adopt the common currency. The Fiscal Compact act is part of the treaty known as the Treaty on Stability, Coordination and Governance (TSCG), which was enacted in January 2013 (European Commission, "Timeline: The Evolution of EU Economic Governance").[5]

The Treaty on Stability, Coordination and Governance (TSCG) is intended to strengthen the economic and fiscal pillar of the euro area and of the European Union in general, by setting specific fiscal rules in the so called Fiscal Compact, to increase the coordination of the policy making, and to improve the economic governance.

The Treaty on Stability, Coordination and Governance (TSCG) is mandatory for the euro area members, and voluntary for the non-euro area members of the European Union. The countries signing the Treaty are expected to run balanced budgets or in surplus. This rule is met when the structural balance of the general government reaches the country-specific medium-term objective (MTO) as defined in the Stability and Growth Pact with a limit of 0.5% of GDP. In case the public debt is lower than 60% of GDP and the risks in terms of long-term sustainability of

[5]https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/timeline-evolution-eu-economic-governance_en

public finances are low, the medium-term objective can go up to 1.0% of GDP. If there are deviations from this MTO, an adjustment mechanism shall be triggered automatically.

The structural budget rule should be implemented in the national legislation through provisions of binding force and permanent character, preferably at the constitutional level.

Also, when the ratio of public debt to GDP exceeds the 60% reference, the contracting party shall reduce it at an average rate of one twentieth per year as a benchmark.

In December 2012 was presented the Four Presidents' Report "Towards a Genuine Economic and Monetary Union", which provides a roadmap for the completion of the Euro area. The focus of the report is on strengthening the economic governance at the European Monetary Union level, in particular on the implementation of a Banking Union for the euro area through the Single Supervisory Mechanism, new rules on bank resolution and recovery, and on deposit guarantee scheme. The process is organized in 3 stages. In stage 1 (2012–2013), the objective was to ensure fiscal sustainability and break the link between banks and sovereigns (one of the main causes of the sovereign debt crisis). In stage 2 (2013–2014), the objective was to complete the integration of the financial framework (through the setting up of a common resolution authority) and promote sound structural policies.

In stage 3 (after 2014), the objective was set to improve the resilience of the euro area through the creation of a shock-absorption function at the central level. This will be done through an insurance system set up at the central level, and by increasing the coordination of decision-making on national budgets, in particular in the field of taxation and employment.

In February 2013, the "two-pack" was passed by EU lawmakers which approve legislation for the euro area countries to prepare their budgets according to common standards and a common timeline. Moreover, the draft budget will be submitted to the European Commission and to the other EMU Member States.

In 2014, a review of the Six-Pack and Two-Pack rules was prepared in order to improve transparency and simplicity.

In 2015, the Five Presidents'[6] Report "Completing Europe's Economic and Monetary Union" was prepared, being intended to deepen the Economic and Monetary Union in three stages. The report established 3 stages to fulfil its targets:

– in Stage 1 or "Deepening by Doing" (1 July 2015–30 June 2017) the objective was to reach sound fiscal policies at national and euro area level and completing the Financial Union, by using existing Treaties.
– in Stage 2, or "completing EMU", the objective is to make the convergence process more mandatory, including the setup of a common euro area treasury.

[6]Jean-Claude Juncker, Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz.

– in Stage 3 or final stage (at the latest by 2025) the objective is to reach a deep and genuine monetary union.

The Five Presidents' Report proposed to complete four Unions: Economic, Financial, Fiscal, and Political. In order to reach the Fiscal union, the report proposed in Stage 1 to set-up an advisory European Fiscal Board which would coordinate and complement already existing national independent fiscal institutions (Fiscal Councils). The European Fiscal Board will provide an independent evaluation and analysis at European Union level on how the fiscal policy perform vs the rules and targets established in the new EU fiscal governance.

In Stage 2, the plan is to establish a common macroeconomic stabilization function to address the shocks which cannot be properly addressed at the national level. To reach that objective, some instruments will be considered, such as the European Fund for Strategic Investments.

3 The Relationship Between Public Finances and Economic Development

High budget deficit translates usually into higher debt. Recently, the interest of economists and policy makers on the public finance situation and its impact on economic growth has increased once again, as the global financial crisis triggered a significant increase in public debt worldwide. It is well known from the literature that a low level of public debt seems to be beneficial for economic growth, but in the long run the increasing public debt could become detrimental for the economic growth. Reinhart and Rogoff (2010) used a sample of 20 advanced and 24 emerging market economies for a long historical data series (1790–2009) to assess the relationship between economic growth and public debt. They found a difference of 2 pp for developed economies (and 1.6 pp for emerging economic) in median economic growth rates between low debt and high debt countries. They concluded that there is a debt turning point at 90% of GDP, beyond which the impact of public debt becomes negative on growth.

Égert (2015) used a formal econometric testing for the Reinhart-Rogoff dataset to see whether public debt has a negative nonlinear effect on growth if public debt exceeds 90% of GDP. He detected that the negative nonlinear relationship between debt and growth, but he showed that the effect materializes at much lower levels of public debt (between 20% and 60% of GDP).

Caner et al. (2010) detected a threshold of 77% of GDP for the public debt for developed markets, beyond which each additional pp of debt costs 0.017 pp of annual real growth. For emerging economies, they estimated a threshold of 64% of GDP for the public debt, beyond which each additional pp of debt costs 0.02 pp of annual real growth.

Cecchetti et al. (2011) detected the threshold at 85% of GDP. Checherita and Rother (2010) estimated also the turning point at about 90–100% of GDP.

Using a dataset for 25 EU countries, Mencinger et al. (2014) found a statistically significant non-linear impact of public debt on GDP per capita growth rates with a threshold between 80% and 94% for the Old Member States and about 53% for New Member States. Also, Égert (2012) found a tipping point for debt with a range between 20% and 60% of GDP.

Dincă and Dincă (2015), explored also the relationship between the ratio of government debt to GDP and the per capita GDP growth rate for a sample of 10 New Member States of EU for the 1999–2010 period. They found a significant non-linear relationship and a debt turning point at around 50%.

The channels through which public debt will be a drag for long-term growth are multiple, some of the most important being the following (see for instance the seminal paper of Balassa 1988):

- if public debt increases, at some point there would be a need to hike taxes to service the debt which will be negative for growth through the crowding out of the private investment by reducing disposable income and saving;
- increasing public debt increases the probability of default and thus increases the long term sovereign yields possibly in a non-linear form (see Modigliani, 1961). Increasing long term yields are negative for investments;
- policy makers (especially in countries with week institutional set-up) can decide to fight with increasing public debt just inflating prices, and high inflation has a negative effect on long term growth.

4 Impact of the EU Fiscal Governance Regulations in Romania

The general goal of the Treaty on Stability, Coordination and Governance (TSCG) is to strengthen fiscal discipline by requiring that national budgets are balanced or in surplus. This requirement is met if annual structural deficit does not exceed 0.5% of GDP. If the public debt is significantly below 60% of GDP and risks in terms of long-term sustainability of public finances are low, the structural deficit may reach up to 1% of GDP.

Also, there are automatic penalties and provisions for better enforcement. Member States are obliged to introduce the "target for a balanced budget" in their national legal systems, preferably at the constitutional level. The deadline for fulfilling this obligation is 1 year after the entry into force of the Treaty.

As of today, there are 25 Contracting Parties to Treaty on Stability, Coordination and Governance (TSCG), 22 being formally bound by the Fiscal Compact (the 19 euro area Member States plus Bulgaria, Denmark and Romania).

Romania notified the ratification of the Treaty on Stability, Coordination and Governance in Economic and Monetary Union (TSCG) in November 2012. The Treaty was enforced by national legislation starting with 1st of January 2014. The main relevant national legislation is the Law on Fiscal and Budgetary Responsibility

No 69/2010 (LFBR), amended by Law No 377/2013 which is amending and supplementing the LFBR adopted on 23 December 2013.

The Law on Fiscal and Budgetary Responsibility sets a general framework for fiscal budgetary policy conduct in Romania. The medium-term objective (MTO) and the correction mechanism defined in the Law on Fiscal and Budgetary Responsibility are consistent with the Treaty on Stability, Coordination and Governance in Economic and Monetary Union (TSCG). Law on Fiscal and Budgetary Responsibility also sets a system of policy response if public reaches specific thresholds, respectively 45%, 50%, 55% and 60% of GDP, including measures such as public sector wage freeze. The monitoring institution is the Fiscal Council, an independent authority within the Romanian Academy.

Recently, significant discussions focused on the new fiscal pact, which was thought by initiators as a decisive solution to the problems of the euro area. At the conceptual level, the new agreement does not bring much novelty, it only introduces an automatic correction and penalty mechanism in case of slippages. The 3% of GDP threshold for budget deficit and 60% of GDP for public debt have been in place for a long time, being created under the Maastricht Treaty of 1992. The Stability and Growth Pact (1997) also established that the medium-term structural position of the budget to be on balance or in surplus ("close to balance in surplus"). The new fiscal compact introduces a structural budget deficit target of maximum 0.5% of GDP.

The fiscal pact is a major step forward, introducing an automatic mechanism to correct fiscal slippages, thus contributing to increased fiscal policy discipline and better coordination at the EU level. But can the new fiscal pact be considered sufficient to ensure the smooth functioning of the monetary union (the euro area)? The answer is probably not.

When discussing about the impact of the fiscal compact on Romania, we should clarify first the difference between headline budget deficit and its cyclical and structural components.

The 0.5% of GDP threshold set by the new fiscal compact applies to the structural budget deficit. As the structural budget deficit is a technical term, less familiar to the general readership, some clarifications/explanations are required (see for instance Mourre et al. 2014).

The actual budget deficit (the difference between actual budget expenditures and revenues) can be divided into two components, a cyclical one and a structural one:

Effective budget deficit = Cyclical budget deficit (automatic stabilizers) + Structural budget deficit (discretionary policies)

The evolution of budget revenues and expenditures is influenced both by the evolution of the volume of economic activity (by the economic position on the economic cycle) and by the "discretionary" decisions of the policy maker.

Budget expenditures and revenues have several components that are influenced by the economic cycle. Regarding budget revenues, most of their components record cyclical variations. Taxes such as social security contributions, corporate income tax, value added tax, income tax, or excise duties are heavily influenced by the position in the economic cycle—recession or "boom".

Budget expenditures are weakly influenced by the economic cycle, with the exception of unemployment benefits and payments.

The components of budget revenues and expenditures that are influenced by the economic cycle act as “automatic stabilizers”, contributing to smoothing the economic cycle and lowering the volatility of GDP, with a beneficial impact on long-term economic growth potential. Automatic stabilizers can act on both the revenue side and the spending side of the budget. Regarding the revenue side, if the economy is on the downside part of the economic cycle (in recession), budget revenues decrease, and fewer taxes are being collected (these being driven by economic activity). This decline stimulates aggregate demand, thus contributing to GDP growth. If the economy is in a “boom” period of the economic cycle, budget revenue increases cyclically, which makes agents’ revenues fall, thus contributing to limiting the increase of aggregate demand.

If we consider the budget expenditures, automatic stabilizers usually act through the unemployment benefits system. Thus, if the economy is in recession and the unemployment rate rises, the increase in unemployment benefits stimulates aggregate demand, and in the event of an economic boom, the decrease in these aids limits the expansion of aggregate demand. Thus, automatic stabilizers act as a “brake” for economic activity when GDP is above its potential level, or as a “stimulus” for economic activity in times when the GDP is below its potential level. Thus, GDP is automatically “forced” to stabilize at its potential level.

The mechanism described above is more powerful as the tax system is more progressive. Structural budget deficit is the fiscal position when GDP is at its potential level, i.e. when the economy is midway between an economic “boom” and a recession. The change in the structural deficit from 1 year to another reflects discretionary fiscal policy decisions (the “fiscal impulse”). The magnitude of the cyclical budget deficit is due to the output gap and the semi-elasticity of revenues and expenditures to the change in the volume of economic activity (estimated by econometric methods). Output gap represents the actual percentage deviation of actual GDP from its potential level, the potential level of GDP representing the GDP level at the “normal” use of production capacities, without generating inflationary pressures. Potential GDP is determined by fundamental factors such as the organization of the economy, the level of physical and human capital, the productive capacity of the economy because of technology and demographic factors affecting the workforce, etc. A key element in determining cyclical and structural deficits is potential GDP. This is not a directly observable variable and it is determined by various econometric methods (data filtering techniques, production functions), each method having advantages and disadvantages.

When the actual GDP is above the potential (positive output gap), there is a cyclical budget surplus and the actual deficit is lower than the structural deficit. When the actual GDP is below the potential (negative output gap) there is a cyclical budget deficit and the actual deficit is higher than the structural deficit.

Figures 1 and 2 show that when the actual GDP was above the potential, the authorities had a pro-cyclical fiscal policy, i.e. the structural budget deficit increased even though GDP was above its potential level (especially in

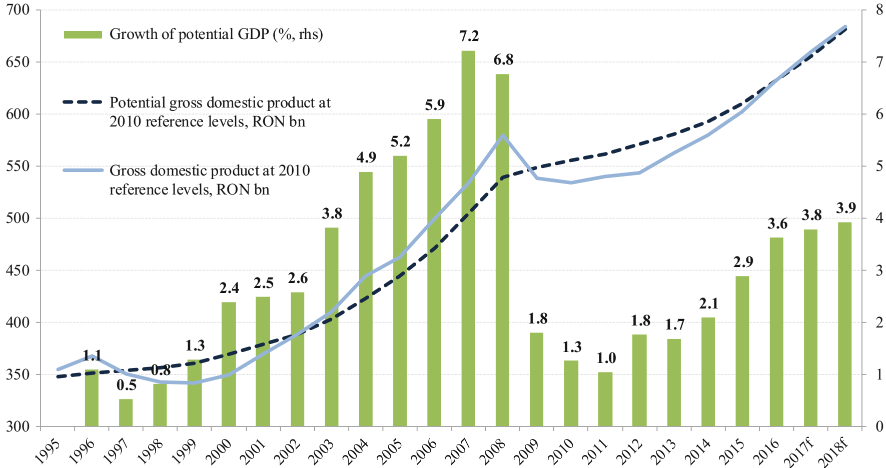


Fig. 1 Actual GDP growth, potential GDP and potential economic growth in Romania. Source: Author's own illustration based on data from AMECO database and European Commission

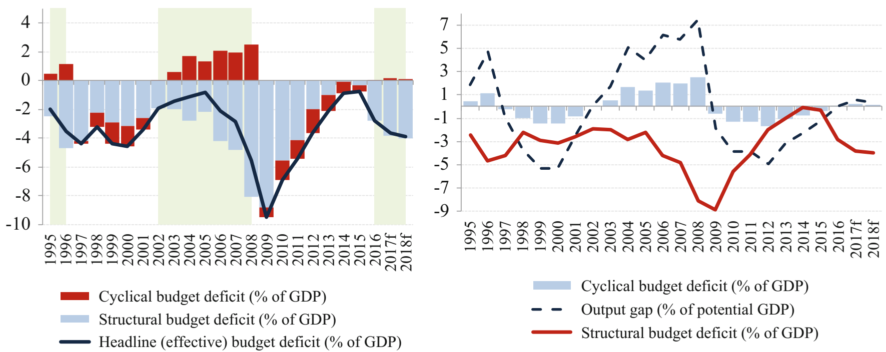


Fig. 2 Evolution of the actual, cyclical and structural budget deficit. Source: Author's own illustration based on data from AMECO database, European Commission, and author's calculation. Note: Shaded areas indicate periods in which the output gap is positive (actual GDP above potential GDP)

2006–2008, but also in 2016–2018). Permanent (structural) expenditures were committed during these periods based on temporary (cyclical) revenues. Thus, the automatic stabilizer function of the cyclical deficit (automatic stabilizers) was canceled by the pro-cyclical discretionary policy.

The new limit for the structural deficit imposed by the European fiscal pact will require very strict control over public finances in Romania, with clear advantages, but also disadvantages. Romania had in the past a pro-cyclical discretionary fiscal policy, with lack of discipline, accentuating macroeconomic imbalances rather than mitigating them. Thus, the structural deficit increased unnecessarily when GDP was

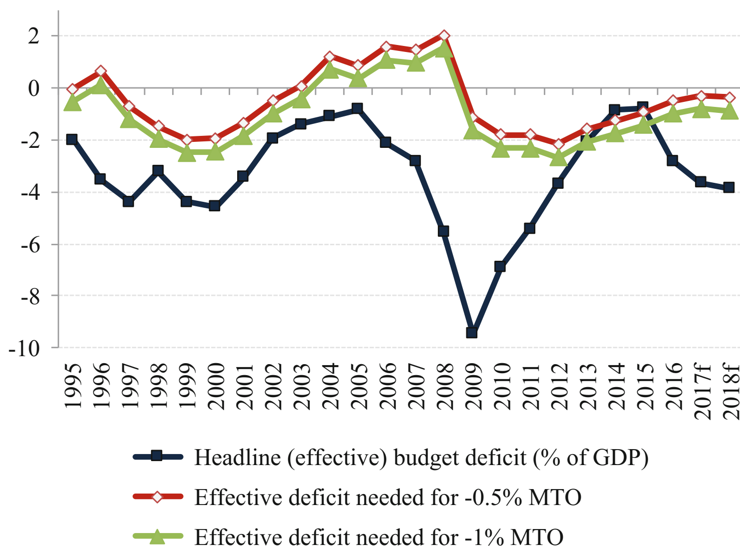
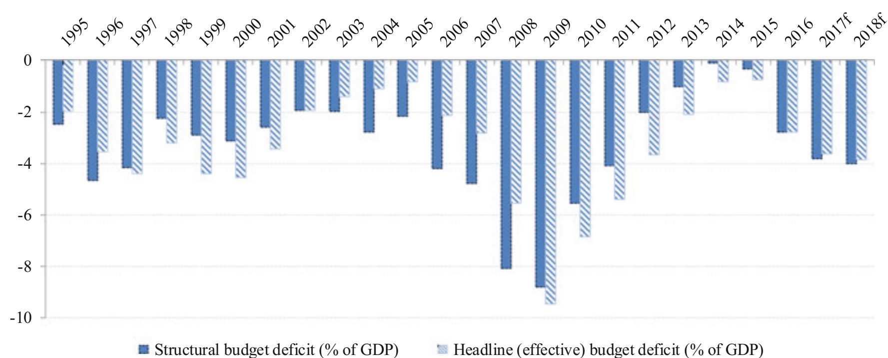


Fig. 3 Evolution of effective budget deficit in the context of the rule of the fiscal pact. Note: deficit recalculated based on the relationship: −0.5%/−1% + cyclical deficit (% of GDP). Source: Own calculations based on European Commission estimates

above potential, thus offsetting/canceling the action of automatic stabilizers. The new rule limiting the structural deficit to 0.5%/1% of GDP will almost result in the impossibility of practicing pro-cyclical fiscal policies and a pronounced fiscal discipline, which for a country like Romania, given the negative track record in using discretionary fiscal policy (see Dumitru and Stanca 2010; Canagarajah et al. 2012), can be a significant advantage.

If the rule had worked in the past, a simple calculation (see Fig. 3), though not entirely correct, shows that, for example, in 2008 when GDP was above potential, Romania would have had to have a budget surplus of more than 2% of GDP instead of a effective budget deficit of −5.5% of GDP. In fact, over the period 2003–2008, Romania should have had budget surpluses, GDP being above its potential level at that time, and the structural budget deficit of only 0.5% of GDP would have forced the actual budget balance to turn to a surplus.

The disadvantage of the new European fiscal rule for Romania is that the existing maneuvering space to stimulate the economy during recession periods will be very low (see also Iancu and Olteanu 2015). In the case of Romania, the structural deficit limit of 0.5%/1% of GDP (MTO) will most likely be reached before the actual public deficit reaches 3% of GDP. Romania would be allowed to run budget deficits of 3% of GDP only in extreme crisis periods (with negative gap of more than 8%, given the cyclical balance semi-elasticity to the output gap of only 0.34). In addition, in the 2009–2010 recession, actual budget deficits could not have exceeded 2% of GDP. In medium and long term (over a full economic cycle), the



	Last business cycle (2000-2016)	Last 2 business cycles (1995-2016)
Annual average of the effective budget deficit (% of GDP)	-3.3	-3.3
Annual average of the cyclical component of the budget deficit (% of GDP)	0.0	0.0
Annual average of the structural budget deficit (% of GDP)	-3.3	-3.3

Fig. 4 Evolution of the actual and structural budget deficits. Source: Author's own illustration based on data from AMECO database, European Commission, author's calculation

average actual deficit is equal to the average structural deficit and the average of the cyclical deficit is 0 (see Fig. 4).

By assuming a maximum structural deficit of 0.5%/1% of GDP, Romania assumes the obligation that the actual budget deficit, as an average during an economic cycle (and the average for a long-term horizon) to be at most 0.5%/1% of GDP, which would mean a much lower budget deficit/"maneuver space" than historical standards (3.3% of the average structural deficit over 1995–2016).

Also, the ability of the government sector to contribute by automatic stabilization to the mitigation of economic cycle fluctuations is relatively low in Romania compared to other European countries. The size of automatic stabilizers in Romania is the second lowest among European countries. Automatic stabilizers are the most effective, as expected, in countries such as Netherlands, Denmark, Belgium, France, and Sweden, countries where taxation has a strong progressivity character.

Due to weak automated stabilizers (see Fig. 5), Romania would need the possibility to apply more discretionary fiscal stimuli (greater structural deficit) in times of recession to help the economy get out of recession sooner and return it to potential. As the literature shows, the size of automatic stabilizers is closely linked to the tax system (progressive or flat tax) and to the share of the government sector in GDP (Figs. 6 and 7).

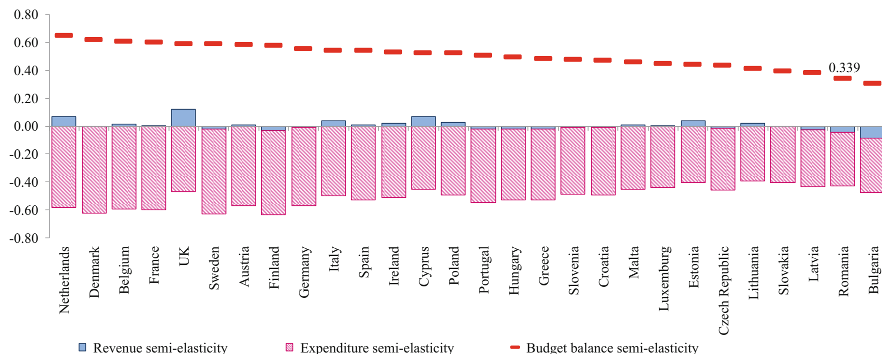


Fig. 5 Revenue/expenditure and budget balance semi-elasticities to the output gap. Source: Author's own illustration based on data from AMECO, own calculations

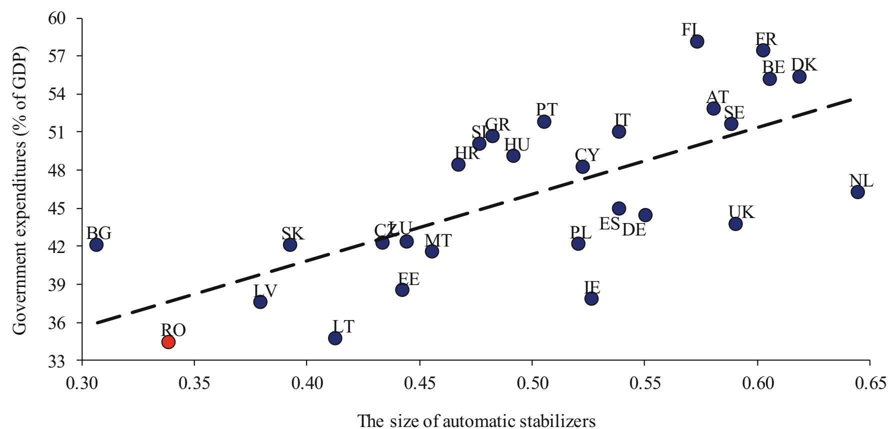


Fig. 6 Size of automatic stabilizers versus government spending. Source: Author's own illustration based on data from European Commission and AMECO database

Empirical studies tend to find a positive relation between the size of the Government (expenditure to GDP ratio) and per capita income only for some countries and certain time periods (see Arpaia and Turrini 2008; Wahab 2004; Martinez-Mongay 2002). Based on theoretic foundations, when the government sector is relatively small, long-term economic growth could be stimulated by providing more public goods. However, the marginal increase is positive but decreasing with the size of the Government. At some point, continuing to increase the size of the Government the growth effect becomes negative.

Clearly, Romania needs in the future to increase the effectiveness of automatic stabilizers, the cap imposed to the structural deficit requiring stronger automatic stabilizers. In addition to increasing government intervention in the economy, a questionable solution according to the embedded ideological trend, there are some

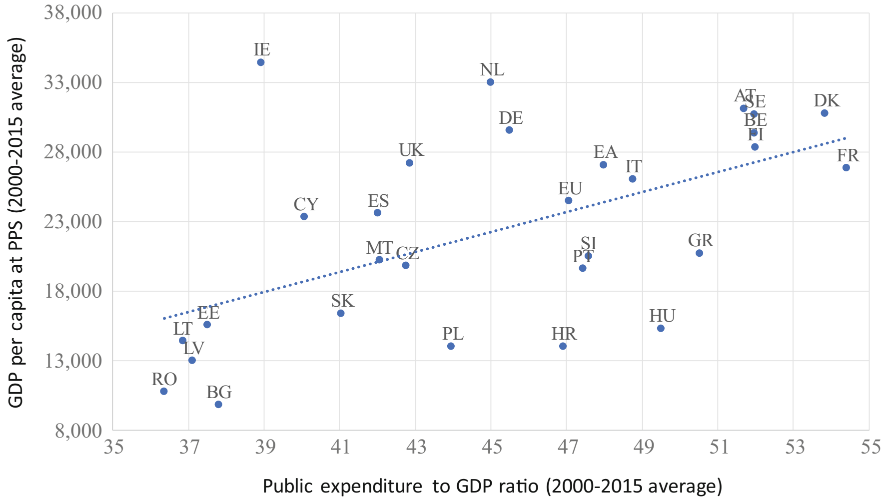


Fig. 7 Size of Government vs GDP per capita. Source: Author's own illustration based on data from European Commission and AMECO database

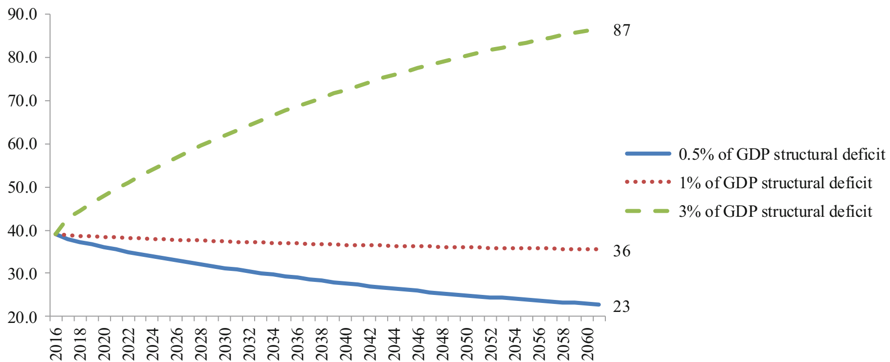


Fig. 8 Public debt trajectory simulation. Source: own calculations

other methods identified in the literature by which automatic stabilizers can be grown (see Thomas Baunsgaard and Steven A. Symansky, Fiscal Stabilizers, IMF, 2009).

By assuming a target of a maximum structural deficit of 0.5%/1% of GDP, Romania assumes the obligation that the effective budget deficit, as a mean over a long-time horizon, should be maximum 0.5%/1% of GDP, which will mean in terms of primary balance (budget deficit before interest payments on public debt) a primary budget surplus (public debt interest rates are now around 1.5% of GDP). This will force the reduction of public debt (see also Edoardo Campanella 2011). In the medium and long term, the 0.5%/1% of GDP limit for the structural deficit leads to a fall in government debt (as a % of GDP, see Fig. 8).

In this context, should Romania reduce its public debt so much in the long run, given that the country has one of the lowest public debts in the EU? The literature suggests that up to a certain threshold, public debt accumulation can stimulate economic growth. On the other hand, the current level of public debt in Romania tends to become relatively high given the limited absorption capacity of local financial markets (see Fig. 9).

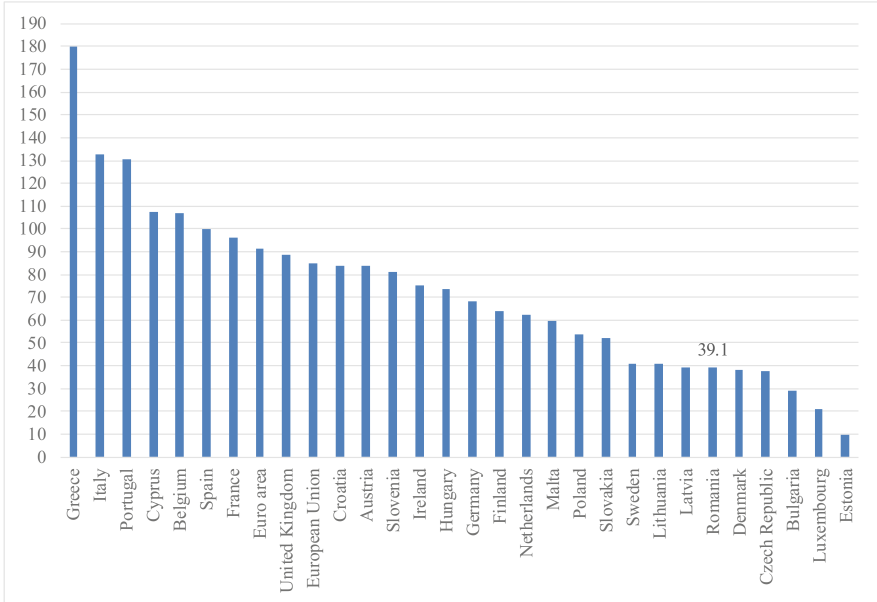
In the context of the fundamental change in the fiscal policy approach in the coming years because of the new fiscal pact, the fiscal-budgetary policy room for maneuvering will be much lower than in the past. Moreover, the reduced efficiency of automatic stabilizers is an additional constraint for Romania. In this context, some solutions should be identified to stimulate the economy even in the context of a much more limited space for discretionary fiscal policy.

A first solution to this is the absorption of EU funds. This is an enormous stimulus Romania can have in the economy, which is crucial in the new context of limited discretionary fiscal policy space and low size of automatic stabilizers. The potential for multiplication of own budget expenditures for projects funded by EU funds is much higher than for projects funded entirely from own resources. With only 5% co-financing for EU-funded projects, one own monetary unit of budget deficit can be multiplied in budget expenditure of 20 monetary units (the absorption of EU funds only impacts on the budget deficit with the co-financing part, the money received from EU being reflected on both revenue and expenditure), against a 1:1 equivalent in the case of fully locally funded projects. According with IMF (2017), an increase of EU funds absorption to close to 95% in the 2014–2020 financial package would imply in the case of Romania an increase in the potential growth to about 4.5% (more than 1.5 pp acceleration).

Unfortunately, so far, Romania's performance in terms of absorption of EU funds is relatively poor (see Figs. 10 and 11). Romania must have as a high priority the urgent and substantial increase in the absorption of EU funds.

Besides the absorption of European money, the new budget constraints imposed by the fiscal pact also force Romania to spend much more efficiently the public money. With the same budgetary resources, limiting the budget deficit forces Romania to achieve far greater effects in the economy by spending public money. Efficiency reserves on the expenditure side are very high. For example, Romania had one of the largest allocation for investment expenditure as a percentage of GDP (and the second highest as a percentage of total budget budget) among all EU countries during 1995–2016, but the results were modest, with Romania still the weakest in terms of road infrastructure quality (Fig. 12). This example clearly shows that money was spent inefficiently (see Dumitru and Stanca 2010).

Also, Romania should identify and focus more on 'growth-enhancing' types of expenditure, although in practice this assessment is difficult to make (see Barrios and Schaechter 2008). In general, all public goods that addresses market failures can be growth enhancing. In practice, this can be done for instance through public investments which can raise labour and capital productivity.



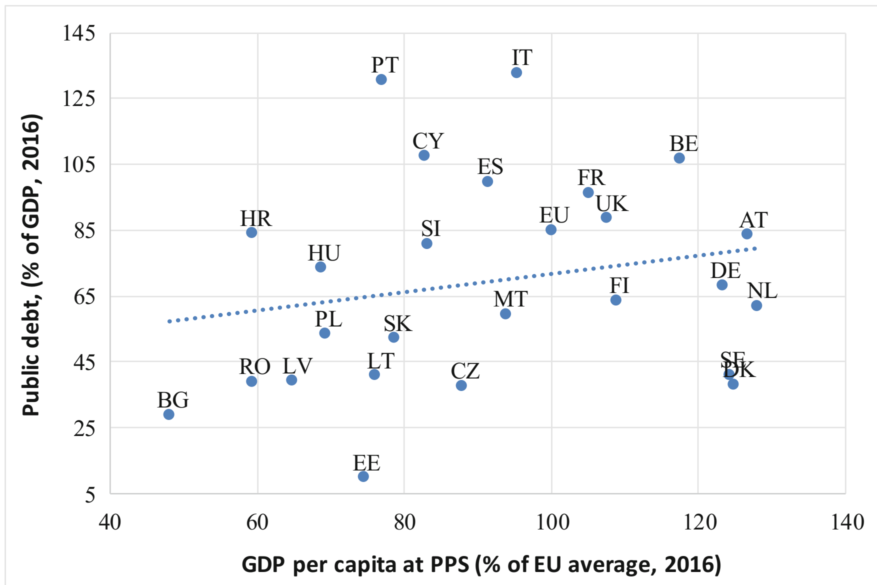


Fig. 9 Public debt (% of GDP, 2016) versus GDP per capita. Source: Author's own illustration based on data from EUROSTAT

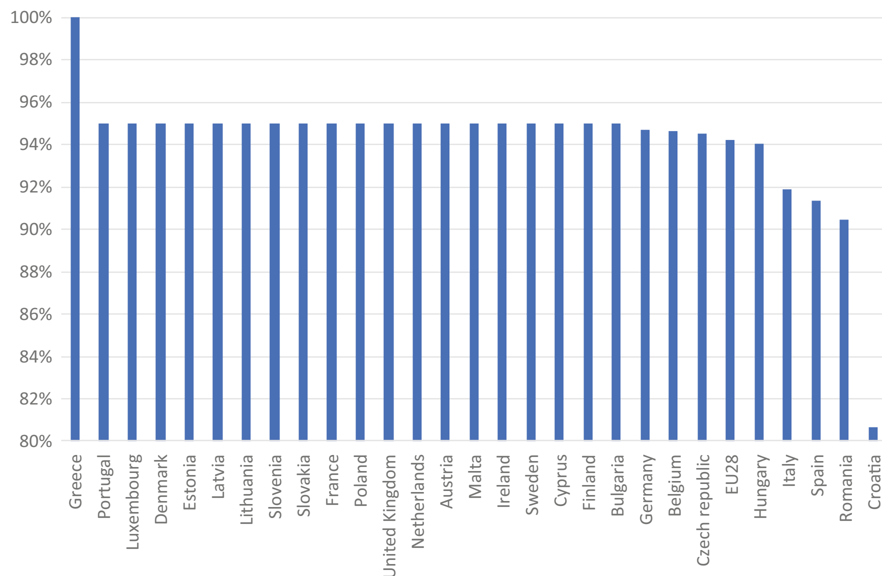


Fig. 10 European Commission payments as of 2016 to member countries under 2007–2013 budgeting program (% of total allocation)

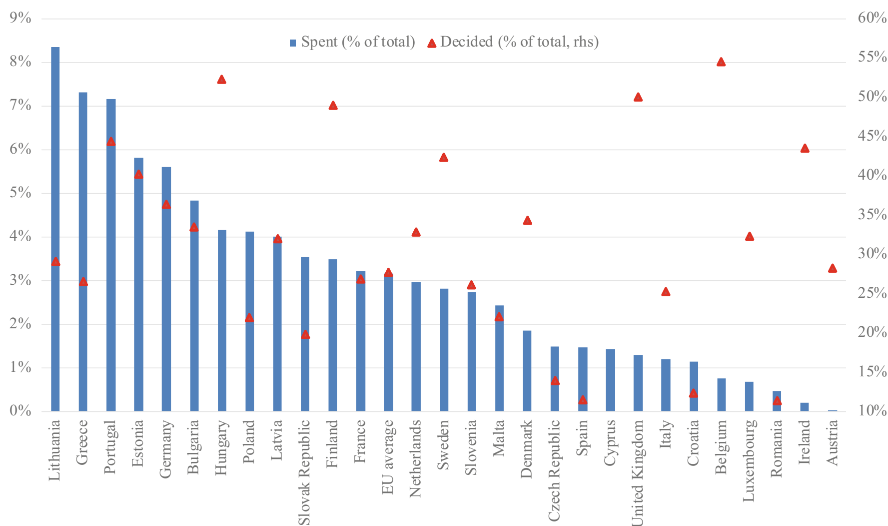


Fig. 11 European Commission payments as of Feb 2017 to member countries under 2014–2020 budgeting program (% of total planned allocation). Note: Planned—Total budget of the programme; Decided—Financial resources allocated to selected projects (project pipeline); Spent—Expenditure reported by the selected projects. Source: Author's own illustration based on data from European Commission

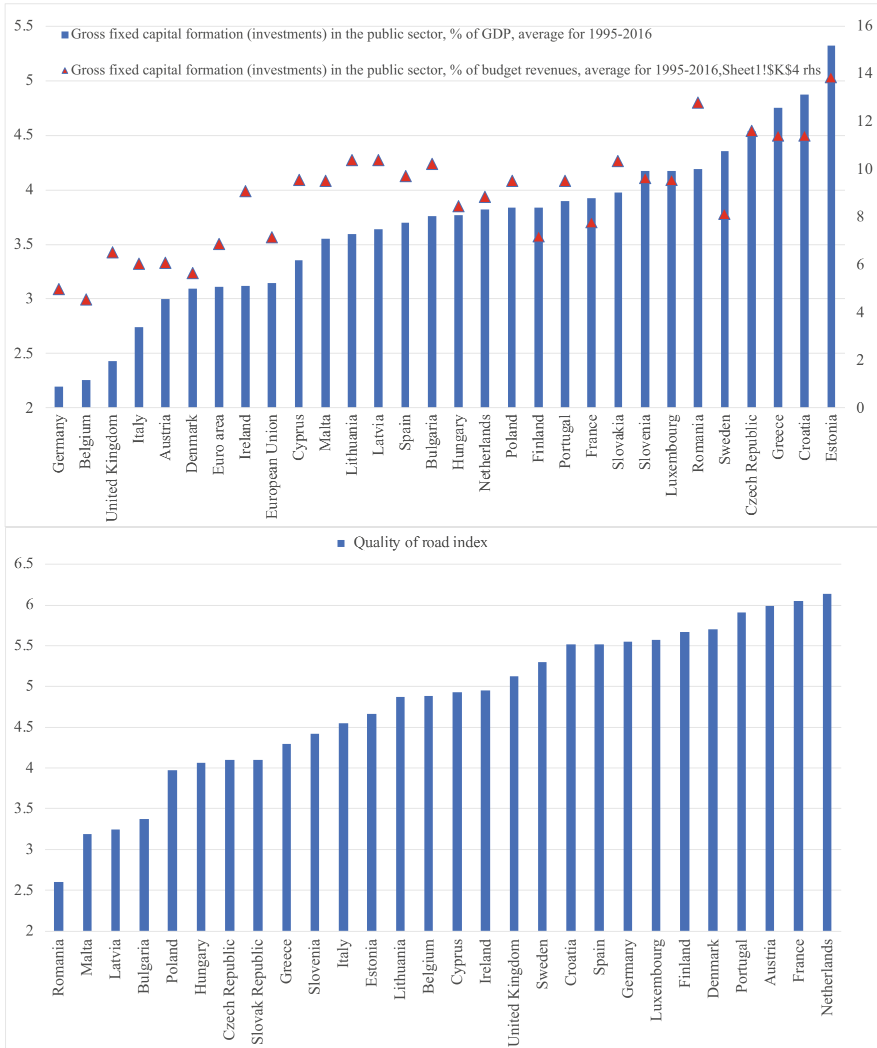


Fig. 12 Expenditure on investments and quality of roads. Source: Author's own illustration based on data from EUROSTAT, World Economic Forum, The Global Competitiveness Report 2016–2017

However, in empirical studies the impact of public investments to growth was found to be mixed (in some studies the impact was found positive, in some other the evidence in non-conclusive).

Also, public transfers and public consumption are typically estimated to negatively impact growth. In some empirical studies spending for education, healthcare, R&D and public infrastructure are found to be growth enhancing. Romania spends

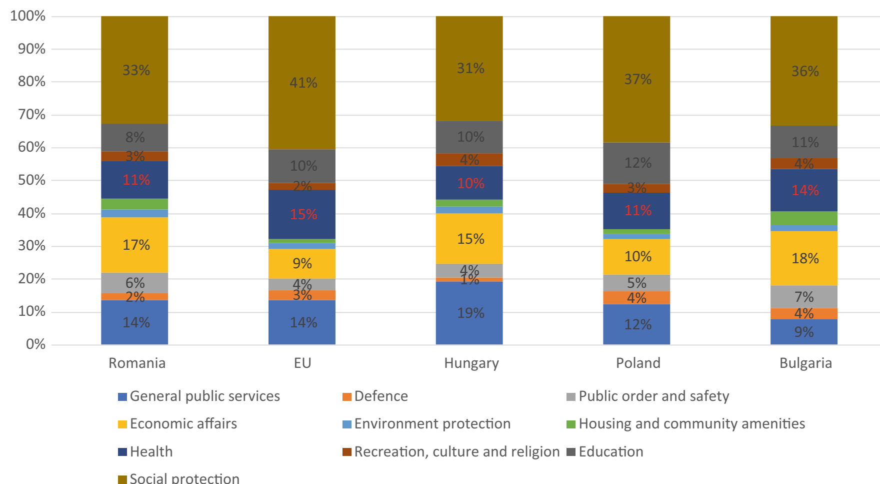


Fig. 13 Expenditure structure by function (averages for 2012–2015). Source: Author's own illustration based on data from EUROSTAT

too little for education and healthcare compare with the European averages, both as % of GDP but also as % of total budget spending (Fig. 13).

Questions and Activities

1. Explain why the European Union needs a fiscal union?
2. Explain the medium term objective set in EU economic governance regulation
3. Why can the business cycle affect the budget balance?
4. What are the consequences of the cap for the structural budget balance set in the Fiscal Compact?
5. Explain the concept of structural budget balance.
6. How will Romania be affected by the Fiscal Compact and why?
7. How can Romania cope with the impact of the Fiscal Compact?

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