

## THE PRO AND CONS OF THE NEW TREATY ON STABILITY, COORDINATION AND GOVERNANCE IN THE ECONOMIC AND MONETARY UNION

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**Abstract:** *In our study, using a descriptive research methodology based on survey and data interpretation, we are trying to state our opinion regarding the pro and cons of the Fiscal Compact, wheather our country made a step forward towards fiscal stabilization or a step backwards towards the space for manouver of the fiscal policy. Stability and Growth Pact, signed in Amsterdam in 1997, maintained the two limits set by the Maastricht Treaty, signed in 1992, namely those set within 3% of GDP for budget deficit and 60% of GDP for public debt, and established at the same time the regulatory framework for the coordination of national fiscal policies in the EMU. Medium-term objective, enshrined in the Stability and Growth Pact, is for the budgetary position of the Member States of the euro zone to be "close to balance or in surplus" – and to enable them to deal with normal cyclical fluctuations without exceeding effectively the 3% of GDP budget deficit. Achievement of the medium-term objective requires rapid evolution towards a sustainable situation, able to generate sufficient fiscal space for the promotion of discretionary fiscal policy measures - such as those embodied in the increase of budgetary allocations for investments in infrastructure.*

**Keywords:** *budget deficit, public debt, fiscal rules, restrictions, automatic fiscal stabilizers*

**JEL classification:** *E32; E62; H61.*

### 1. Introduction

Maximum limit of 3% of GDP for the budget deficit - included in the Stability and Growth Pact – is a limit that can not be reached every year, but the high level which can not be exceeded even in adverse economic conditions.

Thus, in periods of **economic expansion**, the total value of income taxes and social contributions mobilized at consolidated state budget increase - due to increasing the size of the base of calculation of tax or contributions, without implying any change in the fiscal policy or growth of the collection of taxes and social contributions. At the same time, the total volume of various monetary compensations and payments for unemployment allocations decreases and the result of these developments is that *the actual budget deficit is reduced or even a positive budget balance (surplus) is achieved.*

*Ensuring an adequate budgetary position, which is not dependent on cyclical fluctuations in the economy and can be capped at 3% of GDP for the actual budget deficit even during economic recession, becomes essential for compliance with the Stability and Growth Pact stipulations and achievement of a sustainable fiscal position in the medium and long term.*

Because of the extension of economic recession in many Member States of the euro zone, in order to strengthen the surveillance of budgetary positions and coordination

of economic policies, after several meetings of finance ministers, prime ministers and heads of state, on 2 March 2012 (i.e. after nearly 15 years of operation of the Mechanism of Stability and Growth), 25 of the 27 Member States of the European Union - with the exception of the United Kingdom of Great Britain and Northern Ireland and the Czech Republic - signed the **Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (EMU)**. In the structure of this Treaty, the most important component is the **European Fiscal Compact** aimed at *strengthening fiscal discipline in Europe* by introducing penalties to be applied "in a more automatic manner" and a stricter supervision.

Unlike the **Stability and Growth Pact (SGP)** - medium-term objective of which was that budgetary positions of euro zone Member States to be "close to balance or in surplus", the new treaty includes the requirement that **national budgets "should be balanced or in surplus"**, and this requirement will be met if the annual structural deficit does not exceed 0.5% of GDP. This "rule of a balanced budget" should be introduced into national legislation, preferably at constitutional level, within one year of the entry into force of the Treaty - which will happen after it is ratified by at least 12 Member States of the Economic and Monetary Union, becoming afterwards mandatory for all members of the EMU. Other Member States of the European Union will come under the provisions of the Treaty on the adoption of the single currency or earlier if requested to do so.

If a member state has a public debt significantly below 60% of GDP and the risks to long-term sustainability of public finances are reduced, it is allowed to have a structural budget deficit of more than 0.5% of GDP, but not more than 1% of GDP. Failure to meet this requirement regarding the structural deficit will trigger an "*automatic correction mechanism*" – which shall be determined by each Member State on the basis of principles proposed by European Commission.

The authority responsible for monitoring compliance with this rule of a balanced national budget or in surplus is the **European Court of Justice**; its decisions are binding, and the failure to respect them can be followed by fines of up to 0.1% of GDP for Euro zone member states to be paid to the "European Stability Mechanism".

## **2. Structural Budget Deficit and the Impact of Discretionary Fiscal Policy on Aggregate Demand**

The real budgetary position or fundamental fiscal position, as stated in the Report of Fiscal Council of Romania for year 2011 (*Annual Report of the Fiscal Council for 2011. Macroeconomic and budgetary developments and prospects, 2012*) contains the data needed to calculate the budget balance adjusted cyclically or structurally, which is obtained by deducting from the actual budget balance the effects of the economic cycle on the general consolidated budget.

In this context, the structural deficit is defined as the size of budget deficit that would be recorded if GDP was at its potential level or could be recorded without the influence of the economic cycle.

Actual budgetary position has two components, depending on the factors causing them - temporary and permanent factors - and the determination of the structural budget deficit is based on the identity:

Actual Budget Deficit = Cyclic Budget Deficit (as effect of the action of automatic stabilizers) + Structural Budget Deficit (result of the discretionary fiscal policy)
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Cyclically adjusted budgetary balance represents the most important reference point for defining the objectives of a state's fiscal policy, providing premises for action to reduce economic fluctuations due to automatic stabilizers' influence and, consequently, long-term sustainability of public finances.

Automatic stabilizers action points out that evolution of tax revenues and social security contributions is interrelated with their position in the economic cycle, to which the change of size of some categories of budget expenditures is added and the effect is abatement of cyclical fluctuations.

As mentioned above, in the event of economic expansion, budgetary revenues related to direct taxes (profit tax, dividend tax, income tax, tax on buildings owned businesses) and indirect taxes (VAT, excise duties) as well as social contributions collected by the state are increased, and the result is the relative decrease in the population and economic operators' level of income which reverberates on the solvable demand that goes down, effects being the mitigation of the economic growth and the return of GDP at its potential level.

Conversely, when economic recession is installing, revenues such as those mentioned above are smaller, and budget expenditures for support allocations, various monetary compensations for dismissed employees and unemployment payments increase, with positive impact on income remaining available to economic operators and population, favouring overcome of recession and return to economic growth and GDP reaching its potential level.

Undoubtedly, the effectiveness of automatic stabilizers' action depends on the size of government sector and the elasticity of budgetary incomes and expenditures in relation to the cyclical fluctuations of the economy. Thus, it is doubtless that the larger the dimensions of government sector, the more extensive is the variation in budgetary revenues and expenditures in relation to cyclical fluctuations of the economy and the dampening effect of these fluctuations like a result of the automatic stabilizers' action is higher.

In the last three years, the global economic crisis has highlighted that in terms of important shocks of aggregate demand, monetary policy is unable to respond with significant impact on economy, if the transmission mechanism is blocked by the conditions existent on financial markets. In this case, if there is an appropriate fiscal environment, is required to be promoted and expansionary discretionary fiscal policy, although some disadvantages are associated to it, with reference to: requirement for a relatively long implementation period; high intensity of political influences; lack of automatic reversal when the position in the economic cycle changes.

Automatic stabilizers do not have these disadvantages, but, as mentioned in some of the specialized literature (Cottarelli and Fedelino, 2009), (Baunsgaard and al., 2009), their effectiveness increases when the importance of government sector growths or if the progressive of taxation goes higher.

After reviewing the Stability and Growth Pact in 2005, the cyclically adjusted budget deficit has become the focus of fiscal surveillance mechanism of the European Union - in the sense that the key requirements imposed on EMU Member States in matter of fiscal policy are expressed in cyclically-adjusted and net values of temporary or single ("one-off") measurements.

Using the cyclically adjusted budget deficit concerns both the sustainability of public finances and the impact of discretionary fiscal policy on aggregate demand due to fiscal stimulus (which is calculated as the annual change/deviation of the structural deficit compared with the previous year's one). Thus, a positive fiscal impulse, corresponding to an increase in the structural budget deficit, reflects an incentive fiscal policy - embodied in reducing taxes and increasing the size of budgetary expenditures, while a negative fiscal impulse, which corresponds to a reduction of the structural budget deficit, indicates a restrictive fiscal policy - characterized by raising taxes and reducing the size of government spending. Taking into account the cyclical position of the economy, it can be assessed whether fiscal policy acts as macroeconomic stabilizer - to reduce pressure on aggregate demand during periods of economic expansion or to stimulate aggregate demand during economic downturns.

According to the identity mentioned in the first part of the paper, the budgetary deficit in structural year  $t$  (or  $CAB_t$ , "Cyclically Adjusted Budget  $t$ ") is obtained by subtracting the cyclical component ( $CC_t$ ) of the actual budget deficit (or budget balance -  $BB_t$ ), corresponding to the relationship:

$$CAB_t = BB_t - CC_t = BB_t - \varepsilon OG_t \quad (1)$$

Structural budgetary deficit is the tax position in which the GDP is at its potential level, i.e. when the economy is midway between an economic "boom" economy and a recession in economy (Dumitru, 2012).

The size of the cyclical component of the actual budget deficit is given by the effective output - gap ( $OG$ ) - which represents the percentage deviation of actual GDP from its potential level, multiplied by the cumulative sensitivity parameter of budgetary income and spending ( $\varepsilon$ ) at the change of economic activity's volume, estimated with econometric models.

For Romania, the sensitivity parameters were estimated as: 0.28 for revenues and 0.02 for budgetary expenditure, resulting a total sensitivity parameter ( $\varepsilon$ ) equal to 0.3 (Larch and Turrini, 2009). Estimating the structural budget deficit is made, either based on the Blanchard methodology (Blanchard and al., 1990) – consisting in the direct estimation of cyclically adjusted revenues and expenses by using regression analysis, or using the alternative methodology proposed by Carine Bouthevillain and all in 2001, which shows that estimation of budgetary components' elasticity is made by reporting directly to the relevant macroeconomic bases (GDP, private consumption, government consumption and so on) rather than output - gap, thus taking into account the changes that occur in the structure of aggregate demand and revenues.

### **3. Analysis of the actual deficit trend and structural budget deficit for Romania in the period 2006-2011**

In Romania, the actual balance of consolidated state budget for the period 2006 - 2011 was negative, registering an annual budget deficit, as shown in Table. 1.

**Table 1:** Evolution of Romanian GDP and budgetary aggregates, during the period 2006-2011

- Mil. Lei and % -

Nr	Name		2006	2007	2008	2009	2010	2011
1	GDP		344.651,0	412.762,0	514.654,0	491.007,5	511.582,0	563.100,0
2	Budgetary Revenues	abs. val.	106.975,3	127.108,2	164.466,8	156.624,9	168.674,2	181.566,9
		% of GDP	31,04	30,80	31,96	31,90	32,97	32,24
3	Budgetary Expenditures	abs. val.	112.626,3	136.556,5	189.121,5	193.025,5	202.282,0	210.054,0
		% of GDP	32,68	33,08	36,75	39,31	39,54	37,30
4	Actual Budget Deficit	val. abs.	-5.651,0	-9.448,3	-24.654,7	-36.400,6	-33.607,8	-28.487,1
		% of GDP	-1,64	-2,28	-4,79	-7,41	-6,57	-5,06
5	Cyclic Component of State Budget	% of GDP	2,10	0,70	3,80	-0,60	-0,83	-0,61
6	Share of Structural Budget Deficit in GDP	% of GDP	-3,74	-2,98	-8,59	-6,81	-5,74	-4,45

Source: Ministry of Finance reports on the consolidated general budget during the period 2009-2012, Convergence Programme 2009-2012 and own calculations.

As can be seen from the data presented in the Table, the evolution of budgetary revenues, in absolute value, is increasing during the period (excluding the drop in 2009) - from 106 975,3 million to 181566,9 million, with share in GDP ranging from 31.04% in 2006 and 32.24% in 2011 – which are some of the lowest percentages in the EU, as shown in figure 1. Increase in the absolute amount of budget revenues totaled 74591,6 million lei at the end of 2011, being with 69,73% over the revenues from December 31, 2006.

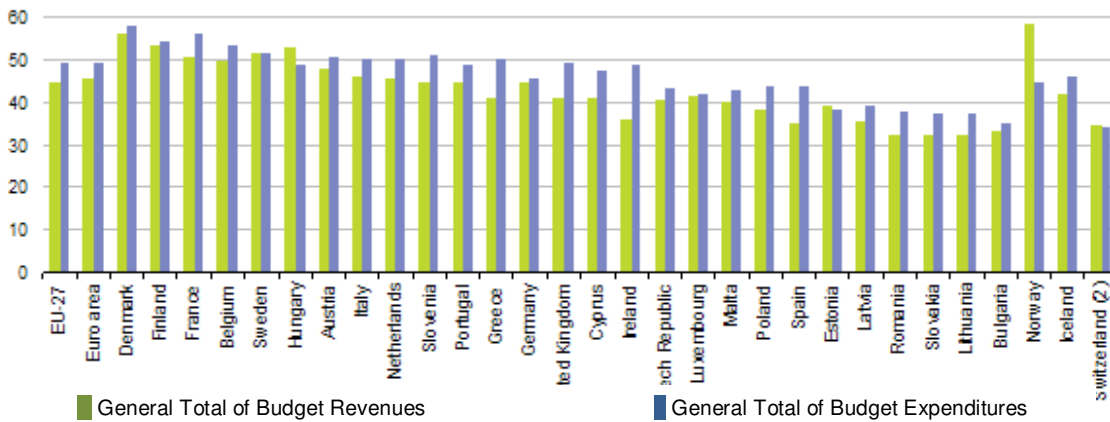
Budget expenditures increased constantly during the period - from 112626,3 million in 2006 to 210054,0 million in 2011 (with an increase in absolute amount of 97427,7 million, i.e. 86.51% ) and shares in GDP increased from 32,68% in 2006 to 39,54% in 2010 (the "top" period) and, respectively, to 37,30% in 2011. These percentages in GDP, as those revenues are among the lowest in the EU, as shown in Figure 1.

The size of the actual budget deficit has recorded significant annual increases, in nominal terms, during 2006-2009, with 67,2% in 2007 compared to 2006, with 160,94% in 2008 compared to 2007 and 47,64% in 2009 compared to 2008.

Most significant increase in the size of actual budget deficit was recorded in 2008, compared to 2007 (with +15206, 4 million, i.e. .160.94%), but the "top" of the actual budget deficit was recorded at the end of reporting period 2009 (-36400, 6 million, accounting for 7.41% of GDP - which is the highest of the period).

In 2010, under the impact of fiscal stabilization measures undertaken by government authorities, the budget deficit was stopped, being registered a decrease of 7.67% of it, in nominal terms, compared to 2009.

In 2011, the general consolidated state deficit fell to 28487,1 million lei, with 5120, 7 million lei (15, 24%) compared to 2010, reaching to 5,06% of GDP.



Data from 23.04.2012, arranged in descending order by total average of income and expenditure.

**Figure 1:** Share of budgetary revenues and expenditures in GDP, within EU-27, Euro Zone, and Member States of the EU-27, Norway, Iceland and Switzerland.  
 Sursa: [http://epp.eurostat.ec.europa.eu/statistics\\_explained/](http://epp.eurostat.ec.europa.eu/statistics_explained/)

Budget balance at the end of 2011, *is however distorted* by the impact of clarifying the statistical treatment of Romanian state obligations to several categories of employees in the public sector, which were decided by court rulings. Thus, in the implementation of ESA95 of the general consolidated state budget were included additional expenses in the amount of 6400 million lei (1,1% of GDP), with corresponding increases in the budget deficit - both in nominal expression and as a share of GDP. In the absence of this temporary measure, the general state deficit (according to ESA95) would have been significantly lower than the target set in the Convergence Programme 2009-2012, prepared by the Government and adopted in April 2011 (4,9% of GDP) and below the level included in the Memorandum of Understanding with the European Union (under 5% of GDP), reaching a level similar to cash basis (4, 1% of GDP). Elimination of the ordinary differential cash-accrual is explained mostly by the fact that a significant proportion of payments made towards the end of 2011 were for settlement of the arrears belonging to state-owned companies and the public health sector. Under a negative cyclical component (-0,61% of GDP), 87,94% of the actual budget deficit in 2011 is structural, reflecting the spread of fiscal consolidation measures introduced in mid 2010 and a further reduction the number of employees in the public sector. As a percentage of GDP, the actual budget deficit recorded values in continuous increase in the period 2006-2009, from a low of -1,64% in 2006 to a level of -7.41% in, 2009. In 2010, the budget deficit actually decreased compared to 2009, but remained at a considerable value, representing -6.57% of GDP.

The following year, 2011, the actual budget deficit was further reduced, but its share in GDP remained still high, being 5,06%.

Doubled by a "twin" deficit of the current account, deficit of the general consolidated state budget may represent in the coming period a factor with negative impact on overall macroeconomic stability of the country.

It must however be noted that *the level of budget deficit is strongly influenced by the position of the economy in relation to the business cycle.*

Even a low deficit can hide serious imbalances in fiscal position to the extent that is due to an increase of budget revenues obtained by over stimulating the economy.

Therefore, it is necessary to balance the public budget over the economic cycle.

In this respect, a particularly important indicator is **the structural budget deficit**, based on the assumption that the current size of the budget balance is the result of the influence of factors with both permanent and temporary action.

Considering the cyclical component of the budget balance, which had positive values in the years 2006-2008 and, respectively, negative ones in the next three years, except in 2007, it results that in the remaining five years of the period, the share of structural deficit in GDP exceed 3% of GDP, *indicating a relaxation of fiscal discipline.*

The increase of actual and structural budget deficit was due to an increase almost "exuberant" of public spending (which evolved increasingly from 32,68% of GDP in 2006 to over 39% of GDP in 2009 and 2010 and, respectively, 37.3% in 2011), and based on the relative stability of revenues that only in 2010 were close to 33% of GDP (32,97%). During 2008 and 2009, the structural budget deficit increased significantly from a level of -3,74% of GDP in 2006 to a high of -8,58% of GDP in 2008 and to -6,81 of GDP in 2009, *as a result of inadequate fiscal policy pursued by government authorities.*

This high rate of structural budget deficit in 2009 (-6,81%) is mainly the result of divergent evolution of revenues and expenditures. Thus, budget expenditures increased by 3.904 million from the previous year, reaching a share of 39,31% of GDP while revenues of 2009 decreased from the previous year with 7841, 9 million, representing 31,90% of GDP. These divergent developments of 2009 **led to recording the maximum effective budget deficit of that period**, with a percentage of -7,41% of GDP and a structural component of -6,81% (representing 91,9% of the actual budget deficit). Obviously, in 2006-2008, a period of expansion of the economic cycle, **it was necessary to promote a countercyclical fiscal policy and not a pro-cyclical expansionary fiscal policy.**

The efforts of fiscal consolidation undertaken by the government in 2010 caused the further downward trend in the structural budget deficit, reducing it to a level of -5,74% of GDP at the end of 2010 and -4,45% at the end of 2011.

These efforts should be appreciated in terms of the tolerance or indulgence that was shown by the employees in the public sector and pensioners who have been their incomes "cut"! But we should not overlook the fact that *European authorities have initiated the procedure of excessive budget deficit for Romania*, requiring that, by the end of 2012, the actual budget deficit to fall below 3% of GDP.

Structural budget deficit is a particularly important indicator regarding the sustainability of the fiscal policy implemented by government authorities.

Since the growth of structural budget deficit is likely to lead to growth of unsustainable debt (Talpos and al., 2007), (Talpos and al., 2009), the evolutions

presented above should be an interference signal for a proper intervention of government authorities.

The changes occurring in the structural budget deficit's size provide at the same time information on the extent of stimulating aggregate demand through fiscal policy, and on the degree of fiscal consolidation.

The analysis of the structural budget deficit's dynamics correlated with the position of the economy in the economic cycle allows assessment of the extent to which the fiscal policy acts as a stabilizer or, conversely, in the sense of exacerbation of imbalances.

In Romania, in the period of rapid growth before the financial crisis (2006-2008), the fiscal impulse was positive (+2.1, +0.7, +3.8) contributing to the over stimulating of the economy and thereby increasing the imbalances accumulated the economy (*Annual Report of the Fiscal Council for 2011. Macroeconomic and budgetary developments and prospects*, 2012).

In addition, the pro-cyclicality of fiscal policy during the pre-crisis economic upswing *has exhausted the fiscal space necessary to stimulate the economy during the recession that followed*, and the need to reduce the budget deficit during the crisis (primarily due to funding constraints) has inevitably *led to maintaining the pro-cyclicality of fiscal policy*. Thus, the automatic, beneficial and stabilizing action of cyclical budget deficit (automatic stabilizers) *was canceled by the pro-cyclical discretionary fiscal policy*.

The structural budget deficit decreased from -6,81% of GDP in 2009 to -5,74% and -4,45% of GDP During 2010 and 2011, the rate of adjustment being a very fast one; at the same time, we must bear in mind that the starting level was high (-8, 59%), which required the rapid adoption of decisive measures to ensure the sustainability of fiscal policy.

Adjustment was made mainly on the expenditure side, the structural reforms being promoted particularly in the fields of budgetary personnel's remuneration, the public pension system and budgetary programming. In terms of budget revenues, the most important measure was the increase in the standard VAT rate from 19 to 24%, starting from July 2010. The estimated cumulative adjustment for 2009-2012, undertaken by Romania is considered *to be the third most ambitious in the European Union*.

#### **4. Conclusions**

We believe that the major con for the new Fiscal Compact is generated by the restrictions imposed thus contributing to the narrowing of the space for maneuver of fiscal policy by limiting structural deficits. Also, referring the means of financing the budget deficit, there has been *an increase in recent years of the relative importance of recourse to domestic financing in the short term*. High aversion to risk of commercial banks in the Romanian banking system has led to their substantial involvement in this process, with the immediate consequence of reducing the funds available for lending financial operators.

The important effect of crowding out of public credit on private investments is confirmed by the perception of economic operators who consider the problem of access to financing as the main constraint the Romanian business environment is facing, also, the consumption behavior of the households is being distorted by the premises of those changes.



We consider that by signing the Fiscal Compact, our country has made a statement towards fiscal discipline thus becoming virtuous in the eyes of the foreign investors, this being the most important pro that we can identify. The full impact of this gaining in the image and credibility chapters is yet going to be felt on a medium and long term.

## 5. Acknowledgements

\*This work was co-financed from the European Social Fund through the Sector Operational Program Human Resources Development 2007-2013, project number POSDRU/107/1.5/S/77213 "Ph.D. for a career in interdisciplinary economic research at the European standards"

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