The European fiscal compact. Implications for Romania

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* The opinions expressed in this presentation are those of the author and do not necessarily represent the views of the Fiscal Council

1. What does the European fiscal compact comprises?

- **Part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union - new treaty to be signed by all EU countries except the United Kingdom and the Czech Republic.**
- **The treaty aims to strengthen fiscal discipline by introducing automatic penalties and better enforcement.**
- **The new treaty includes the requirement that national budgets are balanced or in surplus. This requirement will be met if annual structural deficit will not exceed 0.5% of GDP.**
- **Member States will be 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 one year after the entry into force of the Treaty.**
- **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.**

2. Is the fiscal compact enough for the proper functioning of the Monetary Union? (1)

- **The 3% of GDP budget deficit ceiling and the 60% of GDP ceiling for public debt have always existed, as established by the Maastricht Treaty in 1992.**

- **The Stability and Growth Pact (1997) - the position of medium-term structural budget balance to be ‘close to balance or in surplus’.**

- **The new fiscal pact sets automatic correction rules and penalties when a country exceeds these limits.**

- **The Eurozone is an unprecedented currency union in history, sharing only the monetary policy, without having a fiscal union.**

- **Successful monetary unions in history are those that have combined the monetary union with the fiscal one (U.S., Canada, Germany and Switzerland).**

2. Is the fiscal compact enough for the proper functioning of the Monetary Union? (2)

- **Bordo, Markiewicz and Jonung (2011) – required characteristics for a successful monetary union:**
  - **an independent central bank that aims price stability**
  - **free trade and movement of production factors and capital**
  - **a common fiscal policy, with strong fiscal rules, member states having a certain fiscal independence, but fiscal discipline imposed by the financial markets and strengthened by the rule of "no bail-out" of member states by the federal government**
  - **the existence of strong mechanisms to deal with asymmetric shocks (automatic stabilizers such as unemployment benefits and progressive income taxation, as well as transfers from the states less affected by shocks to those most affected).**

- **The EU budget accounts for slightly above 1% of GDP, a low value, and it is not used as a stabilization mechanism.**
- **There are no fiscal transfers between member states when asymmetric shocks occur, while labor mobility and flexibility in Europe is much lower than in U.S. or Canada.**
- **EU member states are quite heterogeneous in terms of economic development and competitiveness.**

3. The fiscal compact impact for Romania

The cyclical and structural deficit

- Actual budget deficit = Cyclical deficit (automatic stabilizers) + structural deficit (discretionary policies)

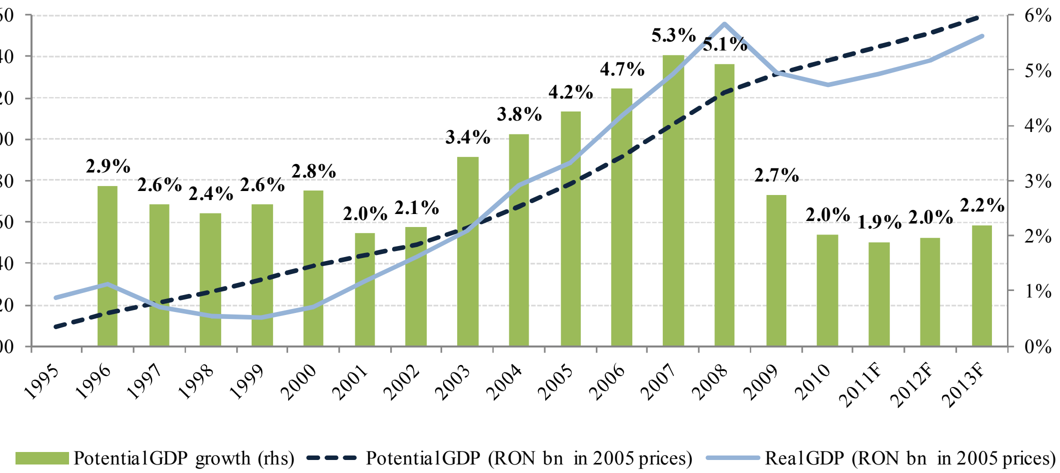
- Both public revenues and expenditurse have components influenced by the economic cycle. Through its cyclical fluctuations, the budget balance automatically contributes to the "smoothing" of fluctuations in aggregate demand and economic cycle.

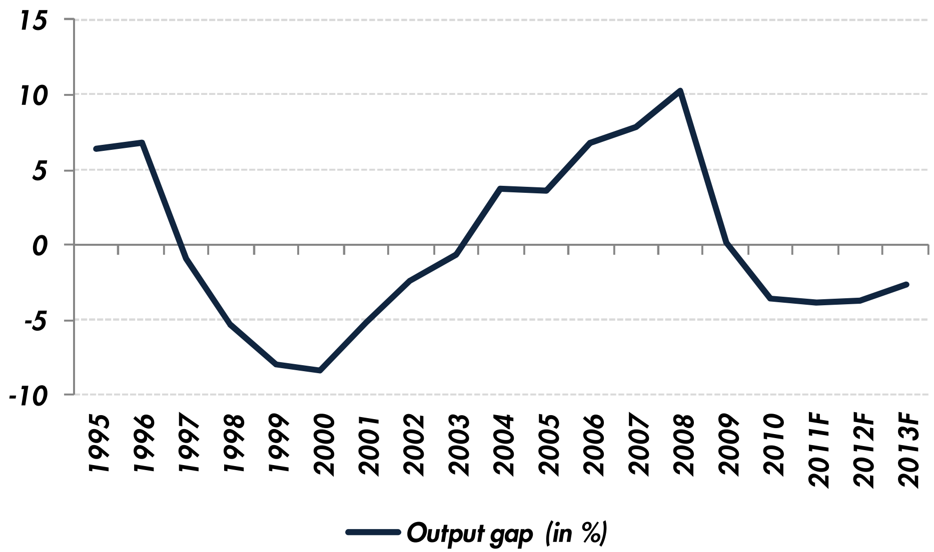
- The revenues and expenditure components influenced by the economic cycle act as "automatic stabilizers" smoothing the economic cycle and reducing GDP volatility. The more progressive the tax system is, the better the action of this mechanism.

- The structural balance represents the fiscal stance when the production factors are at their "normal" level, i.e. when the economy is midway between an economic boom and a recession.

- The economic cycle impact on the cyclical balance is determined by the output-gap and the revenue and expenditure elasticity to changes in the economic activity.

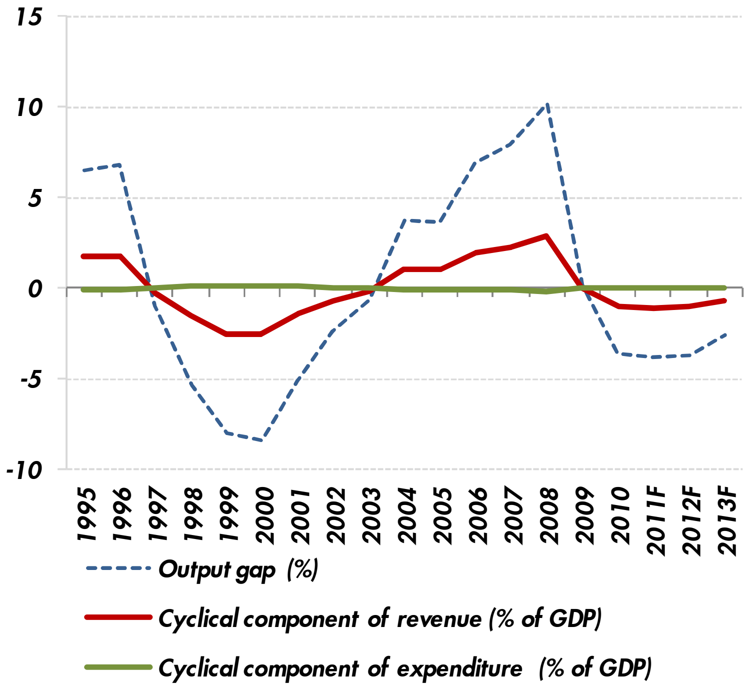
Estimation of potential GDP and GDP deviation from the potential level – a key element

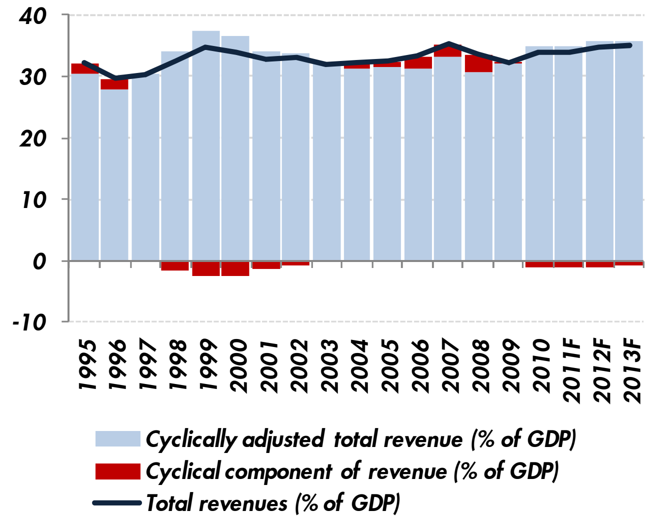


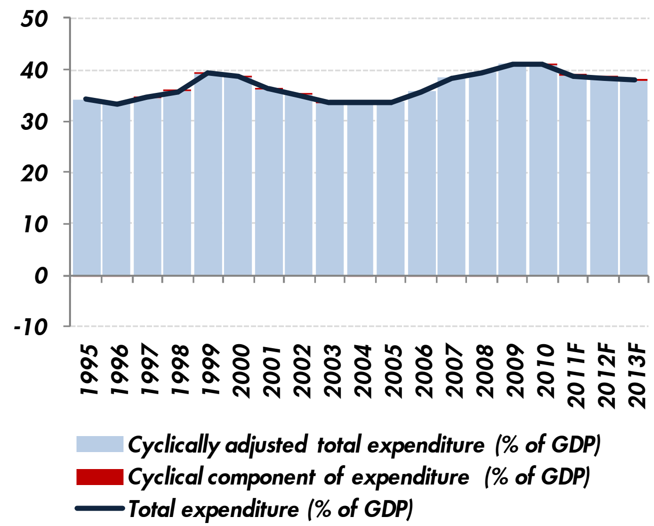


Note: European Commission estimates, November 2011

Cyclical and structural component of public revenues and expenditure



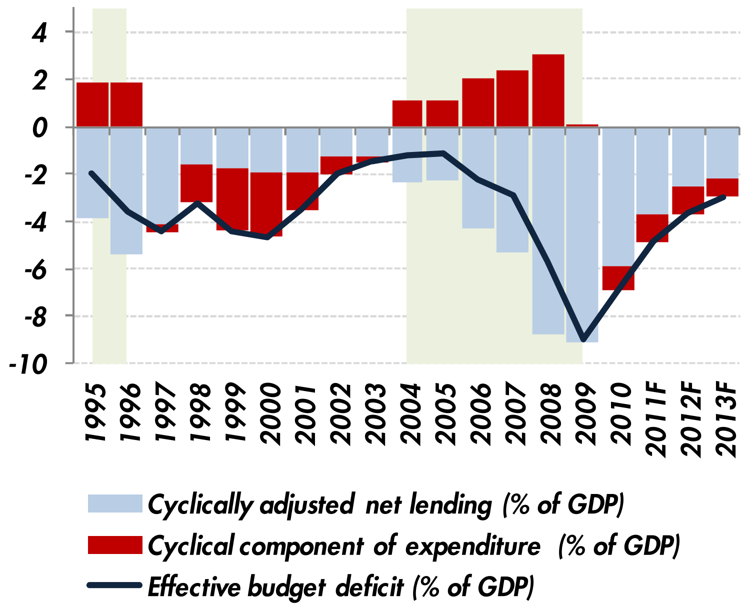


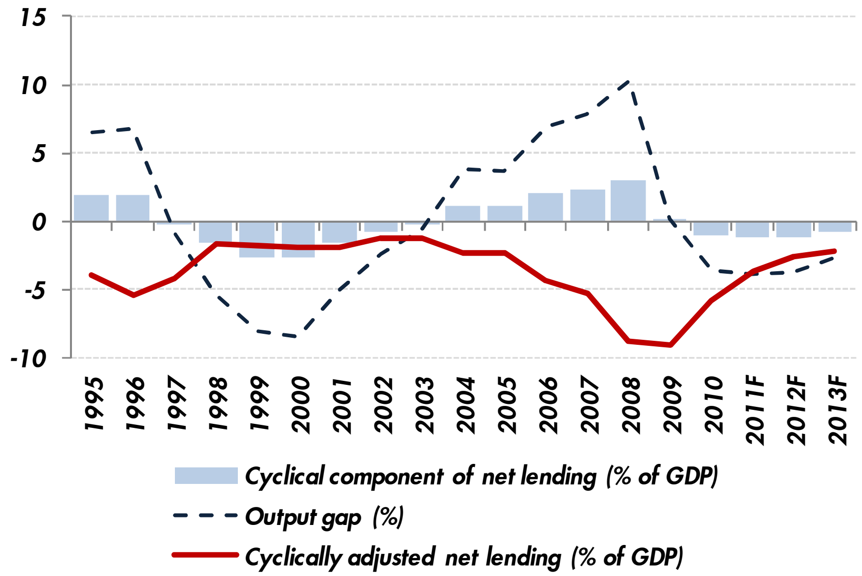


- **The cyclical component of revenues is higher than the cyclical component of expenditure**

Note: European Commission estimates, November 2011

Actual deficit, structural deficit and the cyclical deficit



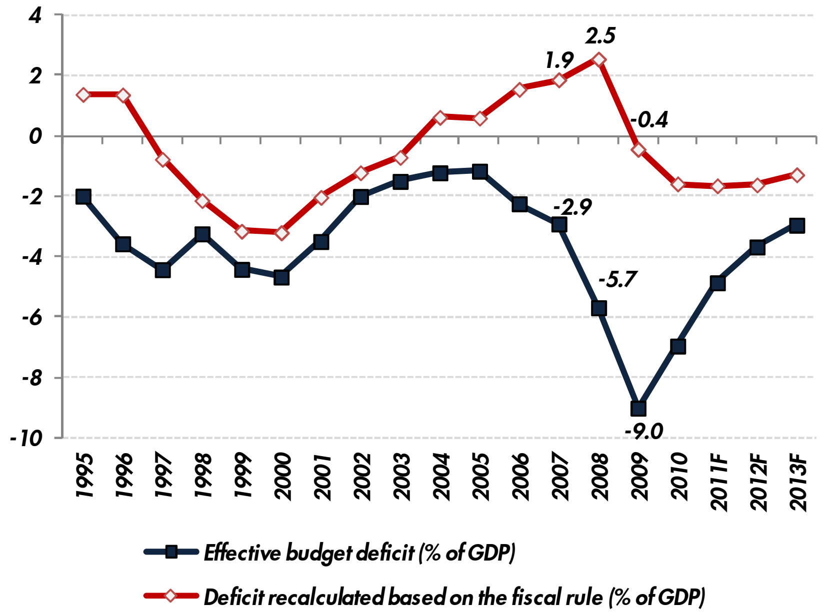


- **When the economy grows above potential (positive output gap), a cyclical budget surplus is recorded and the actual deficit is lower than the structural deficit ➔ the risk that policy makers implement expansionary policies by increasing public expenditure based on temporary income (of cyclical nature)**
- **Pro-cyclical discretionary fiscal policy has abolished the economic cycle stabilization role of automatic stabilizers.**

Note: green hatched areas designate periods when output gap is positive (economy is growing above potential)

European Commission estimates, November 2011

The new rule imposes a very strict control over public finances, with advantages and disadvantages



Advantage: very low risk of pro-cyclical fiscal policies.

- For example, if the rule would have been applied in the past, in 2008 when the economy was growing above potential, a budget surplus of 2.5% would have been required instead of an actual deficit of 5.7%

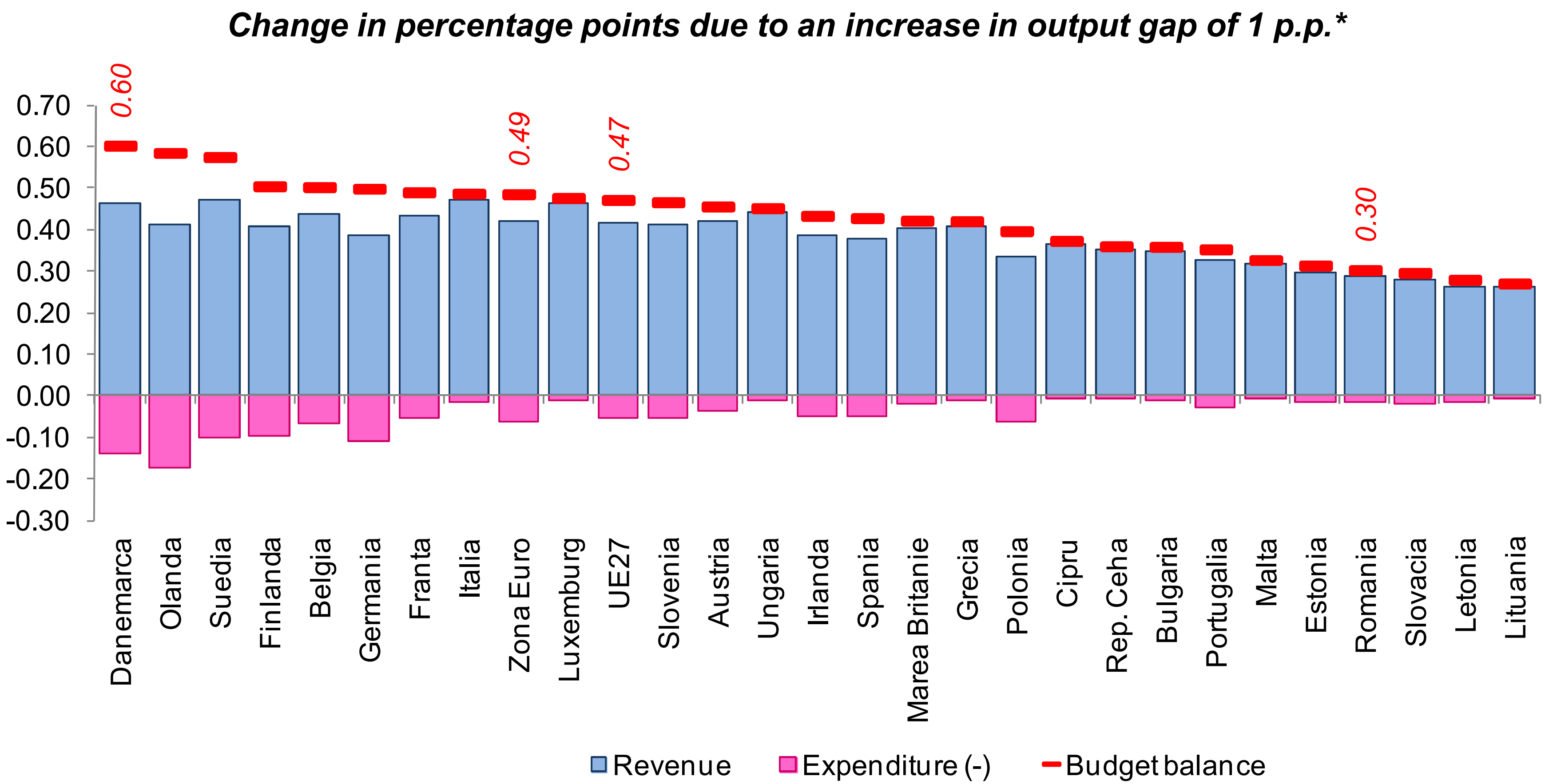
Disadvantage: reduced fiscal space during recessions.

- In Romania, the structural deficit limit of 0.5% of GDP will likely be reached before the actual government deficit equals 3% of GDP (Romania may have budget deficits of 3% of GDP only in times of extreme crisis - negative output gap of about 8.3%)

Note: deficit recalculated by the relation: -0.5% + cyclical deficit (% of GDP)

Source: own calculations based on European Commission estimates, November 2011

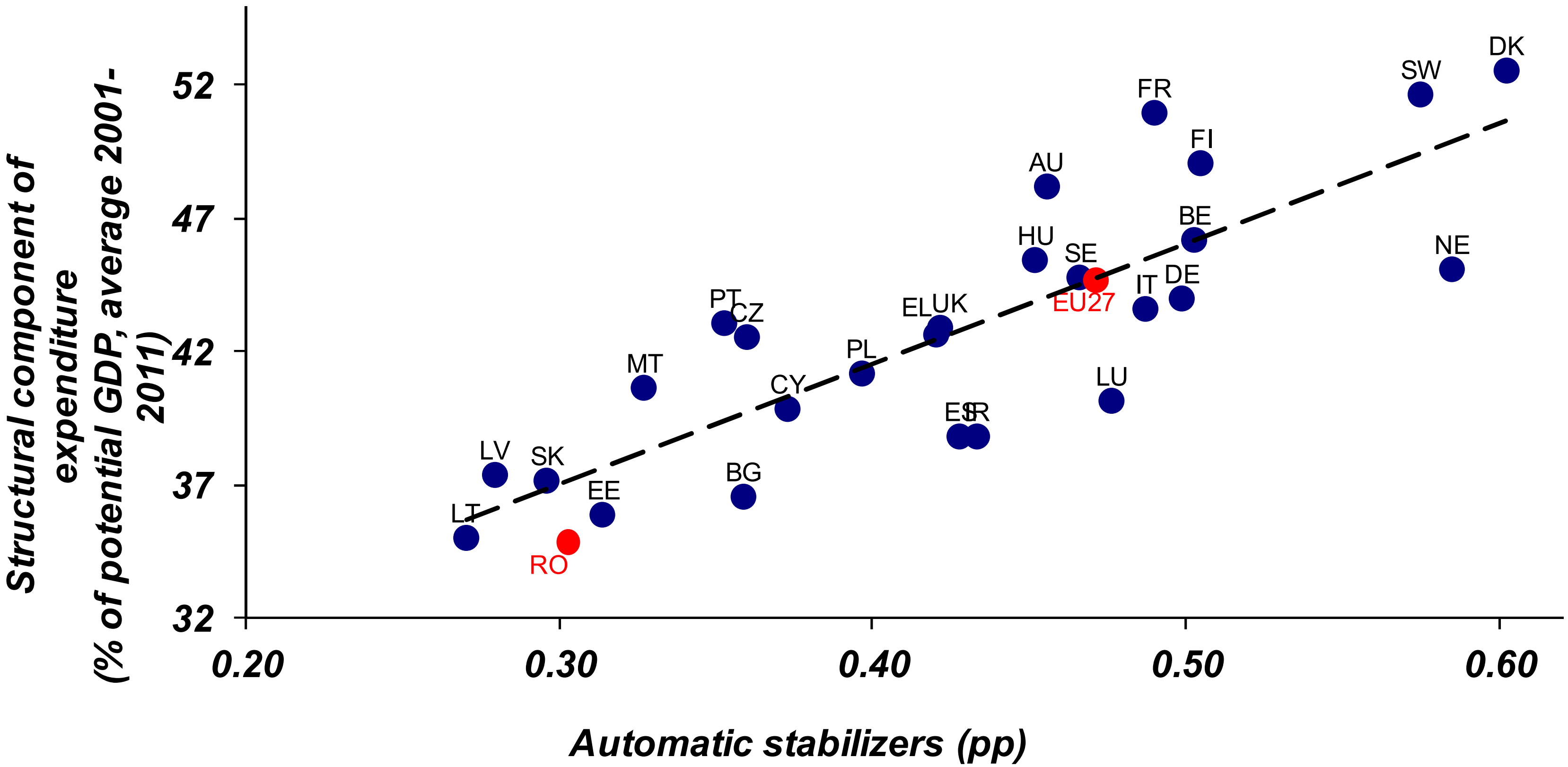
The size of automatic stabilizers in the European economies



- **Compared with other European countries, the government's ability to contribute to the smoothing of fluctuations in the business cycle through automatic stabilizers is relatively low for Romania. Romania would need stronger discretionary fiscal stimulus (structural deficit) during recessions.**

* For the budget balance, the graph presents the impact as % of GDP
Source: AMECO, author's estimates

The size of automatic stabilizers is closely related to the tax system and public sector as share of GDP



Source: AMECO, author’s estimates.

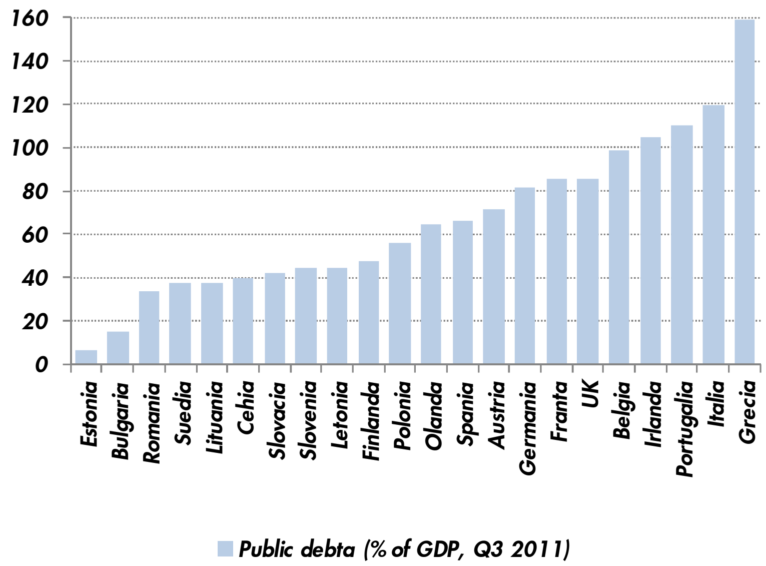
In the medium and long term, the actual deficit is equal to the structural deficit

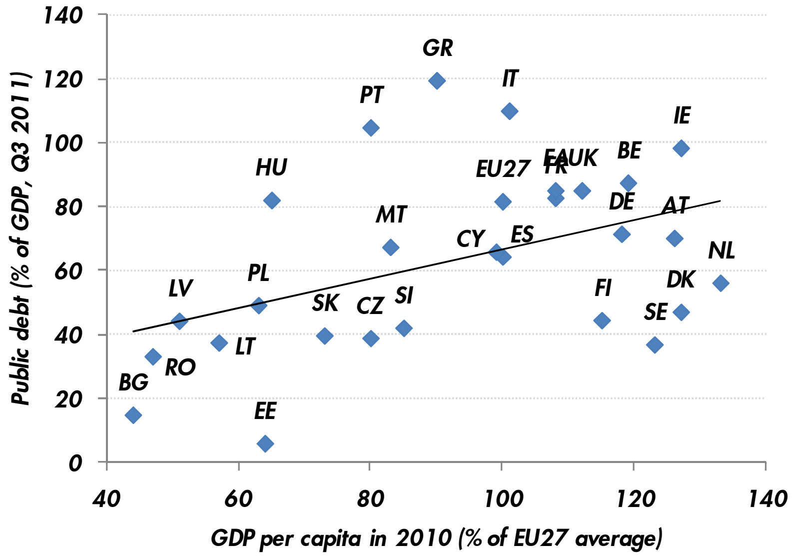
	Last economic cycle (1999-2011)	Last two economic cycles (1995-2013)
Average of the budget deficit (% of GDP)	-3.8	-3.7
Average of the cyclical component (% of GDP)	0.0	0.0
Average of the structural deficit (% of GDP)	-3.8	-3.7

- On average over an economic cycle (and the long-term average), the effective budget deficit should to 0.5% of GDP

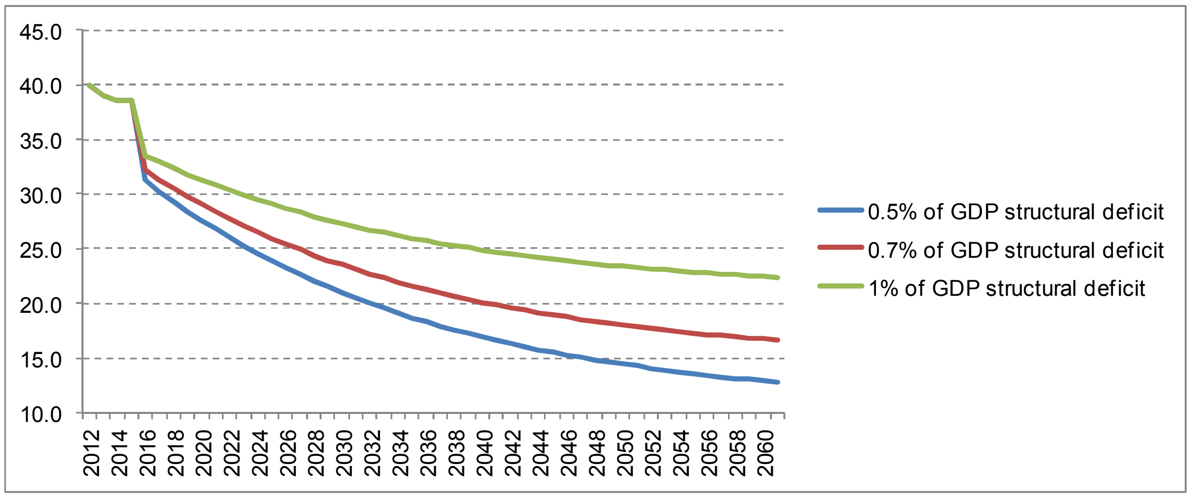
Source: Calculations based on estimates of the European Commission, November 2011

Public debt: what is the optimal level?





Long-term dynamics of public debt (% of GDP)

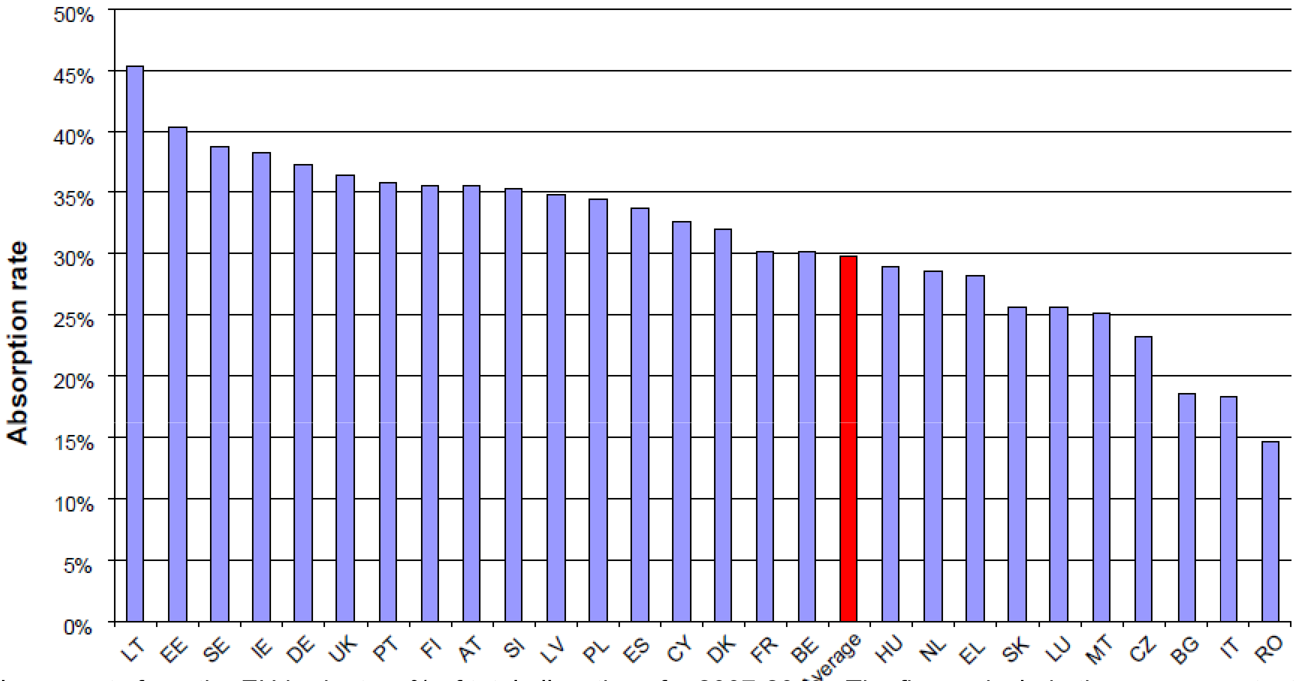


In the medium and long term, the 0.5% of GDP ceiling for the structural deficit leads to lower public debt (as % of GDP). In about 20 years, assuming an average GDP nominal growth rate of 5%, public debt will reach 20% of GDP.

Source: calculations based on Eurostat data

Improving EU funds absorption is a must

European Commission payments to member states under the Cohesion Policy 2007-2013 **(** the situation from October 2011**)**

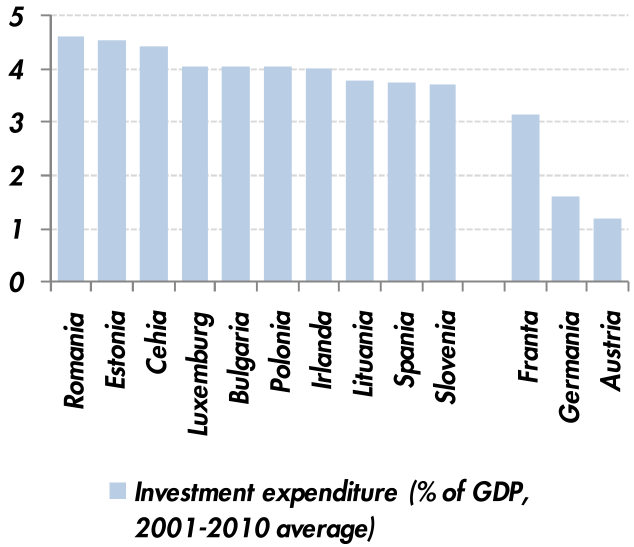


Note: total payments from the EU budget as% of total allocations for 2007-2013.. The figures include the prepayments that are between 7.5% and 11% for a Member State

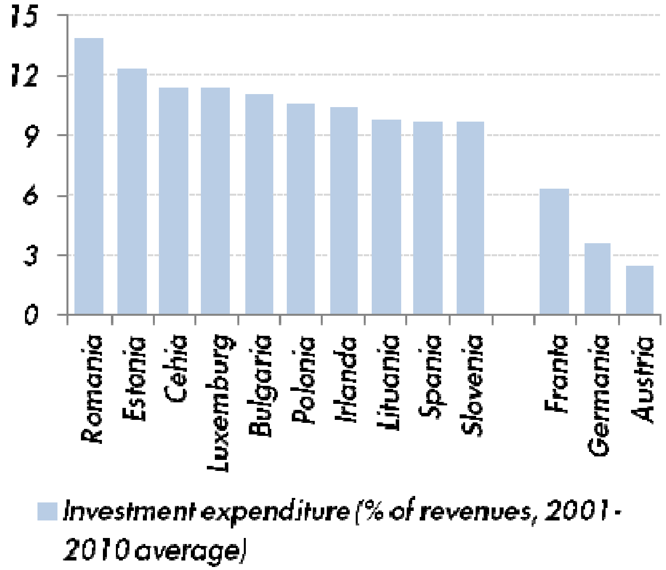
EU funds absorption is an enormous stimulus for the economy (for 1 leu own resources – budgetary deficit – public expenditure amounting 20 lei can be made), which is crucial in the context of discretionary fiscal policy constraints imposed by the new fiscal pact and the small size of automatic stabilizers!!!!!!!

Source: EUROPE'S SOURCES OF GROWTH - Presentation of J.M. Barroso to the European Council of October 23, 2011

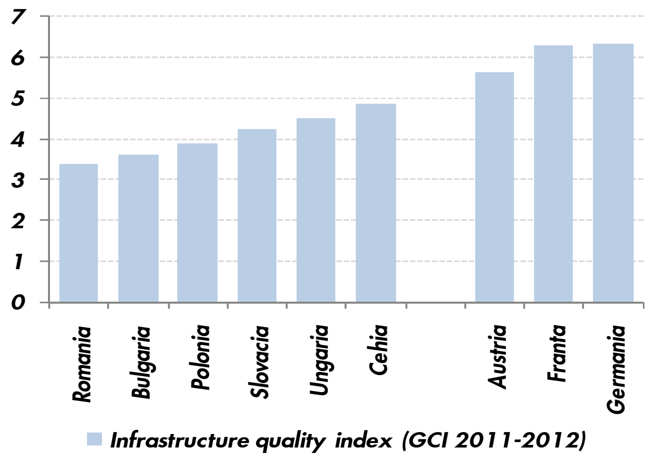
The necessity to increase the efficiency in public spending



Source: computations based on Eurostat data



Source: computations based on Eurostat data



World Economic Forum, The Global Competitiveness Report 2011-2012

- **Important financial resources allocated for public investment expenditure, but:**
  - **there is a strong sentiment that the infrastructure progress was very small**
  - **poor infrastructure remains a critical problem for Romania**

4. Concluding remarks

- **The new fiscal pact includes as a major advantage for Romania the introduction of a strict fiscal discipline, thus avoiding the pro-cyclicality of discretionary fiscal policy.**

- **Disadvantage - the use of discretionary fiscal policy, especially in times of recession, is limited, while the automatic stabilizers are relatively too low to be enough in stabilizing the economy.**

- **The 0.5% of GDP structural deficit ceiling is more restrictive for Romania than the 3% of GDP ceiling for actual deficit.**

- **Possible solutions:**
    - **Top priority - urgent and substantial increase of EU funds absorption**
    - **increase efficiency of public expenditure**
    - **increasing the magnitude of automatic stabilizers**

- **In the medium and long term, the 0.5% of GDP ceiling for the structural deficit leads to a substantial reduction of the public debt (as % of GDP). Is this desirable for an economy like Romania's economy?**