The analysis of fiscal policy management in Romania: Lessons for emerging countries

Cristian Socol and Aura Gabriela Socol*


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Subsequently to the adherance to the European Union, Romania prepares itself for the last stage of integration admission, the economic and monetary union. In this context, the study analyzes the fiscal management performance in Romania, to what extent the fiscal policy is prepared to act as a sole instrument capable of absorbing the asymmetrical shocks and stabilize the national economy after entering the Euro zone. The efficiency of the fiscal policy has been analyzed taking into consideration a reaction function assessment of the fiscal policy, both the response of the actual budget balance and of the structural budget balance being tested to the shocks of the modification in the degree of public indebtedness upon the output-gap and the previous values of the primary / structural budget balance. Thus, we have analyzed the sustainability degree of the Romanian public finances during the period 1999 – Q2 2008 and we have made recommendations for strengthening the role of the fiscal policy within the mix of the Romanian macroeconomic policies.

Key words: Potential GDP, output-gap, cyclically budget balance, structural budget balance, fiscal reaction function, monetary integration.

INTRODUCTION

The criteria of the convergence to the Euro zone will represent the economic test of the economic preparation stage for the adherance to the economic and monetary union. The Maastricht treaty does not mention a strict calendar for adopting the Euro currency, leaving this process at the choice of each country, taking, at the same time, the advice of the European Central Bank and the European Commission. But the treaty establishes that only the countries which demonstrate that they have reached a sustainable convergence may take part to the final stage of the economic and monetary union. When joining a monetary union, a country gives up one of the JEL classification: E61, E62, H62 two macroeconomic instruments, the monetary policy, maintaining, at the same time, the complete control over the second, the fiscal policy. In case the asymmetrical shocks occur, identified by the theory of the optimal currency areas (OCA) as representing the main source of costs in monetary union, the fiscal policy remains the only macroeconomic instrument available for balancing the national economy.

With reference to this, the study estimates a fiscal reaction function of the fiscal policy, which tests the response of the current budget balance / structural budget balance to the shocks of the level for the degree of public indebtedness, of the output gap and of the previous values of the primary / structural budget balance. This is a means of investigating the efficiency of the fiscal policy and of the public finances' sustainability, recommended by Bohn (1998, 2005) and used, improved or enlarged, by many other authors (Fatas and Mihov 2002; Gali and Perotti, 2003; de Mello 2005).

The model

Beginning with Barro (1979) proposal, for the analysis of the fiscal and budgetary policies' sustainability, the tax smoothing model, also used at present as a start in the reference literature. Barro considers that the budget balance can be estimated depending on the degree of indebtedness and on a set of control variables which can determine its size. In his original work, Barro (1979) was considering that the
primary budget balance is influenced by the economic cycles and by the temporary government’s expenses. Moreover Greiner et al. (2005) used, besides the variable which emphasizes the economic cycles, the real long term interest rate and values from the previous periods for the degree of public indebtedness. De Mello (2005) has estimated a fiscal reaction function based on the values from the previous periods of the budget balance, of the degree of indebtedness, of the inflation rate and of a few qualitative variables which caught the modifications occurrence in the fiscal laws.

The estimation of a fiscal reaction function (in the reference literature it is referred to as the “core” fiscal reaction function) is based on the following relation (Gali and Perotti, 2003).

\[ PB_t = a \times PB_{t-1} + b \times DEBT_t + c \times GAP_t + \text{constant} + \text{error term}, \]  

(1)

Where:
- \( PB \) = primary budget balance.
- \( GAP \) = output gap.
- \( DEBT \) = public debt.
- \( a, b, c \) = coefficients.

The variables (primary budget balance, output gap and public debt) are expressed as a % of the gross domestic product. If \( a > 0 \), we interpret that there is a tendency to balance the budget, increasing the sustainability of the public finances. The coefficient \( b > 0 \) demonstrates the existence of an active constraint regarding the public debt (in the reference literature it is referred to as the “core” fiscal reaction function). If \( c > 0 \), the fiscal policy is considered to be anticyclic.

Gali and Perotti (2003) suggest the use of 2 different measures of the budget balance: (i) the cyclically adjusted balance (the structural budget balance) to examine the discretionary characteristic of the fiscal policy, as well as its pro-cyclical or anti-cyclical characteristic. (ii) The cyclic budget balance to evaluate the efficiency of the automatic stabilizers.

The fiscal reaction function for Romania will be estimated using the following three models (Golinelli and Monigiliano, 2007).

### The CAPB (cyclically-adjusted primary balance) model

Most of the reference studies use the so-called “CAPB model” to estimate the rule of fiscal policy, in which the discretionary fiscal policy actions are measured through the modification within the structural primary budget balance (\( \Delta \text{CAPB} \)). The estimate of the structural primary budget balance for Romania has been achieved during 3 stages: (i) estimate of the gap between the effective gross domestic product and the potential gross domestic product (potential GDP) (output gap). (ii) Estimate of the cyclic component based on the output gap and on the sensitivity of the budget balance (this one, in its turn, has been obtained by the help of the incomes elasticity and of the budgetary expenses according to the GDP). (iii) Estimate of the structural component by eliminating the cyclic component from the current budget component.

The modification within the structural primary budget balance (\( \Delta \text{CAPB} \)) is explained by the initial position of the public finances (measured by the structural balance and by the public debt, both of them in the moment \( t-1 \)) and by the cyclic conditions (measured by the level of the output gap).

\[ \Delta \text{CAPB}_{it} = \phi_1 \times \text{CAPB}_{it-1} + \phi_2 \times \text{DEBT}_{it-1} + \phi_3 \times \text{GAP}_{i(t-1)} + u_{it} \]  

(2)

Where:
- \( \Delta \text{CAPB}_{it} \) = modification of the structural primary budget balance (cyclically-adjusted primary balance).
- \( \text{CAPB}_{it-1} \) = structural primary balance during the previous period.
- \( \text{DEBT}_{it-1} \) = public debt during the previous period.
- \( \text{GAP}_{i(t-1)} \) = output gap, during the current/previous period.
- \( \phi_1, \phi_2, \phi_3 \) = coefficients.

It is considered that the model is stable if the coefficient \( \phi_1 \) is negative, while the coefficient of the public debt has to be positive. Also, it is considered that the fiscal and the budgetary policy are sustainable if the response of the primary balance to the shocks of the public debt is instantaneous and not delayed. A positive value of the output gap coefficient (\( \phi_3 \)) shows that the fiscal policy is anti-cyclical, while a negative value means that the fiscal policy is pro-cyclical.

### The CAPB/PB model

The CAPB/PB model is similar to the previous one. The difference between them resides in the fact that, in the last case, the modification of the structural primary budget balance (\( \Delta \text{CAPB} \)) is explained by the primary budget balance in the moment \( t-1 \) (replacing the structural primary budget balance in the previous moment). For the rest, the same variables are maintained.

\[ \Delta \text{CAPB}_{it} = \phi_4 \times \text{PB}_{it-1} + \phi_5 \times \text{DEBT}_{it-1} + \phi_6 \times \text{GAP}_{i(t-1)} + u_{it} \]  

(3)

Where:
- \( \Delta \text{CAPB}_{it} \) = modification of the structural primary budget balance.
- \( \text{PB}_{it-1} \) = primary budget balance during the previous period.
- \( \text{DEBT}_{it-1} \) = public debt during the previous period.
- \( \text{GAP}_{i(t-1)} \) = output gap during the current period / previous period.
- \( \phi_4, \phi_5, \phi_6 \) = coefficients.

This model has been mostly used in the European Union,
especially after 1997, after the Stability and growth Pact has been introduced. Initially, this model was especially used (compared to the CAPB model) because the data referring to the cyclically-adjusted balance were not always available and their calculation modality was much more difficult than that of the current budget balance.

The PB model

Finally, the third model is based on reference studies which are especially interested in the asymmetries in the fiscal policymakers response, thus adopting a rule which practically replaces the modification of the structural primary budget balance ($\Delta$CAPB$_{it}$) in the 2$^{nd}$ model, with the modification made in the primary budget balance ($\Delta$PB$_{it}$).

$$\Delta$PB$_{it} = \phi_7 \times \text{PB}_{it-1} + \phi_8 \times \text{DEBT}_{it-1} + \phi_9 \times \text{GAP}_{it(t-1)} + u_{it}^{it} \tag{4}$$

Where:
- $\Delta$PB$_{it}$ = modification of the primary budget balance.
- PB$_{it-1}$ = primary budget balance during the previous period.
- DEBT$_{it-1}$ = public debt during the previous period.
- GAP$_{it(t-1)}$ = output gap during the current period / previous period.
- $\phi_7$, $\phi_8$, $\phi_9$ = coefficients.

The PB model supposes a significantly different behavior of the fiscal authorities compared to the other 2 models, such that the depending variable in this case includes, at the same time, both the effects of the discretionary policymakers’ actions and those caused by the automatic stabilizers. In fact, this is demonstrated in the identity from equation (5) below, where the primary budget balance is decomposed in its 2 component parts, the cyclic component and the structural component. The cyclic component is equal to the multiplication of the output gap with a coefficient $\rho$, which indicates the effects of the automatic stabilizers.

$$\text{PB}_t = \text{CAPB}_t + \rho \times \text{GAP}_t. \tag{5}$$

With the help of these relations, we can identify to what extent the discretionarism of the fiscal policy is cause by the cyclic component. This can be achieved by subtracting an average ($\rho$) of the individual coefficients $\rho_t$ from the analyzed period from the estimated coefficient of the output gap from the relation (4), respectively $\phi_9$.

$$\phi_{\text{discretionary}} = \phi_9 - \rho. \tag{6}$$

Estimations’ results and their interpretation

The variables have been chosen taking into consideration the reference literature and also the results of the stationarity tests. There have been used series of quarterly time from the period 1999-Q2 2008, having as a source the data coming from the ministry of economy and finances, national bank of Romania, national statistics institute of Romania and Eurostat. To estimate the coefficients from the above equations, the Johansen procedure of cointegration has been used. The number of lags used for the stationarity tests have been chosen depending on the SC information criterion. The results of the ADF stationarity test reveal the fact that the series are 1$^{st}$ degree integrated, this allowing the investigation of the existence of a cointegration relation between the variables. The series non-stationarity allows the usage of the cointegration procedure in order to identify the presence of a long-term relation between the non-stationary series. With reference to the lags taken into account within the cointegration, this has been determined based on the estimation of a VAR (auto-regressive vector) type model in which we have introduced the variables used within the analysis. For the choice of the lags number, we have used the econometrical criteria such as Hanan-Quinn information criterion (HQ), Akaike information criterion (AIC) and Schwartz information criterion (SC). The estimated coefficients are presented in the Annexes. Based on them, there have been made estimates regarding the relations between the variables.

The CAPB model

$$\Delta$CAPB$_{it} = \phi_1 \times \text{CAPB}_{it-1} + \phi_2 \times \text{DEBT}_{it-1} + \phi_3 \times \text{GAP}_{it(t-1)} + u_{it} \tag{1}$$

$$\Delta$CAPB$_{it} = (-0.022) \times \text{CAPB}_{it-1} + 0.088 \times \text{DEBT}_{it-1} + (-0.652) \times \text{GAP}_{it-1} - 0.010 \text{ (Table 1).}$$

The CAPB/PB model

$$\Delta$CAPB$_{it} = \phi_4 \times \text{PB}_{it-1} + \phi_5 \times \text{DEBT}_{it-1} + \phi_6 \times \text{GAP}_{it(t-1)} + u_{it} \tag{2}$$

$$\Delta$CAPB$_{it} = (-0.053) \times \text{PB}_{it-1} + (-0.0011) \times \text{DEBT}_{it-1} + (-0.244) \times \text{GAP}_{it(t-1)} + 0.0033 \text{ (Table 2).}$$

The PB$_{it}$ model

$$\Delta$PB$_{it} = \phi_7 \times \text{PB}_{it-1} + \phi_8 \times \text{DEBT}_{it-1} + \phi_9 \times \text{GAP}_{it(t-1)} + u_{it} \tag{3}$$

$$\Delta$PB$_{it} = (-0.183) \times \text{PB}_{it-1} + (-0.245) \times \text{DEBT}_{it-1} + (-1.556) \times \text{GAP}_{it(t-1)} + 0.041 \text{ (Table 3).}$$

The estimation of the fiscal reaction function for Romania, with the help of the three models presented above, has lead to the following results:

The CAPB model: Within the first model, the coefficient of the structural budget balance in the previous moment ($\phi_1 = -0.022$) is insignificant from a statistical point of view. This reveals the fact that the Romanian fiscal policy makers do not analyze the evolution of the previous structural budget balance indicator within the taking decision.
Table 1. Cointegration vectors for the structural deficit (the CAPB model).

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<th>Co-integrating Eq:</th>
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<tr>
<td>MODIF-DEF-STRUCT(-1)</td>
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<td>DEF-STRUCT-1(-1)</td>
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<td>(0.03800)</td>
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<tr>
<td></td>
<td>[ 0.97641]</td>
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<tr>
<td>DAT-PUB-1(-1)</td>
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<td></td>
<td>(0.01572)</td>
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<td></td>
<td>[-5.33330]</td>
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<tr>
<td>OUTPUT-GAP-1(-1)</td>
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Error correction:

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Table 2. Cointegration vectors for the structural deficit (the CAPB/PB model).

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<td>DEF-PRIMAR-1(-1)</td>
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Error correction:

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<td>(3.52746)</td>
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decisions process. The coefficient of the public debt share in the GDP ($\varphi_2 = 0.088$) is positive, demonstrating the fact that the fiscal authorities take into consideration the constraint related to the public debt, but not giving it a sufficient importance. This fact is mostly explained for Romania, where the public debt share in the GDP (an average of 15% of the GDP during the period 1999 - Q2 2008), harmonizing without problems with the criterion mentioned in the Maastricht treaty, a public debt share in the GDP lower than 60% of the GDP. But the increase of the structural budget balance in Romania will have to modify the view of the Romanian fiscal policymakers, under the terms in which a rapid increase in the need of financing the twin deficits-budget balance and current account balance, which becomes more and more non-sustainable, increases the risk of occurrence of the Ricardian equivalence phenomenon. The analysis of the factors which influence the modification of the structural budget balance shows the fact that the only indicator taken into consideration by the authorities in substantiating the decisions is the output gap. The coefficient ($\varphi_3 = -0.652$) argues the fact that, during the analyzed period, the fiscal
policy was mostly pro-cyclic, thus reducing the sustainability of the public finances. Moreover, the recommendations of the International Monetary Fund (IMF) and of the European Commission regarding the adoption of an anti-cyclic and forward-looking type fiscal policy have not been efficiently taken into consideration by the Romanian authorities, especially during the period 2005 - 2008, when the structural budget balance increased from 0.85% of the GDP to 7.4% of the GDP. Moreover, the effects of the inconsistent fiscal policy adopted in Romania will also be felt during the following 2 years. According to the European commission forecast (2009) for Romania, the structural budget balance will get deeper to 8.9% of the GDP in 2009 and 2010.

A pro-cyclic fiscal policy combined with the relaxation of the consumer credit during the last 2 years has lead to the deepening of the macroeconomic disequilibriums generated by the over-heating of the Romanian economy. Thus, the excessive aggregate demand could have been found in strong inflationary pressures, in the deepening of the current account and budget balance.

The CAPB/PB model: The second model brings a few interesting pieces of information. If within the first model we have seen that the structural balance modified during the analyzed period irrespective of the previous structural balance size, the second model demonstrates that the modification of the structural balance in Romania is mostly explained, in fact, by the evolution of the previous primary budget balance. At this moment, the usage of the second model for Romania is correct, taking into consideration the fact that our country has not been constrained yet by the provisions in the Stability and Growth Pact, but it is related to the performance criteria imposed by the Maastricht Treaty, which take into account the primary budget balance threshold < 3% of the GDP and not a certain reference level of the structural budget balance. Together with entering the Euro zone, the assessment of the fiscal decisions efficiency will be related to the structural budget indicator.

The PB model: Unlike the first two models, the third take into consideration both the effects of the discretionary policies actions and those caused by the automatic stabilizers in Romania. The analysis of the factors which influence the modification of the primary budget balance demonstrates the fact that all the three factors taken into consideration are significant ($\varphi_7 = -0.183$, $\varphi_8 = -0.245$ and $\varphi_9 = -1.556$). The negative sign of the coefficient $\varphi_7$ reveals the fact that the fiscal actions do not determine the balancing tendency of the situation related to the public budget in Romania, but the contrary. The coefficient $\varphi_9 = -1.556$ validates, on one hand, the fact that the fiscal policy has mostly been pro-cyclic and on the other hand, that the output gap is an indicator which is fundamental for taking fiscal decisions in Romania.

As we have previously shown in the study, the coefficient $\varphi_9$ contains both the effect of the discretionary policy measures ($\varphi_{discretionary} = -1.206$), and the effect of the automatic stabilizers action - $\varphi = \rho$ the average of the budget balance sensitivity related to the GDP during the analyzed period (1999 - Q2 2008). The budget balance sensitivity to the modification of the gross domestic product ($\varphi$) has been calculated as the difference between the budgetary incomes sensitivity (The following categories of budgetary incomes have been taken into consideration: the direct taxes, the indirect taxes and the social contributions) ($\varphi_v$) and the budgetary expenses sensitivity (among the budgetary expenses, only those supposing transfers towards the unemployed are considered to be
sensitive to the production variation) \((\phi_3)\) at the variation of the internal production:

\[
(\phi) = (\alpha_V \cdot \text{the incomes share in the gross domestic product}) - (\alpha_3 \cdot \text{the expenses share in the gross domestic product})
\]

Where:

\(\alpha_V\) = the total elasticity of the budgetary incomes (The elasticity of the budgetary incomes and expenses related to the gross domestic product have been estimated using the Johansen procedure of cointegration)

\(\alpha_3\) = the total elasticity of the budgetary expenses.

The level of the coefficient \(p\) calculated for Romania is 0.35, lower in comparison to the level taken into consideration in the case of the countries within the Euro zone (0.5) (Bouthevillain et al., 2001), this fact demonstrating a low efficiency of the automatic stabilizers action in Romania compared to the Euro zone countries.

The analysis of the three models leads to the conclusion that, during the period 1999 - Q2 2008, from the point of view of the new trade-off prices stability-production stability, the Romanian governments have given an increased importance to the economic growth, in the detriment of the inflation stability. With reference to the adherence to the Euro zone, where the fiscal policy has a significant role in the absorption of the asymmetrical shocks, forecasted to affect most of the macroeconomic balances types, this view should be re-analyzed.

Conclusions and Recommendations

In the case of the macro-economic disequilibriums deepening as a result of the negative effects generated by the economic crisis, the necessity of a few constraints, which are strict from a fiscal and budgetary point of view, is imperious. The European Commission’s forecasts for Romania (2009), demonstrate a current budget balance of 5.2% of the GDP in 2008 and of 7.5% of the GDP in 2009, much over the limit imposed by the Maastricht treaty (3% of the GDP), which increases the danger of postponing the calendar for adopting Euro by Romania after 2014.

During the period 1999 - Q2 2008, the Romanian fiscal policy was mostly inconsistent, pro-cyclic and weakly anchored on a medium and a long term. The low budgetary transparency, the divergent spending of the public money, the lack of feasible projects proposed for financing by the government, the poor quality of the public officers’ competence, the absence of priorities in the budgetary expenses and of the strategic vision regarding the management of the public finances have represented the main threats to the efficiency of the fiscal policy in Romania. The great number of budget rectifications (3 - 4 in a year), the practice of some massive budgetary expenses made in the last minute (approximately three billions of Euro spent each year, in December, during the period 2005 - 2008), the administration’s low capacity to spend the allotted public funds (the annual average was lower than 40% of the capital expenses allotted from the budget), the repeated overestimation of the budgetary incomes and expenses (differences of 2 - 4% of the GDP between the dates forecasted in the substantiation of the state budget and reality) and the exaggerations regarding the absorption capacity of the European funds have impeded the consolidation of the public finances’ sustainability in Romania. The fiscal policy, monetary policy, structural policies, social policy, incomes policy mix has been absent. The failures in the fiscal policy will be felt during the period 2009 - 2013, exerting pressure upon the twin deficits (budget balance and current account balance) and upon the inflation.

On the other hand, a reform of the budgetary expenses is necessary, which have to be re-structured so that they could aim to the developing of the national infrastructure, both that for the transportation and that of the education, health, rural development and environmental protection.

In order to avoid the high budget balance pressure upon lowering the economic growth, upon the deepening of the external balance and upon the increase of inflation through the internal demand, we consider that a structural adjusting of the offer is necessary, a more balanced management of the budget having good effects both on a short term and on a long term.

An intensifying factor of the structural budget balance improvement is constituted by the multi-annual planning and the following of a pre-determined strategy. Other modalities through which the state budget could satisfy its needs, besides the assimilation of the European structural funds, could be the raise of the indirect taxes.

It is necessary that the Ministry of Economy and Finances implements the EU procedure regarding the multi-annual budgetary planning, in order to assure the sustainability of the Romanian public finances on a medium term. Adopting a plan of rationalizing the public expenses, which could render the macro-economic financial management more efficient, represents a measure subsequent to that of a sustainable budgetary planning.

The success or the failure of the reform in the fiscal system depends on the moment when it is applied on the economic environment in which it is implemented and on the accompanying measures. A flat tax, lowering of the public expenses, a cautious wages policy, intensifying of the forced execution and of the imposing of strict constraints to all the bad payers, the decrease in the share of the contribution to the social insurances, fiscal predictability, stable competition environment, stimulation of the savings and of the internal investments, coherent strategies for attracting the direct foreign investments, strict settling of the property rights, active industrial policies would ensure more strong effects in stimulating the economy.

The gradual increase in the retirement age both for men and for women, the elaboration of a few measures to increase the birth rate and the adoption of a few poli-
cies to stop the migrationist phenomenon, will help the process of strengthening the public finances. On the other hand, it is necessary to limit the compensations, for the ex-owner of buildings confiscated during the communist regime, to a maximal limit and to confer some public securities instead of the shares owned in the Property Fund.

The continuing of the measures for increasing the business environment predictability in Romania is imperiously necessary. Romania should settle a target to decrease to half the number of para-fiscal taxes (at present 278 para-fiscal taxes, the first place in the top of the EU-27 countries) and to implement the Law on Unique Control (in order to avoid the harassment of the business environment, the overlapping of the control organisms etc). There must not be forgotten the procedures regarding the intensification of the measures for decreasing the tax evasion in fields such as bakery, beverage and tobacco industry, tourism, hotels and restaurants, commerce etc, which could support the increase in the degree of collecting incomes for the state budget.

In order to increase the efficiency of the fiscal policy, as an instrument for decreasing the current account balance and the inflation, through the decreasing of the excessive aggregate demand, it is imperiously necessary to strengthen the dialogue between the experts in the Ministry of Economy and Finances and the monetary policymakers in NBR, thus ensuring the implementation of a coherent mix of economic policies in Romania.

On a long term, we recommend that the monetary and fiscal authorities to use cautious economic policies. The fiscal caution (an objective of budget balance of maximum 3% of the GDP) will allow the automatic stabilizers to act with maximum efficiency and the restrictive / expansionist monetary policy will allow achieving the inflation target established by the central bank. Moreover, the fiscal policy will have to solve the nominal convergence, real convergence trade-off through qualitative investments, which would help to create a favorable environment for the development of the private sector.

The urgent necessity to isolate the budgetary process of inconsistent political stimuli can be achieved through strengthening the macroeconomic and fiscal policies department within the Ministry of Economy and Finances which, through the econometrical modeling, could stimulate the macroeconomic effects of the promoted budgetary and fiscal modifications. Thus, the authorities’ objective to reach a structural balance of 0.9% of the GDP for 2011 is difficult to attain.

In essence, under the terms in which the Romanian economy prepares itself to enter the Euro zone, we consider imperiously necessary the implementation and the maintaining, during a period of at least a few years, of a restrictive fiscal policy, which could improve both the current budget balance and the structural one. In order not to generate negative consequences, the government should not adopt expansionist discretionary policies, but to continue the process of fiscal strengthening.

The poor management of the Romanian budgetary policy will affect Romania’s entry to the Euro zone. Until the entry to the Euro zone, scheduled for 2014, the Romanian fiscal policymakers will have to increase their response speed regarding the adjusting to the shocks upon the aggregate demand or offer the next step being that of rendering the action compatible with the practices of good governing at the European level. By the continuous increase in the effects of the “authorities’ tye hands” phenomenon, authorities who are monetary and rate of exchange policymakers in the member countries, the decisions taken by the experts in public finances become more and more important. The authorities must be aware of the fact that the efficiency of the fiscal policy will become more and more important.

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