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FISCAL POLICY DURING THE CURRENT CRISIS

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Abstract:
Fiscal policy is an important government tool for managing the economy, having the ability to affect the total amount of output produced - GDP. Changes in the level and composition of government spending, taxation or other instruments of fiscal policy have impact on aggregate demand, the pattern of resource allocation, and the distribution of income. The article shows the mechanisms through which fiscal policy stabilizes the business cycle, and the specific requirements for fiscal policy during recession; the practical problems that may occur in implementing an effective fiscal policy are emphasized. Regarding the circumstances of the current financial and economic crises, the revival of the fiscal policy as a macroeconomic policy faces high expectations as to what it can accomplish. The paper highlights the composition of fiscal stimulus package, and reviews the specific fiscal stimulus plans adopted so far by different countries and their objectives. The final section contains an overview of the Romanian government response to the current crises, regarding fiscal policy. The conclusion is that Romania has conducted an inconsistent and ineffective fiscal policy, which has contributed to macro-economic and fiscal imbalances and to an increased fiscal pressure on business. Therefore, a medium-term fiscal framework has to be implemented, in order to ensure effectiveness and fiscal sustainability.

Keywords: *fiscal policy, automatic stabilizers, discretionary fiscal policy, fiscal stimulus, government spending, taxation*

JEL Classification: E62, E63, E65

"The time to act is now"
José Manuel Durão Barroso, 2008

Introduction

Fiscal policy is defined as the deliberate manipulation of government income and expenditure, so that to achieve economic and social objectives, and sustain growth [article on http://www.buythemap.com]. Fiscal policy is based on the theories of British economist John Maynard Keynes. Also known as *Keynesian economics*, this theory basically states that governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending. The two main instruments of fiscal policy are *government spending* and *taxation*. Changes in their level and composition may have impact on aggregate demand and the level of economic activity, the pattern of resource allocation, and the distribution of income [article on http://en.wikipedia.org]. Higher government spending or a decrease in taxes is an injection of income increasing aggregate demand, whilst a decrease in spending or a rising of taxes is an income leakage causing aggregate demand to fall. Based on the Keynesian theory, the level of spending in the economy will determine the levels of output, i.e. Gross Domestic Product (GDP), and employment, hence the government can control these areas of the economy, as it has the power to change aggregate demand, and lessen the fluctuations of the business cycle.

Specific instruments of fiscal policy

Fiscal policy is an important tool for managing the economy having the ability to affect the total amount of output produced, which is GDP. Its ability to affect output by affecting aggregate demand makes it a potential tool for economic stabilization. The basics of the fiscal mechanism is explained by Weil (2008): *if the economy is in recession*, with unused productive capacity and unemployed workers, then increases in demand will lead mostly to more output without changing the price level; *if the economy is at full employment*, by contrast, a fiscal expansion will have more effect on prices and less impact on total output.

Governments have available various instruments to promote their main objectives, like as allocation of resources, stabilisation of the economy, redistribution of income, and economic growth. It must be realised that, at times, while the instruments have changed, the main governmental objectives have remained the four listed above [Tanzi (2008)].

Government spending is the most traditional instrument. Both the level of public spending and its structure or composition are important and can be considered as separate instruments. **Taxation** is the other obvious instrument, which comprises at least four potential and separable instruments, such as the level of taxation, the structure of taxation, tax expenditures and tax incentives. According to Tanzi, some countries rely more on levels and structures (Scandinavian countries) while others have relied more on tax expenditures (Anglo-Saxon countries) and on tax incentives (Asian countries and many developing countries) (see Tanzi (2008) for an overview of fiscal policy instruments).

Fiscal policy can work in two general ways to stabilize the business cycle, which are **automatic stabilizers**, and the **discretionary fiscal policy**.

Automatic Stabilizers consist in a "built-in" fiscal mechanism that acts to reduce automatically the expansions and contractions of the business cycle [fiscal policy, article on http://www.amosweb.com]. This mechanism expands automatically the fiscal policy during recessions and contracts it during booms, being one form of countercyclical fiscal policy [Weil (2008)]. It depends on the level of aggregate production and income, such that business cycle instability is automatically dampened without the need for discretionary policy action.

Automatic stabilizers work automatically, being no need for enacting legislation, passing bills, or undertaking any other policy action. These stabilizers are built into the structure of the economy and the government sets up the rules and criteria under which taxes and transfer payments work. If people meet the criteria, then they pay the taxes or receive the transfer payments. The amount of each depends on the number of people meeting the criteria, which is dependent on business cycle activity [fiscal policy, article on http://www.amosweb.com]. Automatic stabilizers increase budget deficits during times of recessions or decrease them during booms. They enact countercyclical policy without the lags associated with legislative policy changes [article on http://www.investopedia.com]. They include **income taxes** and **transfer payments**.

- **Income taxes** largely depend on the level of aggregate production and income. If production and income rise, tax collections also rise. Income taxes also tend to be progressive, i.e. the proportion of taxes paid increases with income. This means that tax revenue is higher in an economic boom and lower in a recession, not only in absolute terms, but also as a proportion of national income [automatic stabilizers, article on http://www.amosweb.com]. Forms of tax that act like automatic stabilizers are: (i) *Taxes on corporate profits* - go up substantially during boom times, and decline rapidly during times of recession; (ii) *Progressive income taxes* - push people into higher income tax brackets during booms, substantially increasing their tax bill and reducing government budget deficits (or increasing government surpluses). During recessions, many individuals fall into lower tax brackets or have no income tax liability. This increases the size of the government budget deficit (or reduces the surplus). Other forms of tax do not exhibit these effects, because they are roughly proportionate to income (e.g. value added tax), or they bear no relation to income (e.g. property tax) [article on http://www.investopedia.com].
- **Transfer Payments**, including social security to the elderly, unemployment compensation to the unemployed, and welfare to the poor, depend on the level of aggregate production and income. They work opposite to taxes: if aggregate income rises, transfer payments tend to fall, as people are less likely to retire, be unemployed, or fall into the ranks of the poor.

Discretionary Fiscal Policy is a policy action consisting of changes in a fiscal program initiated by the government in order to change aggregate demand, providing an alternative way to stimulate the economy when aggregate demand and interest rates are low and when prices are falling or may soon be falling [Feldstein (2002)]. Discretionary fiscal policy is made more difficult due to lags in recognizing the need for changed fiscal policy and the lags that occur with enacting the changed fiscal policy. There usually is a lag between the time that changes of fiscal policy are needed and the time that the need to act is widely recognized. Additionally, a time lag may be between the moment of recognition and the moment that fiscal policy changes are actually enacted. Lastly, the impact of a change in fiscal policy may not be felt until six to twelve months after the change has occurred. For example, an expansionary fiscal policy (see Box 1) may be enacted when the economy is already recovering from a recession [article on http://www.investopedia.com]. These are accompanied by the lack of accurate forecasts.

Box 1. **Expansionary fiscal policy**

An **expansionary fiscal policy** (government spending higher than tax revenue) is a stance of fiscal policy that involves a net increase in government spending, through a rise in government spending or a fall in taxation revenue or a combination of the two, being associated with a budget deficit [article on http://en.wikipedia.org]. This leads to a larger budget deficit or a smaller budget surplus than the government previously had, or a deficit if the government previously had a balanced budget. According to Weil (2008), in a recession, the government can run an expansionary fiscal policy, thus helping to restore output to its normal level and to put unemployed workers back to work. Often, the focus is not on the level of the deficit, but on the change in the deficit. A **contractionary fiscal policy** (government spending higher lower than tax revenue) occurs when net government spending is reduced through either higher taxation revenue or reduced government spending or a combination of the two, being associated with a surplus [article on http://en.wikipedia.org].

In practice, discretionary fiscal measures are typically slower to arrive than both automatic stabilizers and monetary policy responses. Moreover, fiscal measures often become permanent, implying that public debt moves upward. According to Scott (2008), one of the first questions that policymakers need to address is "whether discretionary fiscal policy can be delivered on time and delivered well".

He concludes that, in the past, it has usually proven a challenge to meet these criteria: discretionary fiscal policy has usually been used less frequently than monetary policy during downturns, and it has taken longer to arrive, often after it is needed. Scott also notes that the response of discretionary fiscal policy is typically weaker than the stimulus provided by automatic stabilizers (Figure 1).

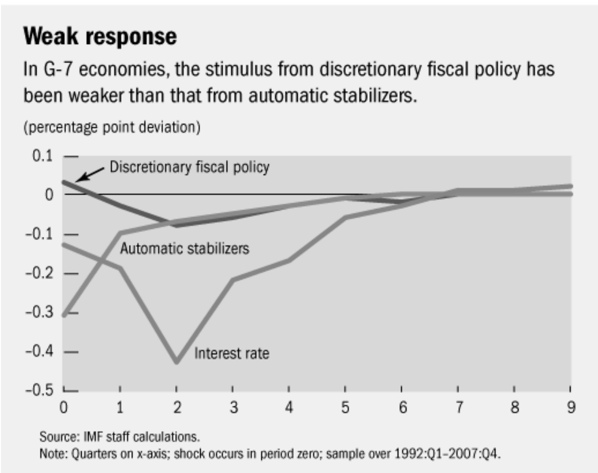

Figure 1. **Responses to business cycle changes**

Source: Scott. 2008. "Policy Responses to Slowdowns: Making Fiscal Stimulus Effective during Downturns", *IMF Survey Magazine*.

Considering the differences between advanced and emerging economies, an IMF survey (2008) finds that in advanced economies, discretionary fiscal policy has typically been countercyclical, that is taxes have been cut and spending increased during downturns. In emerging economies, discretionary fiscal policy has been procyclical that is stimulus has been added during good times and removed during downturns. This suggests that governments could try to enhance the scope and effectiveness of automatic stabilizers. In a report concerning economic crises in Europe (2009), the European Commission notes that government investment yields a somewhat larger GDP multiplier than purchases of goods and services. An increase in government transfers has a smaller multiplier, as it goes along with negative labour supply incentives. According European Commission's findings, temporary reductions in value added and labour taxes show smaller multipliers. Tighter credit constraints tend to increase the multiplier of these measures. A temporary reduction in consumption taxes is more effective than a reduction in labour taxes; it is attractive from a credibility point of view, since the private sector is likely to believe in a reversal of a temporary tax cut more than into a reversing of a temporary spending increase. Permanent reductions in VAT or labour taxes could yield short-run effects exceeding those of a permanent expenditure increase, because they reduce distortions imposed by the tax system [European Commission (2009)].

Fiscal Policy during the current financial and economic crisis

Economic growth is one of the main aims of macroeconomists and the government, as it allows a movement towards a better standard of living for the population. A recession is negative growth of GDP causing a downswing in the economies' business cycle. This is a direct threat to the primary aims of a government and so is high on its agenda of policies, tackling it being a necessity [article on http://www.buythemap.com]. If the economy is in recession then a government's priority will be to stimulate growth, by creating more employment and increasing aggregate demand. **Keynesian economics** suggests that adjusting government spending and tax rates are the best ways to stimulate aggregate demand. This can be used in times of recession or low economic activity as an essential tool in providing the framework for strong economic growth and working toward full employment. In theory, these deficits would be paid for by an expanded economy during the boom that would follow [article on http://en.wikipedia.org]. **Keynes opponents** aver that taxes may be a necessary "evil" to finance government operations and public services, but they distort incentives, reduce investment and labour supply and dampen growth. As for short-term stabilisation, discretionary fiscal spending is too susceptible to political interference. Better to rely on automatic stabilisers that are beyond the reach of politicians' personal interests and to use interest rates and the money supply to influence prices or unemployment levels [Dayton-Johnson (2008)]. Therefore, in a deep crisis, automatic stabilisers may need to be strengthened [European Commission (2009)].

In theory, fiscal policy is effective. However, there are practical problems that would affect policy making in a recession. We point out the most important ones:

- Higher government spending can lead to higher interest rates due to all the borrowing that is going on which would cause a discouragement in private sector investment.
- When tax is lowered, although consumers have more money to spend, they will save more due to the fear of unemployment; increasing the amount of jobs does not create this attitude, and so more is spent.
- The scale and logistics can make it inflexible and hard to implement, as a lot of government spending is contractual and cannot be simply stopped and started easily.

Accordingly, the case for using discretionary fiscal policy to stabilize business cycles is further weakened by the fact that another tool, **monetary policy**, is far more agile than fiscal policy [Weil (2008)]. As an alternative, monetary policy controls the supply of money and inflation, and it can be manipulated day to day. However, as a recession puts the government in a difficult position, both fiscal and monetary policy has to struggle to combat the effects of a downturn in economic growth. Fiscal policy is only one way of controlling the economy, if it is used in the correct way and, along with monetary policy, it can be an effective way of keeping growth buoyant [article on http://www.buythemap.com].

In the current financial crisis, governments around the world must formulate and implement policies for taxation and public spending. Due to their major impacts on economic growth, income distribution, and poverty, nowadays they tend to be at the centre of economic and political debates [The World Bank (2007)]. The same opinion is expressed by Dayton-Johnson (2008) who emphasize that one of the unexpected by-products of the current global financial crisis is that “it has placed fiscal policy back at the centre of the public policy debate”. Fiscal systems can provide the resources needed to carry out pro-growth investments and structural transformations, which in developing and emerging economies are so essential for long-term growth. Moreover, taxes and public spending can directly attack poverty and inequality, twin problems that continue to beset the region [Dayton-Johnson (2008)]. Terrones et al (2009) also emphasize that, during recessions associated with financial crises, fiscal policy tends to have a more significant impact, being more effective when economic agents face tighter liquidity constraints.

As a response to the financial crisis, monetary policy has been radically eased, in terms of significant interest rate reductions [Andersen (2009)]. Olivier Blanchard, IMF Economic Counselor, and Carlo Cottarelli, Director of the Fiscal Affairs Department within IMF [interviewed by Andersen (2008)] expressed the opinion that in the current financial context, the room for further monetary easing is shrinking, as in some countries policy interest rates are approaching zero. The same opinion has Andersen (2009), according to whom interest rates have been reduced to low levels, implying that the room for further interest rate reductions is small. Accordingly, it is a widespread perception that monetary policy cannot deliver sufficient stabilization in the present situation [Andersen (2009)], an opinion that is constantly brought forth since the collapse of Lehman Brothers [Belke (2009)].

Corsetti and Muller (2008) underline the necessity of the financing mix (taxes vs. future spending cuts), as well as coordinated cross-border fiscal expansionary policy. The opinion of a common and coordinated fiscal policy implementation is not commonly shared. For example, Belke (2009) suggests that it might be better to have independent national fiscal policies that are not coordinated or not correlated under Economic and Monetary Union (EMU), based on several arguments: (i) fiscal policy can be a source of shocks in the context of the current crisis; (ii) policy makers do not have full control over the outcome, therefore the effect of a certain measure is quite different from what is anticipated; and (iii) the economic forecasts underlying fiscal policy might turn out to be wrong.

Many researchers have the opinion that the global financial crisis is now turning into a worldwide economic crisis [Andersen (2009)]. This opinion is argued by the continuously revised downwards of business cycle forecasts. Negative growth rates are expected for many OECD countries for 2009. More specifically, overall deficits are projected to increase by 5.5 percentage points of GDP in 2009 and 2010, with respect to both 2007 pre-crisis levels and excluding losses from financial sector support. In advanced G20 economies, fiscal deficits in 2009-2010 are now estimated to be larger, in some cases reflecting weaker growth prospects in 2009 before a stronger recovery in 2010. By contrast, changes in fiscal balances are now expected to be smaller in other G20 countries, particularly those where commodity revenues are important, according to Horton et al (2009). Growth rates are expected to recover only sluggishly, and, consequently, unemployment rates are soaring in all OECD countries [Andersen (2009)].

In the Spring Forecast for 2009 issued by European Commission, several factors are mentioned for the sharp increase in the projected general government deficits: (i) the economic downturn is bringing about declining tax revenue and rising social security expenditure, notably unemployment benefits; (ii) exceptional revenue windfalls witnessed in the recent boom period are continuing to reverse, which is reflected in a relatively strong erosion of some tax bases; and (iii) in line with the Commission's **European Economic**

Recovery Plan (see Box 2) many Member States have adopted significant discretionary fiscal stimulus packages to promote investment and sustain demand in general.

According to the EERP, actions should aim *protecting employment* and *promoting entrepreneurship* and they have to be done in the four priority areas of the Lisbon Strategy: **people**, **business**, **infrastructure and energy**, **research and innovation**.

a) **People**: ***the top priority must be to protect Europe's citizens from the worst effects of the current crisis***.

1. *Launch a major European initiative on employment support* by (i) rapidly reinforcing activation schemes, and (ii) improving the monitoring and matching of skills development and upgrading with existing and anticipated job vacancies, in close cooperation with social partners, public employment services and universities;

2. *Create demand for labour* through (i) reducing employers' social charges on lower incomes to promote the employability of lower skilled workers, and (ii) adopting the proposed directive to make permanent reduced VAT rates for labour-intensive services.

b) **Business**: ***sufficient and affordable access to finance as a pre-condition for investment, growth and job creation by the private sector***. In order to reduce administrative burdens on business, promote their cash flow and help more people to become entrepreneurs, the Member States should:

▪ Ensure that starting-up a business anywhere in the EU can be done within three days at zero costs and that formalities for the hiring of the first employee can be fulfilled via a single access point;

▪ Remove the requirement on micro-enterprises to prepare annual accounts and limit the capital requirements of the European private company to one euro;

▪ Ensure that public authorities pay invoices, including to SMEs, for supplies and services within one month to ease liquidity constraints and accept e-invoicing as equivalent to paper invoicing;

▪ Reduce by up to 75% the fees for patent applications and maintenance and halve the costs for an EU trademark.

Box 2. **European Economic Recovery Plan (EERP)**

The European Commission presented at the end of November 2008, the **European Economic Recovery Plan**, proposing a coordinated stimulus package to be implemented by the Member States taking into account their particular conditions. EERP has one fundamental principle, which is **solidarity and social justice** - *in times of hardship, action must be geared to help those most in need*. In addition, the Plan has two key pillars:

· A **major injection of purchasing power into the economy**, to boost demand and stimulate confidence: Member States and the EU agreed to an immediate budgetary impulse amounting to € 200 billion (1.5% of GDP), to boost demand in full respect of the **Stability and Growth Pact** (SGP) (see Box 3).

· A **direct short-term action to reinforce Europe's competitiveness in the long term**, aiming the area of “smart” investments (e.g. energy efficiency, clean technologies, infrastructure) [Commission of the European Communities (2008)]

Box 3. **Stability and Growth Pact (SGP)**

The **Stability and Growth Pact** pertains to the third stage of EMU, which began on 1 January 1999, in order to ensure that the Member States maintain budgetary discipline after the single currency has been introduced. SGP is a rule-based framework for the coordination of national fiscal policies, established to safeguard sound public finances. It consists of a preventive and a dissuasive arm. Regarding the **preventive arm**, Member States have to submit annual stability programmes, showing how they intend to achieve or safeguard sound fiscal positions in the medium term, taking into account the impending budgetary impact of population aging. The **dissuasive part** governs the excessive deficit procedure that is triggered by the deficit breaching the 3% of GDP threshold of the Treaty of Maastricht on European Union [http://ec.europa.eu].

Following the Commission's guidelines in the EERP, the fiscal stimulus should be well defined and be based on the following principles: (i) it should be timely, temporary, targeted and coordinated at the European level; (ii) it should mix revenue and expenditure instruments; (iii) it should be conducted within the Stability and Growth Pact; and (iv) it should be accompanied by structural reforms that support demand and promote resilience. These principles are particularly relevant given that, at the current juncture, markets tend to react rapidly to concerns related to public finance sustainability with an increase in the risk premium on public debt instruments, even in the euro area context [Banco de Portugal (2009)]. The role of fiscal stimulus, explained by Blanchard [Andersen, Camilla (2008)] is to limit the decline in demand as well as output. If no fiscal stimulus is implemented, then demand may continue to fall and "vicious cycles" may appear, like as deflation and liquidity traps, expectations becoming more and more pessimistic and, as a result, a deeper and deeper recession.

Government support can take various forms, with different implications for gross and net debt. These are summarized below, according to Spilimbergo et al (2009).

Public spending on goods and services – theoretically has a direct demand effect than transfers or tax cuts. Practically, the appropriate increase in public spending is constrained by the need to avoid waste. First, governments should make sure that existing programs are not cut for lack of resources. Governments facing balanced budget rules may be forced to suspend various spending programs (or to raise revenue). Second, spending programs that were delayed, interrupted or rejected for lack of funding or macroeconomic considerations, can be (re)started quickly. A temporary increase in public sector employment associated with some of new programs and policies may be needed.

Fiscal stimulus aimed at consumers need to take into account the present exceptional conditions, specifically: (i) decreases in wealth; (ii) tighter credit constraints, and (iii) high uncertainty. The degree of pass-through to consumers is uncertain, its unwinding can contribute to a further downturn, and it is questionable whether decreases of just a few percentage points are salient enough to lead consumers to shift the timing of their purchases. Possibly larger, but more focused incentives, cash transfers for purchases of specific goods may attract more attention from consumers and have larger effects on demand.

Fiscal stimulus aimed at firms has as a main objective ensuring that firms do not reduce current operations for lack of financing. While this is primarily the job of monetary policy, there is also some scope for governments to support firms that could survive restructuring, but find it difficult to receive the necessary financing from dysfunctional credit markets.

Considering the recommendations of European Commission, it is necessary to answer two important questions: "What is the appropriate fiscal policy in the short term and what does this imply for the fiscal outlook?" and "What are the key elements of a fiscal strategy to ensure fiscal solvency?" [Cottarelli (2009)]. Answering the first question, Spilimbergo et al (2008) highlight that, under the circumstances that the current crisis will last at least for several more quarters, the fiscal stimulus can rely more on spending measures, as they may have advantages over tax cuts or increases in transfers, which operate by raising the purchasing power of households and firms in the economy, given the highly uncertain response of the latter to an increase of their income in current circumstances.

For ensuring fiscal solvency, two priorities have to be considered to ensure that short-term crisis alleviation is aligned with long-run development: (i) strengthening the social safety in order to help the most vulnerable and those most affected by the crisis to cope; and (ii) spending increases should concentrate in areas such as infrastructure that are likely to contribute to growth in the long term [Kraay and Servén (2008)]. In addition, experience shows that lower direct fiscal costs and higher recovery rates were achieved in the past (taking into account the severity of the crisis) when the banking crisis resolution strategy was (i) implemented swiftly, and transparent and received broad political support; (ii) backed by strong public institutions and legal frameworks; (iii) consistent in terms of fair and uniform treatment of market participants; and (iv) was part of a clear exit strategy, including restructuring of the banking sector [Schaechter (2009)].

Factors that matters in strengthening the reaction to fiscal stimulus

Barrell et al (2009) identify two factors, which may matter for the transmission of fiscal policy impulses:

- ***Openness*** of a country, measured by import volumes as a share of GDP, plays an important role in evaluation of the effectiveness of fiscal policy. When a government pursues an expansionary fiscal policy, a one-to-one effect on output cannot be expected, as a part of the aggregate demand's growth will go to imports. The larger is the share of imports in a country's GDP the bigger is the leakage to the imports and the less effective is the fiscal package.
- ***Liquidity constraints*** approximated by the relationship between changes in consumption and changes in real disposable incomes, evaluate the strength of the impact of fiscal policy on domestic demand. Liquidity or borrowing constrained consumers spend more of increase in their current incomes than those who are able to make optimal borrowing and spending plans over time. The greater the share of liquidity constrained agents the larger the effects of fiscal shocks.

When taking into account **the size of the economies of Member States**, the distribution of fiscal stimulus efforts is broadly in line with the distribution of their needs and with the distribution of their ability to implement fiscal stimulus, without running into severe problems with regard of their balance of payments or fiscal position. This conclusion, drawn by the European Commission (2009), is based on the assumption that the fiscal stimulus packages are indeed temporary and will be fully reversed at the appropriate time when the economy recovers.

To maximise its impact, the budgetary stimulus should take account **the starting positions of each Member State**. "Those that took advantage of the good times to achieve more sustainable public finance positions and improve their competitive positions have more room for manoeuvre now", according to EERP. In countries with high pre-crisis ratios of public sector debt to GDP, lack of **fiscal space** (see Box 4) not only constraints the government's ability to implement countercyclical policies, but also undermines the effectiveness of fiscal stimulus and the quality of fiscal performance [Baldacci et al (2009)]. In countries with high debt or lower per capita income, crises lasted almost one year longer. Schaechter (2009) appreciates that during the strong economic pre-crisis times EU Member States "did not sufficiently strengthen their state of public finances, often in contradiction with their medium-term plans".

Box 4. **Fiscal space**

Fiscal space is the room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy. The composite indicator, developed in European Commission, is created including: (i) the general government gross debt-to-GDP ratio, (ii) potential government contingent liabilities to the financial sector, (iii) estimates of foreseeable revenue shortfalls in the medium run, (iv) the current account balance as an indicator of external imbalances, and (v) the share of nondiscretionary expenses as a proxy for the vulnerability of public expenses to meet short-run obligations [Schaechter (2009)]. The fiscal space is very different across Member States [European Commission (2009)].

Actions to alleviate the recession are involving ***fiscal costs*** no matter they are based on automatic stabilizers or discretionary fiscal stimulus. According to IMF (2009), some of these impacts will be short-lived and others will be longer lasting or even permanent. As things stand now, the fiscal costs of the financial and economic crisis are expected to be considerable. In its spring 2009 forecast, the European Commission projected that government borrowing in the euro area would rise to 5.3% of GDP in 2009 and 6.5% in 2010. In the euro area, government debt ratio, which stood at 66% in 2007, is projected to rise to 84% in 2010. Thirteen out of sixteen euro area governments are projected to breach the 3% of GDP deficit reference value of the revised SGP. Moreover, according to González-Páramo (2009), "all are at risk of doing so next year". These figures reflect the impact on public finances of the contraction in economic activity. They also reflect the costs of discretionary fiscal stimulus measures adopted in many countries. It is worth to mention the IMF's conclusion that the automatic stabilizers' impact is increasing as the economic conditions are weakened [IMF (2009)].

Baldacci et al (2009) emphasize that **the composition of fiscal expansions matters for crisis length**. Stimulus packages that rely mostly on measures to support government consumption are more effective in shortening the crisis duration than those based on public investment. 10% increase in the share of public consumption in the budget, reduces the crisis length by three to four months. Many countries have announced fiscal stimulus plans. We summarize them, according to the IMF's Companion Paper (2009):

- **Regarding the composition of fiscal stimulus package**: **(i) Expenditure measures**: Almost 2/3 of the fiscal stimulus has been represented by expenditure measures with particular emphasis on increased spending for infrastructure. Fifteen of the G20 have announced plans to increase spending on infrastructure, largely on transportation networks (Canada, France, Germany, and Korea, among others), either in the form of direct central government spending, or through capital transfers to local authorities. According to Horton et al (2009), emerging G20 countries have announced somewhat larger stimulus packages for 2009, on average, than advanced G20 countries. This reflects smaller automatic stabilizers and consequently greater need, as well as substantial fiscal space in key emerging market countries. China, Russia, Saudi Arabia, and South Africa have introduced large packages. Emerging market discretionary measures are also more heavily weighted to infrastructure investment and less focused on income tax cuts (Figure 2). **(ii) Revenue measures**: Nine G20 countries have announced sizable cuts in personal income taxes (Brazil, Canada, France, Germany, Indonesia, Japan, Spain, the UK, and the US); while in six, indirect tax cuts have been announced. Cuts in the corporate income tax (CIT) have also been frequent but not as large; these include outright reduction in the CIT rate (Canada, Korea, and Russia), investment incentives (France and Korea), or more favourable depreciation schedules (Germany, Russia, and the US).

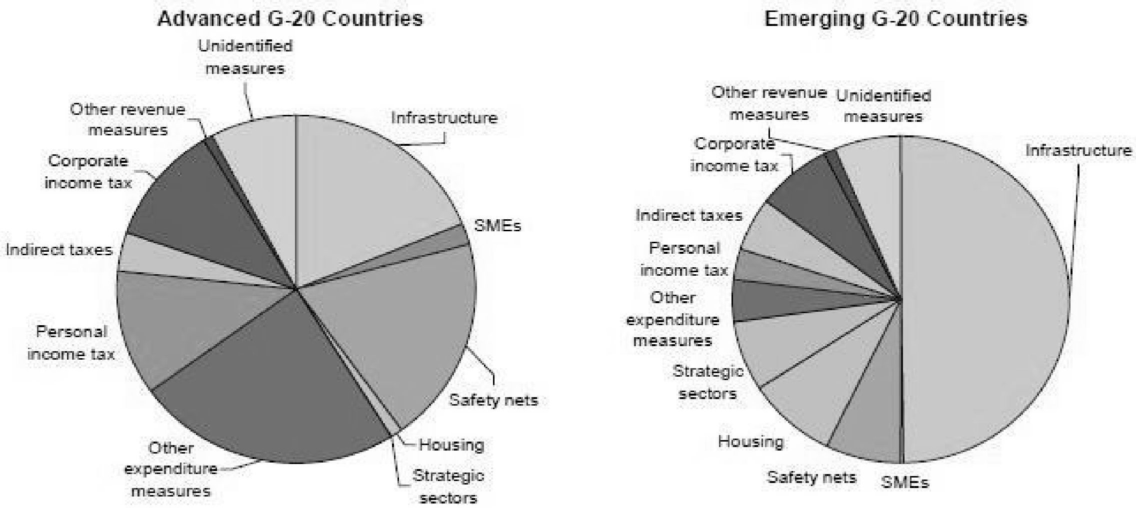

Figure 2. **Group of 20 (G20) economies: Fiscal stimulus by category in 2009**

Source: Horton et al. 2009. *"The State of Public Finances: A Cross-Country Fiscal Monitor"*, IMF Staff Position Note SPN/09/21, pp. 5

▪ **Regarding the aim of fiscal stimulus package**: Many countries have announced plans to protect vulnerable groups, including by strengthening unemployment benefits (Russia, the UK, and the US), cash transfers to the poor (Korea) or support to children (Australia, Germany) or pensioners (Australia, Canada). A few G20 countries are also stepping up support for small and medium enterprises (e.g., Korea) and strategic or vulnerable sectors, such as construction (in Germany, for energy efficient buildings and repairs and renovations), defence and agriculture (Russia). Finally, a few countries are using stimulus measures to address longer-term policy challenges, such as improving the quality of health and education (Australia and China) or introducing incentives for environmentally-friendly technologies (China, Germany, and the UK). Revenue measures have targeted primarily households, through cuts in personal income and indirect taxes.

Reviewing the supportive fiscal policies, IMF shows that the fiscal expansion is greater in advanced economies, reflecting the larger size of their governments and the greater role of automatic stabilizers such as income taxes and transfers (welfare payments, unemployment benefits) [IMF WEO (2009)]. For the G20 economies, crisis-related discretionary measures are estimated at about 2% of GDP for 2009 and 1.5% of GDP for 2010, both relative to 2007 baselines. The categories of stimulus that were implemented most rapidly - tax breaks and transfer payments - are those that typically have lower effects on activity. Stimulus measures that have higher multipliers will likely be implemented at an accelerated pace during the second half of 2009, reflecting the lags inherent in new and expanded government spending programs, particularly in infrastructure. Estimates for 2010 reflect the phased implementation of stimulus spending initiated during 2009 and a carryover of tax provisions as well as the continued operation of automatic stabilizers.

Fiscal policy in Romania during the current crisis

According to the European Commission's Spring Forecast 2009, in the first three quarters of 2008, domestic demand for both consumption and investment boomed, fuelled by strong wage increases and a rapid expansion of credit. However, it proved that the ones less optimistic concerning the impact of the financial turmoil in the US and advanced Europe were, unfortunately, right. The effects of the turmoil have arrived in Romania with a lag, and the real and financial consequences are such that Romania faces a very sharp and disruptive economic slowdown. The largely foreign financed domestic demand boom and overheating pressures came to a sudden end at the beginning of the fourth quarter of 2008, following the significant tightening of international capital inflows, increased investor risk aversion to home-grown vulnerabilities and decelerating disposable income. Hence, domestic demand contracted by almost 2% y-o-y (year-over-year) in the fourth quarter, compared with an average increase of 14½% y-o-y in the first three quarters [European Commission, Spring Forecast (2009)].

In 2008, the budget deficit surpassed the maximum threshold of 3% of the GDP set by the Stability and Growth Pact, being of 5.4% of GDP (ESA methodology). This was mainly due to substantially higher-than-planned current spending, notably in public wages and social transfers. In addition, overly optimistic revenue projections did not materialise and a sudden drop in revenue collection in the last two months of the year owing to the economic slowdown added to the worse-than-expected outcome.

These lead us to the conclusion that managing an economic boom has proved difficult: macroeconomic imbalances have widened - due to a persistent excess of consumption and investment over disposable income - and relatively high inflation has came up. Fiscal policy has contributed to the imbalances by more than spending revenues from higher growth (which led to larger fiscal deficits). Unfortunately, Romania has missed the opportunity to create buffers under the continued-boom scenario as a protection against a possible sharp slowdown [Fernández-Ansola and Jaeger (2008)]. In our opinion, higher revenues from the continued economic boom should have been saved to create room for a fiscal expansion in case that inflows and the economy slow down significantly. A sharp-slowdown scenario has put strong pressure on the fiscal position, in the context that this was already weakened by inconsistency, due to a large number of taxes and their frequent changes, resulting in an increased fiscal pressure on business environment.

The 2009 budget adopted in February 2009, contained several measures to lower the deficit, including a recruitment freeze and the reduction of various bonuses in the public sector, cuts in expenditure for goods and services and subsidies, limiting pension increases to inflation, a 3.3 percentage points rise in the pension contribution rate and a bringing forward of the schedule to increase excise taxes. On the revenue side, measures aimed at eliminating certain tax deductions and allowances (in particular on company cars and depreciation of revaluated assets). On the other hand, the government planed a substantial increase in public investment in 2009 compared with 2008. These measures were reflected in a budget rectification approved by the government in April 2009 [European Commission, Spring Forecast (2009)].

The Business Monitor International's regional report on political risk and macroeconomic prospects, issued in October 2009, argues that the data for Romania showed the economic downturn deepening during the second quarter 2009. According to the National Statistical Institute (NSI), the Romanian economy shrank by 8.8% y-o-y during the second quarter 2009, surpassing the 6.2% decline of the previous quarter, which indicates that economic conditions in Romania have deteriorated comparing to the first quarter. This translates into a poor outlook for tax collection as corporate and household earnings continued to suffer. This is especially pertinent given that unemployment is typically a lagging indicator of the business cycle, with VAT receipts and income tax collection likely to deteriorate even when the economy embarks on recovery. In addition, any expenditure cuts proved unpopular among the electorate, making it increasingly difficult for the government to satisfy the IMF's loan conditions.

Though the IMF has raised Romania's budget deficit target in 2009 to 7.3% of GDP (from a previous 4.6%), the government is still struggling to stabilise the fiscal account. Finance Minister Gheorghe Pogea announced in August that the government would slash RON5.5bn from public expenditures in 2009. Initiatives include sending public sector workers on unpaid holiday for 10 days (contrary to the European Commission's recommendations), eliminating overtime pay, as well as reducing spending on goods and services. While tightening fiscal policy has sustained foreign investor risk sentiment, the risks to political stability has raised as unemployment increased and real incomes fall alongside the reduction in public sector pay. There is still likely that the required deficit target to be exceeded. The Business Monitor International's regional report issued in November 2009 forecasts a shortfall equivalent to 8.0% of GDP in 2009. The planned reduction in public expenditures is likely to prove insufficient to contain the gaping fiscal shortfall, given the extent to which Romania's economic downturn is unfolding.

Under these circumstances, according to the CESifo World Economic Survey published in August 2009, the assessment of the volume and structure of Romanian policy measures to fight financial and economic crisis was 1.3 (WES scale: 9 – fully sufficient; 5 – more or less sufficient; 1 – not sufficient) [Stangl and Nerb (2009)].

Regarding the fiscal measures, our opinion is that they put more pressure on people and business, contrary to the recommendation of European Commission to *"protect employment and promote entrepreneurship"*. Few examples are presented below:

- introducing the flat-rate tax, which, instead of improving the tax collection, led to self-liquidation of small firms, increased unemployment, and reduced private initiative;
- large delays on VAT refund on behalf of public authorities, for exporting companies, which result in lake of liquidity;
- maintaining the requirement to prepare the half-year financial statements for all companies; moreover, in some counties, fiscal authorities imposed that these statements to be audited by an accounting expert (which is not a legal-based requirement); this result in an increased cash burden for the SMEs;
- increasing the social charges, referring to the contribution to social security, which is higher with 1% for employees and 2.3% for companies;
- sending public sector workers on unpaid holiday for 10 days, which is completely against the European Commission's recommendation, contained in the EERP: ***"the top priority must be to protect Europe's citizens from the worst effects of the financial crisis"***.

Therefore, in the current economic context, Romania's first priority should be to tackle macroeconomic and fiscal imbalances that pose risks to the sustainability of its medium to long-term growth path. In order to increase external competitiveness and to lower the current account deficit and inflation, Romania has to implement a medium-term fiscal framework [Ernst & Young (2009)], in order to ensure fiscal sustainability. It is also necessary to revise the composition of expenditure to increase the share of growth-enhancing spending by reducing and redirecting state aid to horizontal objectives and to keep wage developments in line with productivity growth. In the context of a coherent better regulation policy, the implementation of measures to substantially reduce administrative procedures and delays in obtaining authorizations has to be done urgently, in order to improve the business environment and reduce sources for corruption. These will help ensure the European Economic Recovery Plan is implemented in a way that is compliant to long term sustainability as well as responds to the economic crisis.

Conclusion

Crises can have long-term negative effects, damaging human and physical capital with negative implications for productivity and potential output growth. Therefore, early recovery from a crisis is important, to minimize output losses in the short term and enhance medium-term growth prospects. We subscribe the opinion that this calls for timely, targeted and well-designed fiscal responses during downturns.

According to our findings, the impact of fiscal policy on demand depends on the size of fiscal multipliers, the credibility of the sustainability of fiscal stimulus, the uncertainty surrounding the current and future economic environment, and the intensity and effectiveness of international cooperation. Our conclusion is that fiscal responses may not be effective when initial fiscal conditions are poor and fiscal space is limited. High public debt levels and past macroeconomic instability limit the scope for countercyclical deficit expansions and hamper the effectiveness of fiscal stimulus measures as markets perceive the higher future fiscal risks entailed by larger deficits [Baldacci et al (2009)].

In Romania, the policy measures to fight financial and economic crisis ware assessed as "not sufficient". We argue that fiscal measures taken so far are ineffective, resulting in increased tax burden for business and people, increased liquidity constraints, and lack of private initiative. Moreover, these measures are not compliant with the recommendations of European Commission and the EERP provisions. Our conclusion is that, on short-term, Romania should implement a consistent fiscal stimulus package, in order to protect employment and promote entrepreneurship. On medium-term, the fiscal policy objectives should be the implementation of a fiscal framework and an adequate taxation structure, aiming the tax collection improvement and preventing the tax evasion. These will reduce macroeconomic imbalances and ensure fiscal sustainability.

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