

MECHANISM FOR CORRECTIVE ACTION ON BUDGET IMBALANCES*

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* Acknowledgment: This work was co-financed from the European Social Found through Sectorial Operational Program Human Resources Development 2007-2013, project number POSDRU/89/1.5/S/59184, 'Performance and excellence in postdoctoral research in Romanian economic science domain', Academy of Economic Studies.

Abstract

The European Fiscal Compact sets the obligation for the signatory states to establish an automatic mechanism for taking corrective action on budget imbalances. Nevertheless, the European Treaty says nothing about the tools that should be used in order to reach the desired equilibrium of budgets, but only that it should aim at correcting deviations from the medium-term objective or the adjustment path, including their cumulated impact on government debt dynamics. This paper is aiming at showing that each member state has to build the correction mechanism according to the impact of the chosen tools on economic growth and on general government revenues. We will also emphasize that the correction mechanism should be built not only exacerbating the corrective action through spending/tax based adjustments, but on a high quality package of economic policies as well.

Keywords: budget deficit, growth, adjustments, consolidation.

1. Context

The fiscal consolidation policies implemented between 2009 and 2012 in the European Union did not lead to the desired budgetary balance or to the recovery of economic growth, but rather to insignificant growth rates and to the return to recession. Most policies have privileged the removal of budgetary imbalances through spending based on adjustments following unrealistic targets and producing negative effects on aggregate demand. Faced with the failure of spending-based adjustments, most of the European countries have chosen to increase the public revenues by taxation (tax based adjustments) with higher contractionist effects.

Therefore, the European countries have recognized the ineffectiveness of the Stability and Growth Pact in ensuring a climate of fiscal prudence over the business cycle and have tried to strengthen the fiscal and budgetary discipline through a new set of commitments stated in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG, 2 March 2012). Agreed by 25 of the 27 Member States (except the U.K. and Czech Republic), the Treaty contains not only fiscal and budgetary objectives, but also forces the signatory states to set up a national mechanism for automatic correction of deficits, without specifying the optimal policies which should be built within this mechanism: spending based, tax based or the mix of economic policies.

Trying to respond to this lack of information and because the most part of the European economies have not been stabilized yet, we want to provide an answer to a practical necessity, recommending the best policies for correcting deficits in case of exogenous/endogenous shocks, without endangering the potential output. Also, this study aims at demonstrating that budgetary correction mechanisms should be based on a mix of macroeconomic policies, in the medium-term targets, in which not only the quantity, but also the quality of these adjustments are important.

2. Budget imbalances and political pressure

The fiscal and budgetary policies are certainly the strongest governmental policies influenced by political actors. Mostly, these policies are designed before elections, when the rationality and economic sustainability are in competition with the aspiration of politicians to gain the goodwill of voters and to win the elections with the highest score possible – ‘the political dividends’ (Buchanan, 1961, p. 340). For these reasons, Ricardo (1888, p. 525), Smith (1776, p. 65) or Say (1836, p. 478) have *a priori* rejected the construction of budgets based on deficits because it determines the governments to be less sensitive to the real economic situation and to feed the electorate the fiscal illusion that they would be richer than they really are. Buchanan believes that budget deficits are the result of the relationship between opportunistic politicians and naive voters (Buchanan and Wagner, 1967, p. 29). The voters who never have enough information about the budget constraints put pressure on the increase of spending, but are never willing to pay for this excess through taxes. James Poterba (1996, pp. 1-59) believes that the budget deficits are exclusively the result of distortions coming from

politics, because the politicians, in their relationship with voters, are always tempted to engage into projects and public spending over the economy's capacity of funding.

By adopting restrictive fiscal rules, such as the balanced budget rule, the discretion of politicians on fiscal policy and the leaving behind of deficit targets under electoral pressure would be removed.

Janos Kornai (1986, pp. 3-30) formalized the concept of 'soft budget constraints' in his microeconomic studies on state enterprises in Eastern Europe and subsequently extended this concept to a macroeconomic level, in the context of budgetary imbalances caused by the transition, considering that they are the result of an obsolete concept (from the communist period).

The electoral usefulness of these two policies in national competitions, explains the lack of significant progress towards their integration into the European Union or Monetary Union. Thus, budgetary and fiscal policies remain, indefinitely, an exclusive competence of the Member States, rendering the fiscal and monetary policies coordination in the euro area quite difficult.

3. Budget adjustments depend on political factor as well

The major political consequences of strong fiscal adjustments are reflected in the electoral penalty – the loss of votes. Thus, reducing the deficit is the most difficult political mission – 'the kiss of death' (Alesina, Carloni and Lecce, 2011, pp. 1-40); for governments, this means the loss of political power, the loss of governance. Only governments with large parliamentary majorities based on high popular support and trust can implement large spending cuts without losing power over the short term. Nevertheless, as these adjustments become successful, people must have a higher confidence in the appropriateness and necessity of their enforcement.

Alesina and Perotti (1999, pp. 13-36) have investigated how much the government's political structure and ideological orientation is important in the adjustment of budget imbalances. According to them, the governments consisting of a single party and the minority governments are more efficient in achieving fiscal discipline in comparison to the governments based on coalitions of parties. From an ideological standpoint, the center-left governments are more successful in strengthening public finances than center-right governments. Wyplosz (2005, pp. 64-78), on the other hand, believes that budget rules and fiscal institutions are more important than the political factors in the adjustment of budget imbalances. That is why he recommends the delegation of fiscal powers to an independent authority, for a better coordination of fiscal and monetary policies.

Analyzing the effectiveness of austerity in the European Union, we believe that restoring the balance is a long process (multi-years policies), and corrections can not be achieved only through fiscal policy or budgetary measures, designed within one fiscal year. The consolidation implies a wide range package of policies (Perotti, 2011, p. 6), not just in fiscal or budgetary fields, but also involves a sustainable management of the dynamics of public wages, through the exchange rate, by offsetting the domestic demand deficit, exciting exports and so on.

Recently, the NBER economists have analyzed the effects of the two types of adjustments (spending/tax based) on the potential output (Alesina, Favero and Giavazzi, 2012, p. 35). The results show that through spending the adjustments are less costly in terms of output rather than tax based adjustments. Alesina and Ardagna (2012, p. 21) have shown that adjustments based on reducing spending are more successful in decreasing long-term public debt/GDP, and that adjustments in government spending are generally correlated with shorter recession than the adjustments through tax adjustments.

Continuing the Keynesian line, Paul Krugman (2012, p. 87) has strongly rejected the budget cuts during recession or the adjustments through taxes, and believes that the only way to stimulate the aggregate demand is the increase of government spending rather than its reduction – ‘Spend more to fix the economy. It’s Really That Simple!’ – indicating especially the spending for public investment in order to stimulate the economy by spillover effects of growth. The solution proposed by Krugman seems simple and effective in isolated recession contexts rather than in conditions in which European states could have easy and cheap access to financial resources. However, this solution has proved itself impossible given that distressed states have not had a corresponding fiscal space or reliable financial markets.

4. Adjustments in European Union

Past experience in the budget adjustments accumulated in several EU countries, especially in order to achieve the nominal convergence stated in the Treaty of Maastricht, shows that the fiscal adjustment is an objective process that can be met within medium terms, not short or very short ones, in an average of approx. 5-6 years, with an average speed of adjustment of budget deficits above 1.2% - 1.3% of GDP per year. It must be said that the policies chosen for budget adjustments privileged different ways in reaching the budgets balance: the group of Northern countries have frequently used the spending based adjustments, while the Southern states (mostly new members) stimulated the increase of revenues through tax based policies, supported by favorable dynamics of real GDP.

Table 1: Past adjustments in the European Union

Country	Period	Years	Speed of adjustments (% of GDP)
Portugal	'80-'86	6	1.4
Denmark	'82-'86	4	2.5
Greece	'89-'94	5	2.2
Sweden	'93-'98	5	1.8
Ireland	'85-'89	4	1.5
Italy	'89-'97	8	1.3
UK	'93-'99	6	1.2
Finland	'92-'00	8	1.0
France	'93-'97	4	0.9
Belgium	'81-'90	9	0.9
Austria	'95-'01	6	0.8
Netherlands	'90-'00	10	0.4

Source: Alcidi and Gros (2010, p. 2)

The characteristics of the past European Union adjustments, reflected in the analysis of Alcidi and Gros, were largely confirmed in the case of Romania, especially in the period after the second shock of transition (1999-2004), both from the perspective of adjustment periods (5 years) and their rhythm (0.8% of GDP). In Romania, the biggest problem of the public finances is related to the stability of public finances, extremely low share of government revenues to GDP, with over 12% of GDP lower than the European Union average, regardless of the tax system applied (until 2005 progressive taxation, from the 1st of January 2005 flat rate).

5. Contemporary empirical evidence

In Romania, like in most European Union member states, even if the global economic crisis was felt in budgetary terms since the second half of 2007, significant adjustment policies were not implemented until later, in 2010. As in the previous adjustments, the current situation that crosses EU Member States reflects important similarities in terms of: speed of effective budget deficit adjustments (ESA 95), which is around 1.2% of GDP/year, and the average length adjustments, which is still within 5-6 years, except Ireland (with the reduction of the budget deficit of 17.5% in 2011, mainly as a result of reduced spending with 18% of GDP) and Hungary with an adjustment of 8.7% (through increased taxation).

Table 2: Budget adjustments in the European Union (2009-2011)

Country	2010	2011	Speed	Years needed from 2009
Euro area	-0,1	-2,1	-1,1	6
EU 27	-0,4	-2,1	-1,25	6
Belgium	-1,7	-0,1	-0,9	6
Bulgaria	-1,2	-1,1	-1,15	4
Czech Republic	-1	-1,5	-1,25	5
Denmark	-0,2	-0,7	-0,45	6
Germany	1	-3,3	-1,15	3
Estonia	-2,2	-0,9	-1,55	1
Ireland	+17	-17,5	-0,25	-
Greece	-4,9	-1,3	-3,1	5
Spain	-1,5	-0,3	-0,9	12
France	-0,4	-1,9	-1,15	7
Italy	-0,9	-0,6	-0,75	7
Cyprus	-0,8	1	0,1	-
Latvia	-1,7	-4,7	-3,2	3
Lithuania	-2,2	-1,7	-1,95	5
Luxembourg	0	-0,5	-0,25	3
Hungary	-0,2	-8,7	-4,45	1
Malta	-0,3	-0,9	-0,6	7
Netherlands	-0,5	-0,6	-0,55	10
Austria	0,4	-2	-0,8	5
Poland	0,5	-2,9	-1,2	6
Portugal	-0,4	-5,4	-2,9	4
Romania	-2,2	-1,3	-1,75	5

Country	2010	2011	Speed	Years needed from 2009
Slovenia	-0,3	0,7	0,2	-
Slovakia	-0,3	-2,8	-1,55	5
Finland	0	-1,9	-0,95	3
Sweden	-1	-0,1	-0,55	1
United Kingdom	-1,3	-2,4	-1,85	6

Source: Autor's own calculations based on Eurostat, November 2012

In the current economic crisis, we selected five states with the strongest fiscal imbalances during the period 2008-2012 (Greece, Spain, Italy – EMU states, and Hungary, Romania – non-EMU states). In the first stage, we have qualitatively analyzed the main policies implemented by these countries to improve their budget position (in 2009 there were the strongest deficits – Greece 15.6%, Spain 11.2% , Italy 5.4%, Hungary 4.6%, Romania 9%): wage policies and public pensions reforms, social assistance adjustments, and the reduction of government transfers. Ireland has not been introduced in the analysis because the budgetary imbalance source was the government effort to recapitalize Anglo Irish Bank in its post-nationalization period.

Table 3: Key adjustments

Countries/ Measures/ Effects	Total Gov. Revenues* (*Eurostat)	Adjustments spending based Wages/Pensions/Social/Transfers			Increase of the tax
Greece	In 2011 returned to the 2007 level 40.8% of GDP	- 22% public wages cuts	- 12% public pensions cuts	- 200.000 less social allowances	- 10% increase of VAT - new other taxes
Spain	Decrease from 41.1% of GDP in 2007 to 35.1% of GDP in 2011	- 5% public wages cuts and freezing - abolition of public bonuses	- freezing public pensions	- reduced the unemployment benefits - redesigning the social allowances	- two successive increase of VAT 2% and respectively 3%
Italy	Remains relatively constant at 46% of GDP	- redundancies in public administration	- freezing public pensions	- lower health spending and cuts for transfers to the public administrations	- 2% increase of VAT from October 2012
Hungary	Grew strongly in 2011 from 45.2% of GDP up to 53%	- public wages cuts	- public pensions cuts - increasing the retirement age	- social allowances cuts	- increase of VAT from 25% to 27%, highest in EU - tax on financial transactions
Romania	Decrease from 35.3% of GDP in 2007 to 32.5% of GDP in 2011	- 25% public wages cuts - natural redundancies in public administration	- freezing public pensions - increasing the retirement age	- redesigning the social allowances - lower transfer to local administrations	- 5% increase of VAT - new other taxes on capital or labor

Sources: Eurostat and Kormany's Structural Reform 2011-2014; European Commission (2012); Italian Law 228/2012; Romanian Fiscal Strategy 2012-2014

In order to test, for the selected countries, the validity of claims made by Alesina, Favero and Giavazzi (2012, pp. 2-54) and Alesina and Ardagna (2012, pp. 1-53) we

based the analysis on the relationship between the reduction of expenditures in 2011 (X% over the previous year 2010) and the real GDP growth in 2011.

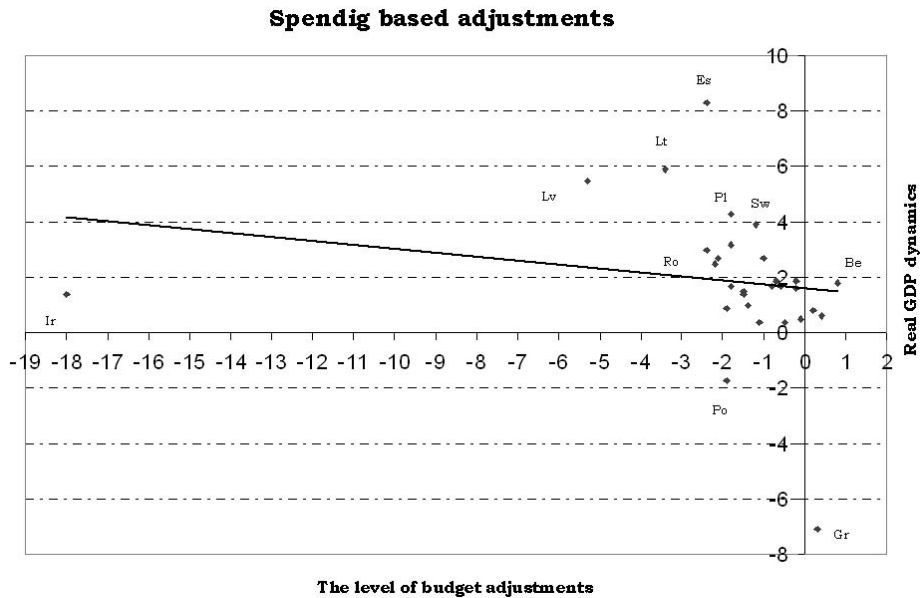


Figure 1: Spending based adjustment and their effect on real GDP dynamics

Source: Own calculations based on Eurostat, November 2012

The selection of the year 2011 was determined by the magnitude of the adjustments in public spending, the largest since the outbreak of the economic crisis (16 states had adjusted the spending over 1% of the GDP and 7 states between 0.2 and 1% of GDP). Regarding the effects of the adjustments through government spending on economic growth, we can see that in 2011 decreasing by up to 2% of GDP over the previous year they were generally associated with real GDP growth rates of 2% to 4%.

However, the poor quality of spending based adjustments caused inconsistent increases of budget revenues, which had to be compensated from other sources and the only tools with immediate effect have been swift and significant tax increases.

But the wrong solution of increasing taxation, especially the indirect taxes, caused a strong contraction of production and consumption, with immediate effects on growth – entering a new episode of recession – recession *W* type.

Private investment also reacted negatively to changes in taxation, by lowering and producing high unemployment rates (Spain 25.8%, Greece 25.4%, Hungary 11%, Italy 10.6%, and Romania 7.1%).

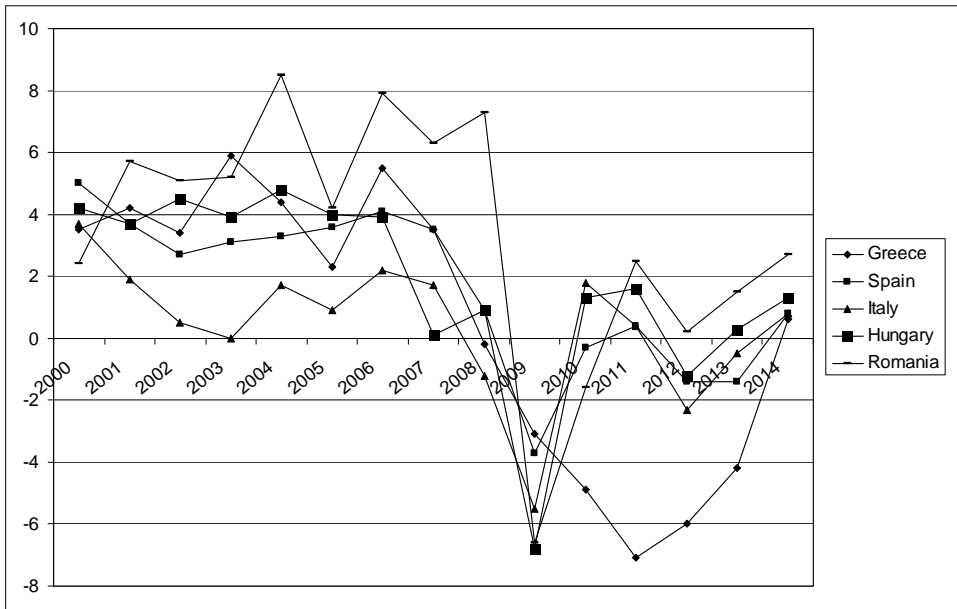


Figure 2: Real GDP dynamics – 2000-2014⁴

Source: Author's own calculations based on Eurostat, November 2012

6. Policy recommendations

Since we aimed to identify the basic principles of future correction mechanisms, we can say that the timing and extent of budgetary corrections should be defined primarily according to the magnitude of internal imbalances. Moreover, budgetary adjustments are easier to achieve in the absence of crisis than in time of recession and should be initiated depending on the evolution of the ratio of the public debt to GDP, in order to create a fiscal space useful in recessionary periods.

Spending-based corrections require a more flexible design of the structure of public spending, i.e. their continuous correlation with parameters of macroeconomic trends (inflation, changes in productivity/wages, gross average wage etc.). The discretion of policy makers in the choice of policy adjustment and the incentives to promote pro-cyclical policies must be limited by implementing the Fiscal Compact principles (pursuit of objectives to reduce structural deficits) and the adoption of fiscal and budgetary restrictions at the national fundamental laws.

If the correction mechanism based on spending will not demonstrate to be good enough and to produce the expected effects, requiring the implementation of tax based measures, a lot of attention must be given to the optimum tax, because the Laffer curve significantly differs from one country to another (Trabandt and Uhlig, 2012, p. 38). To stay away from negative effects on aggregate demand/growth, increased tax revenues can be achieved by increasing taxes on real estate, environmental taxes or charges on public services.

To set budgetary correction mechanisms one must take into account that adjustments are configured as processes on medium term intervals of 5-7 years and they are not the result of a single fiscal or budgetary policy, but of a wide range mix/package of policies, including:

- a prudent policy on exchange rates – to stimulate exports in order to offset the deficit of domestic demand;
- a moderate wage growth dynamic/public pensions;
- efficient collection of tax resources and the reduction of administrative costs associated with fiscal policy;
- maintaining/stimulating FDI net inflows; and
- optimizing the efficiency of public investment – public investment drive large effects in the economy.

7. Conclusions

The policies implemented in the European Union, not only in the five countries analyzed, aimed only a quick reduction of the budget deficits by means of adjusting public expenditure, paying no attention to the importance of structure and efficiency of public spending. Moreover, for the new Member States, setting targets for budget adjustment at a higher speed than necessary negatively influenced the catching up effect and eroded the social support for adjustment policies. In the context in which the financial markets punished countries with accelerated dynamics of public debt, increasing credit costs accredited the idea that the public debt must be annihilated at any cost.

We believe that the fiscal correction mechanisms should not exacerbate the goal of substantial/definitive reduction of public debt, but should be stabilized at a sustainable level, especially because at the time of the adjustment, the stock of the debt continues to grow. Nevertheless, budgetary correction mechanisms should not adversely affect the potential growth and should not lead to long-term recessionary effects. Past and present experiences have already demonstrated that adjustment through spending affects less adversely the real GDP growth, in contrast to the adjustment through taxes, but each state must first correlate internal adjustment mechanisms in response to private investment and then to aggregate demand.

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