FISCAL SUSTAINABILITY: COMPARATIVE TRENDS IN THE EUROPEAN UNION AND CHALLENGES FOR ROMANIA

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ABSTRACT: *Considering that the fiscal policy is the main instrument the government may use for influencing the macroeconomic output, which represents a conclusion of our previous research, the sustainability of public finance represents an important objective for every country, its role becoming more evident during the contemporary financial crisis. Although the fiscal sustainability in the European Union relies on the European principles as stipulated in the European Treaties, different member states have different perspectives and different approaches, subject to the national characteristics, such as the economic level of development, the cost of ageing, the health care system or for political reasons. The results of various fiscal policy reforms in the European Union Member States for enabling fiscal sustainability represent the core of this study. The study aims to provide policy directions related to the most efficient institutional reforms to provide fiscal responsibility at the national level, particularly for Romania. Based on the official data from Eurostat and national authorities for the period 2015-2018, the study presents and evaluates the comparative trends of the fiscal sustainability and projections until 2031 for assessing fiscal sustainability on long-term across European Union Member States, and analyses how the sustainability challenge for Romania should be addressed.*

KEYWORDS: *fiscal sustainability; fiscal responsibility; fiscal policy*
JEL CODE: *E6, F36, H6*

1. INTRODUCTION

The contemporary financial crisis has revealed the high importance of fiscal sustainability because high-debt states have proved to be more susceptible to being wounded by economic shocks. Since the financial crisis, many European Union (EU) Member States continue to face increasing public indebtedness as well as associated costs which can induce supplementary spending and growing debt levels – a vicious cycle with negative effects for economic growth, which, together with the expected rise in ageing-related public spending, presents serious challenges for the sustainability of EU public finances, on long term.

According to recent official reports, the main determinants of fiscal sustainability challenges, the design of fiscal reforms and projections vary widely across EU Member States (European Commission, 2016a, 2016b). In this context, the study aims to provide policy guidelines related to the appropriate and desirable fiscal reforms to ensure fiscal responsibility at the national level to provide economic growth and debt sustainability.

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To achieve this aim, the objectives of the study are as follows: (1) to present the concept of "*fiscal sustainability*" and its main indicators at EU level; (2) to review the Member States' fiscal consolidation since 2015; (3) to compare Romania's public finance within the EU and with regional peers; (3) to present the concerns regarding sustainability gap and specific recommendations for Romania.

By comparing Romania's public finance both within the EU and with regional peers, the study argues that there is ample scope for Romania to implement high-quality fiscal measures, to complete the fiscal adjustment in the medium term, in a sustainable and inclusive manner.

The paper uses official data from the European Union database, Eurostat for the period 2015-2018.

The assumptions of the study rely on our previous research, as follows: (1) Fiscal policy is the main instrument the government may use for influencing the macroeconomic output – which represents the main conclusion of our previous research; (2) Achieving structurally broadly balanced positions is a key commitment of countries under the preventive arm of the Stability and Growing Pact (SGP) – which explains why budgetary deficit (BD) is a core indicator of fiscal surveillance; (3) Long-term sustainability requires that public debt is put and maintained on a sustainable path – which means taking into account the current level of debt and projected future expenditures related to population ageing.

The paper is structured in 5 sections. After de Introduction, Section 2 presents the theoretical view- main concepts**.** Section 3 presents a multidimensional approach for assessing fiscal sustainability, EU comparative trends and projections until 2031, Section 4 provides policy directions related to the most efficient institutional reforms to ensure fiscal responsibility at the national level, particularly for Romania, and the last section concludes.

2. THEORETICAL VIEW- MAIN CONCEPTS

Fiscal sustainability or sustainability of public finances means the capability of a government to ensure long-term fiscal balance in the specific conditions: (1) without failing to meet some financial obligations or promised expenditures, (2) without needing to increase tax rates, and (3) without menacing the public financial solvency. The sustainability of public finances in the EU, object of multilateral surveillance through the European Semester, is connected to principles preserved in the EU Treaties and the Stability and Growth Pact (SGP) and represents an essential element of a "*framework whereby the Commission acts together with the Member States*" (European Commission, 2016b, pp. 2). As a result, the public finances of a state are sustainable if the fiscal policy issued by the government (discretionary and non-discretionary components) can be long-term sustained without insolvency or default inducing.

The structural balance is the primary regular analytical instrument to measure a country's budgetary position and the convergence towards the medium-term objective (MTO). The structural balance represents the base of the Council recommendations regarding the MTO and the fiscal targets**.** According to the *Regulation on preventive arm No 1466/97,* amended in 2005 and 2011, the structural balance is calculated *by subtracting (filtering out) the cyclical component and transitory measures ("one-off* *measures") from the deficit ratio.* (European Court of Auditors, 2018, pp.11). As a result, each EU member state has a medium-term objective of the budget balance set in structural figures which differ depending on the level of public debt and the estimated costs of ageing population, at interval (-1 % of GDP and a balance or surplus) and particularly (0.5% and a balance or surplus) for TECG[1] signatories. The budgetary objectives may be revised every 3 years or whenever a sizable structural reform is launched.

3. MULTIDIMENSIONAL APPROACH FOR ASSESSING FISCAL SUSTAINABILITY. EU COMPARATIVE TRENDS AND PROJECTIONS UNTIL 2031

Both long- and short-term fiscal sustainability analysis is built by specific indicators which express the measure of the sustainability challenges, as presented in Table no.1

Table no.1 INDICATORS OF THE MEASURE OF THE SUSTAINABILITY CHALLENGES

Indicator	**the S_0 indicator**	**the S_1 indicator**	**the S_2 indicator**
Name	Short-Term Fiscal Challenges	Medium-Term Sustainability	Long-Term Fiscal Challenges
Aim	Early detection of fiscal stress within a one-year horizon.	To show the real adjustment effort required as a cumulated gradual improvement in the structural primary balance over 3-5 years.	To show the adjustment to the current structural primary balance required to fulfil the unlimited time horizon inter-temporal budget constraint. It includes the forecasting of any additional costs related to the ageing population (pension and healthcare expenditures)
Core-essence	**An early-detection indicator** - signals risks of imminent fiscal stress when several fiscal and financial-competitiveness variables exceed a certain threshold.	**A 3-5 years adjustment indicator** – signals the cumulative fiscal adjustment required over 3-5 years to reach the 60 % Treaty reference value for the debt-to-GDP ratio in 15 years.	**An infinite time adjustment indicator (unlimited time horizon)** - measures debt sustainability over the long term; - indicates the natural fiscal adjustment needed to stabilize the debt-to-GDP ratio over an infinite time horizon, regardless of the level at which it is stabilized.

Source: Made by the author based on the SGP and TSCG stipulations, and European Commission Fiscal Sustainability Report 2015 (2016a)

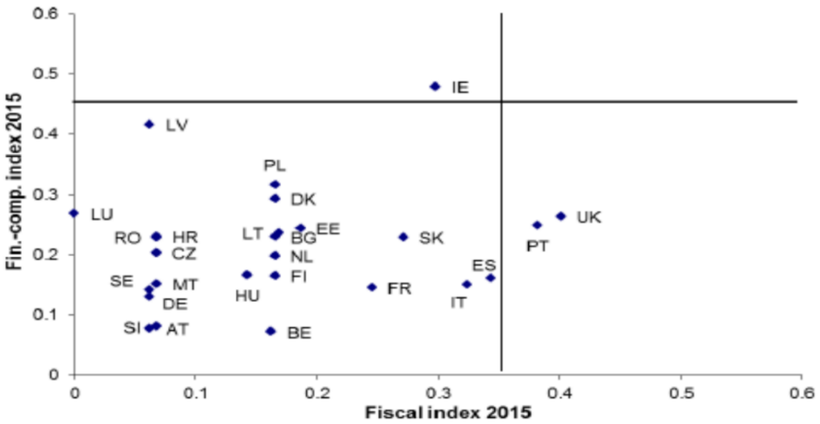
[1] The *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, referred to as *TSCG* or the *Fiscal Stability Treaty*, signed on 2 March 2012 by all member countries of the EU, except the Czech Republic and the United Kingdom (EU summit, 2012), entered into force on 1 January 2013 for the 16 EU countries which completed ratification prior to this date (European Council, 2012), ratified and entered into force on 3 April 2019 for all 25 signatories plus Croatia and the Czech Republic. The Title III - the fiscal chapter named "*Fiscal Compact*"- is compulsory for 22 EU member countries, i.e. the 19 members of the Eurozone, plus 3 opt-in countries, Bulgaria, Denmark and Romania.

As revealed by Table no.1, there is no single generally admitted indicator of budgetary sustainability. There are also country-specific circumstances and elements need to be taken into consideration. As a result, different EU countries use different methods and different indicators with different results. Since S_0, S_1, S_2 are built on different time perspectives of budgetary sustainability, they may support different meanings. Specifically, using the S_2 indicator the debt ratio to GDP may stabilize the debt at a level beyond the 60% threshold.

As revealed by Table no.1, values of the S_0 indicator above the threshold represent risk *signals of imminent fiscal stress.*

According to European Commission calculations (2016b, pp. 6), different EU Member States face different short-term fiscal challenges in 2016 (different S_0) as revealed in Figure 1.

Figure no.1 Short-Term Fiscal Challenges for the EU Member States - the S_0 indicator (2016 calculation for 2015)

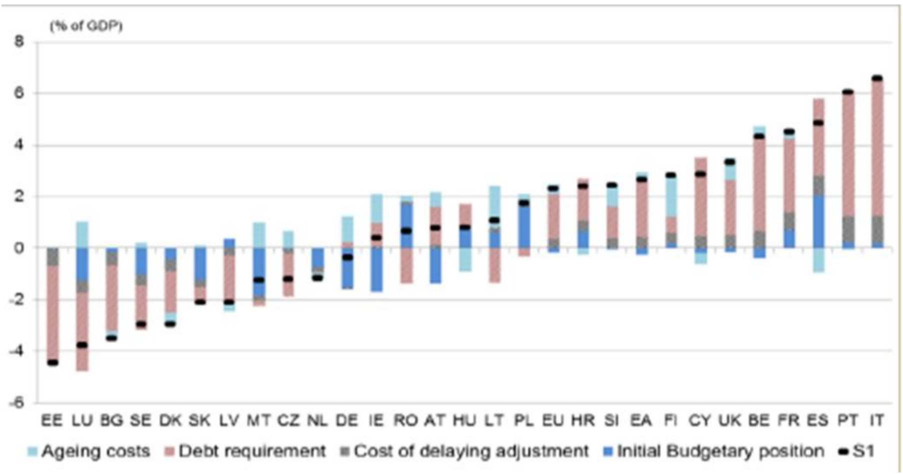


Source: European Commission (2016b), Sustainability of Public Finances - European Semester Thematic Factsheet

As indicated in Figure 1, the reference value of S_0 is 0,46. In 2016 the only one-member state with S_0 situated above 0,46 is Ireland. This means that Ireland is at risk for fiscal stress within a one-year horizon.

The calculation of the S_1 indicator reveals the different positions of the EU Member States in terms of real adjustment effort required (2016b, pp. 6) as shown in Figure 2.

Figure no.2 Medium-Term Fiscal Challenges for the EU Member States - the S1 indicator (% of GDP; 2016 calculations)

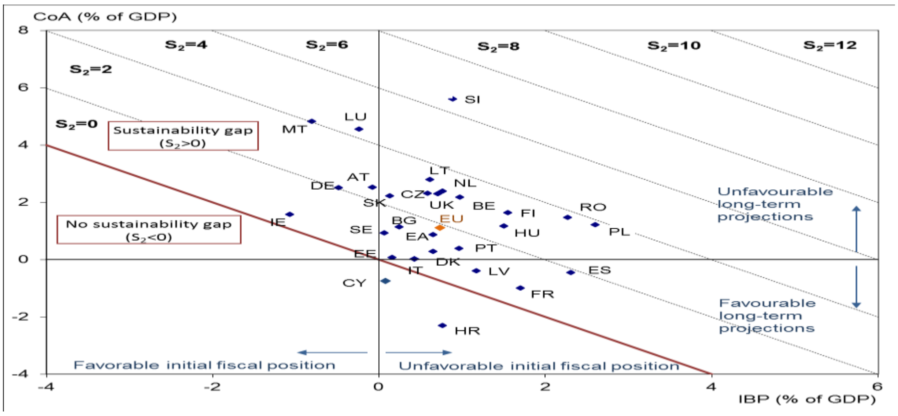


Source: European Commission (2016b), Sustainability of Public Finances - European Semester Thematic Factsheet

As stated in Table 1, the S_1 indicator signals the cumulative fiscal adjustment required over 3-5 years to maintain the public debt under the 60 % to GDP ratio in 15 years, in the "*no-policy-change scenario"*. The starting point to calculate S_1 (Figure no.2) is the budgetary balance in 2018, which represents the last year of the autumn 2016 Commission forecast (3 years), to reach the 60 % public debt to GDP ratio in 2031). Figure 2 indicates a large variation across countries. In several countries, the medium-term fiscal sustainability challenge is mainly determined by ageing costs[2] (i.e. Germany, Ireland, Luxembourg, Lithuania, Finland), in others mainly by initial budgetary position (i.e. Romania, Spain, Ireland).

[2] Ageing costs on medium and long term refer mainly to the pension and health care spending trends.

Figure no.3 Long-Term Fiscal Challenges for the EU Member States - the S2 indicator (% of GDP; 2016 calculation)



Source: European Commission (2016b), Sustainability of Public Finances - European Semester Thematic Factsheet

The S2 indicator, as stated in Table no.1, is an infinite time (*unlimited time horizon*) adjustment indicator. As shown in Figure no.3, the countries with high values of the S_2 indicator face greater fiscal sustainability risk and need high fiscal adjustment, example Slovenia, Romania, Poland, Lithuania and Holland.

IBP means the *Initial Budgetary Position* and is represented by the horizontal axis and LTC means the *Long-Term Change* in the budgetary position and it is represented on the vertical axis. The Member States on the left side of LTC have favourable *Initial Budgetary Position* (Luxemburg, Malta, Austria, Ireland, Slovakia, Cyprus, Sweden, Germany, Estonia), and those in the bottom part of the graph have favourable *Long-Term Change* (Croatia, Cyprus, France, Spain).

Figure no.2 reveals a large variation across the EU Member States in terms of fiscal sustainability gap.

Based on S_2 indicator - *Long-Term Fiscal Challenges*, there are three categories of EU countries, as shown in Table no. 2.

Table no. 2 EU Member States by the fiscal sustainability risk - unlimited time horizon

Long-Term Fiscal Challenges Country Category	**Criterion**	**The EU Member States by the Fiscal Sustainability Risk - *Unlimited Time Horizon***
Low Risk	The value of S2 is lower than 2	CY, HR
Medium Risk	The value of S2 is between 2 and 6	IE, EE, IT, SE, DE, DK, BG, PT, FR, ES, LV, EA, EU
High Risk	The value of S2 is greater than 6	MT, AT, CZ, LT, NL, RO, BE, HU, LU, SI, FI, UK, SK

Source: Made by the author based on EU calculation

The indicators S_0, S_1 and S_2 are designed around essential macroeconomic values, such as ageing costs, nominal growth, and public budget balances. Measuring the entire sustainability of public finances is however a very complex operation which requires to take into consideration many other factors, some of them difficult to quantify, e.g. the political risks or the ability of a government to boost the public revenue – which mainly depends on the efficiency of the fiscal policy.

4. OVERVIEW OF COUNCIL COUNTRY - SPECIFIC RECOMMENDATIONS RELATING TO FISCAL POLICY FOR ROMANIA

As results from the indicators presented above, Romania belongs to the high-risk Fiscal Sustainability category on the long - term (*unlimited time horizon)***.** The concerns and specific recommendations for Romania are synthetically been presented in Table no.3.

Table no.3 The concerns regarding sustainability gap and specific recommendations for Romania

Relevant information	**Concerns regarding the Fiscal Sustainability (2018/2017)**			
Applicable provisions of the SGP: preventive arm; MTO -1%, D<60%	The budgetary deficit in 2018 rose compared with 2017;	The rapid increase of government's interest expenses[3];	Slow absorption of EU funds;	Low performance and efficiency in research and innovation;
	Budget revenues rose 13.7% but the expenses surged by 18%;	The highest annual inflation rate among the EU Member States;	The rapid increase of public wages and pensions;	Intense pressure on the judicial system;
	Social contributions rose, VAT revenues increased while revenues from income tax declined;	Higher public deficit comparing with Poland, Slovakia, Hungary, and budget excedent for the Czech Republic and Bulgaria;	The health status of the population has improved, but remains below EU standards;	The deficient condition of infrastructure and the slow development of the transport sector;
	The low GDP/capita compared with the EU average and with regional peers;	Despite the high investment ratios, the quality of investment is low;	The increasing of the current account deficit;	The tax diminutions and spending expansion financed with public debt.

[3] Romania is already EU's member state which pays the highest interest rates for its debt (3.96% per year in 2017) (Commission Staff Working Document, 2018)

	Specific fiscal policy solutions for Romania to reduce the sustainability gap
	- to pursuit a counter-cyclical fiscal policy, to temper the growth of the fiscal deficit;
	- to increase tax compliance, especially regarding VAT; strengthen verification control systems to tackle the undeclared work and tax evasion;
	- to increase the efficiency and control of public spending;
	- to reduce the incidence of underground work;
	- to respect the national fiscal framework as stated by the TSCG stipulations to assure compliance with or convergence to the medium-term budgetary objective (MTO) of a structural deficit of 1 % GDP[4] and a budgetary deficit of 3%of GDP;
	- to improve the efficiency of the investment public spending to deliver results as the poor quality of infrastructure limits economic growth;
	- to improve the business environment; further measures to support SME's entrepreneurial initiatives;
	- to improve the operational and financial performance of state-owned enterprises;
	- judicial reform
	- to increase the fight against corruption;
	- to implement a culture of transparency and participative government at the national and local level;
	- the annual budget process guided by the medium-term fiscal strategy;
	- structural fiscal policy changes to reduce the public debt on the medium and long term[5];
	- to reverse the pension reform to increase back the second pension pillar to strengthen the sustainability of the pension system and to stimulate the local capital market;
	- to increase the access to social protection for workers without a standard employment contract and for self-employed people;
	- to increase the effectiveness of the family benefits system, to reduce the risk of poverty for people with disabilities and children;
	- to reform the education system considering that its weak performance will limit economic growth in the long term.

Source: Made by the author based on the Commission Staff Working Document, *Country Report Romania 2018*

According to the EU official documents, the serious fiscal consolidation pursuit by Romania beginning with 2009 is responsible for the achieving its medium-term (MTO) objective in 2014 and 2015, but the expansionary fiscal policy pursuit since 2016 generates a substantial deviation from that objective. (European Commission, 2016a; European Commission, 2016b; Commission Staff Working Document, 2018)

To reduce the sustainability gap and to complete the fiscal adjustment in the medium term, Romania must implement a countercyclical fiscal policy.

[4] As requires the Title III - "Fiscal Compact", compulsory for 22 EU member countries, i.e. the 19 members of the Eurozone, plus 3 opt-in countries, Bulgaria, Denmark and Romania

[5]According to the official European data, "*Romania is one of the few EU countries where debt is projected to rise by 2028 and it is the EU Country with the largest projected debt increase*". (European Commission, 2016a; European Commission, 2016b; Commission Staff Working Document, 2018)

5. CONCLUSIONS

The sustainability of public finances, closely linked to principles established in European Treaties and subject to multilateral surveillance carried out through the European Semester, set strong suitable principles to all governments for all time horizons and represents the core of the government fiscal policy. Leading public finances to a sound position allows fiscal policy to have a counter-cyclical role and to ensure that the budget deficit remains under the 3% of GDP reference threshold, able to preserve the sustainability of public finances in the long term by keeping the debt ratio below the 60% of GDP reference value.

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