Budget policy from an EU perspective

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The accession to EU represents a great achievement for all of us while the effective integration represents a real opportunity and a challenge on the same time. The real convergence of the country is not an automatic process and there are needed a certain number of prerequisites for securing a sustainable path in this regard. The implementation of the right mix of economic policies is crucial to safeguard the macroeconomic stability and to foster private sector development. In a small country with a liberalized capital account, the budget and income policies and the continuation of the structural reforms will play a key role in attaining a low and sustainable level of inflation while on the same time creating the right infrastructure to improve the international competitiveness of the country in attracting domestic and foreign investment.

In this context we have to ask ourselves what is the right strategy for the budget policy given both the internal characteristics and needs of the country and the European institutional context and trends.

We have to acknowledge that the welfare state, developed through decades in the Western Europe, and which implies a very high involvement of the government in the economy (with an average expenditure/GDP ratio around 45%) leads to a comparative disadvantage in terms of economic growth vis-à-vis other areas, with much lower expenditure/GDP ratios, such as the United States or Japan. The virtuous example of Scandinavian states, where high state intervention and social equity are combined with high efficiency and competitiveness, is unlikely to be replicated easily elsewhere in

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Europe, because of specific social, cultural and historical factors. Thus, our anticipation is that, sooner or later, the EU member states will have to cut down their budgets (getting to ratios of expenditure/GDP around 40%), which will allow them to gain efficiency and competitiveness on the international markets.

Our budget policy has to create sufficient fiscal space to absorb the EU grants and to pay national contribution to EU budget. Moreover, there have to be accommodated also the quasi – mandatory increases in expenditures related to human capital: education, research & development, health, environment and pensions. It must be clearly understood that, from a comparative perspective, Romania lags in these fields. Significant increases in these expenditures are necessary, if Romania is to reap the benefits of accession. From a comparative perspective, our total public expenditures are estimated at around 32-33 percent of GDP due to both lower revenue and deficit ratios. It is clear that we have to increase this ratio by a set of measures aiming at consolidating our revenue base and increasing in a cautious way our budget deficit.

The implementation of the flat tax and the improvement of the tax collection led to a positive Laffer curve effect with an estimated 1.5 percent of GDP additional revenues evident in each of the years 2005 and 2006. The continuation of the collection improvement process correlated with the sustainable enlargement of the tax base in the environment area and the improvement of the asset management of the state-owned companies, would guarantee an increasing trend of the budget revenues as percent of GDP. Moreover, the reform of the agricultural sector by increasing the efficiency trough land consolidation and rural development represents an additional opportunity for budget revenues on the medium and long term.

Given the strong economic fundamentals, including the lower and diminishing trend in the public debt, strong and well-capitalized banking system and high reserve ratio, Romania could benefit from additional resources by increasing in a cautious and moderate way the budget deficit. If real convergence is the crucial macroeconomic goal, then the Romanian state cannot shy away from providing much needed public services. This should happen even in the context of the massive reduction of state involvement in Western European countries, which have a problem of global competitiveness. The implementation of cautious wage policies (in both the public sector and the state-owned enterprises) and the continuation of the structural reforms will be the key to the success of the strategy, in securing the disinflation trend and for preserving the external sustainability while on the same time investing in the infrastructure of the country, including here rural development. On the medium and long term, Romania should have a neutral budget policy and should observe the stability and growth pact requirements of a structural deficit of up to 1 percent of GDP (given the low debt and the higher rate of potential output growth) necessary for entering in the ERM 2 and finally adopting the euro.

On the expenditure side, the main priorities should be related to the consolidation of the financing commitment of the Lisbon agenda reform process, including education, research and development, health and environment protection. The allocation of additional resources in these fields should be accompanied also by sectoral reforms required to increase the accountability and improve efficiency. In this regard, the implementation of the per-capita financing in the education sector and the continuation of the decentralization process correlated with the increase of the resources allocated to primary and preventive medicine in the health sector would be key to the success of the strategy. Moreover, the reform of the first pension pillar and the implementation of the second pillar will be crucial for ensuring long term sustainability of the public finances given the negative demographic developments.