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FISCAL POLICY IN ROMANIA

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1. Introduction

An assessment of Romanian fiscal policy cannot ignore the massive shift of the previous quasi-fiscal expenditures onto the budget in 1997. The switch to a market-based management of reserve money accompanied the suspension of selective credits from the National Bank, in particular to agriculture. An explicit budgetary subsidy to agriculture replaced the directed financing by the National Bank at concessionary interest rates. The liberalization of the market for treasury bills entailed a surge of budgetary interest payments. Explicit subsidies to energy-intensive state enterprises facilitated the liberalization of the foreign exchange market. All of these changes seem to have cost the budget about 4% of gross domestic product in 1997.

Budget expenditures remained stuck at the level of the previous year to accommodate the suspension of the previous quasi-fiscal subsidies. The significant fiscal contraction in 1997 is only marginally reflected by the otherwise slight shrinkage of the recorded budget deficit to 3.5% of gross domestic product--only 0.4 percentage points lower than in 1996. Further reduction of the budget deficit proved extremely difficult, so that in 1998 it remained at about the same level as in 1997.

Table 1: The Consolidated Government Balance
(% of Gross Domestic Product)

	1996	1997	1998
Budget Revenues, of which:	29.9	30.3	32.0
Tax Revenues	26.9	26.5	28.2
Budget Expenditures	33.8	33.8	35.6
Budget Deficit	-3.9	-3.5	-3.6

Source: Estimations on the basis of data released by the Ministry of Finance and the National Commission for Statistics.

Against the background of the severe economic recession, the switch from direct to indirect taxes was associated with an increase of tax revenues by 1.7 percentage points of gross domestic product in 1998 as compared to 1997. Following widespread criticism that the fiscal contraction in 1997 endangered the provision of basic public services, budget expenditures in 1998 fully absorbed the tax revenue increase. Higher interest payments accounted for about 44% of the expansion of budget expenditures in 1998.

Privatisation of state industries failed to significantly accelerate and a policy requiring the utilities to cut energy supplies to delinquent customers, supported by a budget subsidy to socially sensitive state enterprises, was not fully enforced. As a result, energy-intensive state enterprises continued to accumulate large arrears to the utilities which in turn passed on the burden to the budget by either incurring tax arrears or defaulting on governmentally guaranteed credits. Next to utilities, state commercial banks were forced to act as buffers, having absorbed large operating losses generated by the enterprise sector. The systemic threat created by the large state-owned commercial banks with portfolios dominated by bad loans surfaced in the second half of 1997. The authorities were thus forced to take over USD 1 billion in bad debts from two ailing state banks. The interest payments on the associated public debt overburdened the budget in 1998.

Contingent budgetary liabilities arising from the operating deficits of enterprises and the poor financial standing of the state banking system contributed to increasing stress on fiscal policy. The monetary policy seems to have been by itself insufficient to contain the current account deficit in 1998. The demand for imports stayed high as enterprises continued large imports of raw materials and intermediate goods. In 1998, the deficit of the external current account returned to the historical high of 1996 – 7% of gross domestic product.

In the face of the severe external imbalance and the substantial service on external public debt, the government acknowledged the need for fiscal tightening. Indeed, the Romanian fiscal policy experienced a new major contraction in 1999, with the budget deficit having been, according to preliminary estimates, contained to 3% of gross domestic product excluding the privatisation receipts. To meet the demands for higher budget expenditures, the contraction was engineered through tax increases and not expenditure cuts. The revenue measures comprised increases in social security contributions, property taxes, and fuel excises, as well as delaying tax decreases approved earlier.

At the end of 1999, the fiscal situation of Romania seems to be subject to considerable uncertainty and risk. Pressure groups, rebelling for fiscal relaxation, succeeded in determining the approval of legislation on domestic investments and the generous granting of fiscal incentives for small and medium-sized enterprises. This legislation, postponed by the budget for 1999, is due to come into effect at the beginning of the year 2000. The additional costs of further bank restructuring which turned out to be significantly higher than initially expected, could no longer be fully budgeted in 1999. The control of discretionary budget expenditures is under attack from a number of fronts. Non-discretionary entitlement spending is likely to explode in circumstances of weak economic activity and declining living standards. The incentive to inflate in order to take advantage of the lag between the indexation of revenues to a higher nominal tax base and the legislative revision of initial budget appropriations gets stronger.

Ad-hoc tax increases and quasi-generalized exclusions of voted appropriations have become the fundamental pillars of the Romanian budgetary cycle. The tax burden increase on enterprises as a response to the low collection rates has consolidated the relative expansion of the informal economy, undermining the stabilization goals. The tax increases in excess of the enterprise capacity to adjust have negatively impacted savings, aggravating the economic recession. The exclusion of voted appropriations has indiscriminately affected all governmental programs, becoming an important source of arrears in the economy. The unsustainable budget cycle has reduced the autonomy of the state, undermining the credibility of governments.

This paper is primarily aimed at analysing the vicious circle of fiscal policy as inducing and consolidating the vicious circle of savings, as well as the vicious circle of the informal economy, with significant impacts on deteriorating enterprise competitiveness and prolonging the recession. All three vicious circles are fundamental in understanding the unsustainable character of the Romanian fiscal and budgetary cycle and deriving relevant policy implications.

The conclusions of the paper run contrary to the prevailing opinions, first, by recognizing the positive adjustments of enterprises, including in the state sector. It is, however, beyond the purpose of the paper to assess the speed and the profoundness of these adjustments. The paper is, by intention, limited to revealing the negative impact of tax increases in excess of the capacity of enterprises to adjust their competitive position and financial standing. Second, the conclusions of the paper are surprising to the extent to which they explain the low level of tax collection without the routine appeal to the traditional verdict of poor fiscal discipline, but by the expansion of the informal economy. This paper, far from denying prevailing opinions about and explanations of the fiscal problems Romania is presently faced with, intends to modestly cast doubts on the long-run viability of successive fiscal contractions dominated by tax increases. Consequently, the main policy implication of this paper refers to the need for a sustainable rationalization of budget appropriations.

The paper is organized in four sections. The first three sections are devoted to analysing the three vicious circles relevant to Romanian fiscal policy. The last section draws the policy implication.

2. The Vicious Circle of Savings

One of the most important aspects of fiscal policy is the management of the budget deficit – the excess of spending over revenue in the governmental sector. The budget deficit itself does not automatically induce macroeconomic problems. If the use of budget revenues is efficient, future income can be generated to service the costs of the debts incurred.

Countries with high rates of domestic savings and well-developed capital markets absorb budget deficits more easily. A relatively high budget deficit may not cause problems in a high-saving economy. By contrast, even a small budget deficit may be destabilizing in a low-saving economy. A sound fiscal policy maintains the budget deficit at a level that is consistent with the goal of macroeconomic stability.

One way to assess the soundness of fiscal policy is to determine the extent to which the financing of the budget deficit is consistent with the other macroeconomic goals assumed by the government. The starting point of the assessment can be the identity stating that the sum of all investments in the economy must be equal to the savings available from both residents and foreigners. According to this identity, the budget deficit must be balanced by a domestic non-governmental sector that saves more than it invests and/or by an external current account deficit.

In the case of Romania, the non-governmental sector (defined to comprise non-financial enterprises, households, financial institutions and private administrations) as well as the governmental sector registered financing deficits throughout the period from 1996 to 1998. Consequently, the external current account covered the financing deficits of both the non-governmental and the governmental sectors. The current account deficit peaked at 7% of gross domestic product in 1996 (having corresponded to a non-governmental financing deficit of 3.2% of gross domestic product and a budget deficit of 3.8% of gross domestic product) and in 1998 (having corresponded to a non-governmental financing deficit of 3.4% of gross domestic product and a budget deficit of 3.6% of gross domestic product). In 1997, the financing deficits of the non-governmental and the governmental sectors were lower –

Table 2: The Savings-Investments Balance
(% of Gross Domestic Product)

	1996	1997	1998
Total Economy			
Savings	18.8	14.6	14.4
Investments	25.8	20.6	21.4
Current Account Deficit	-7.0	-6.0	-7.0
Non-Governmental Sector			
Savings	17.4	13.3	14.4
Investments	20.6	15.8	17.8
Non-Governmental Financing Deficit	-3.2	-2.5	-3.4
Governmental Sector			
Savings	1.4	1.3	0.0
Investments	5.2	4.8	3.6
Budget Deficit	-3.8	-3.5	-3.6

Source: Estimations on the basis of data released by the National Bank of Romania, the National Commission for Statistics and the Ministry of Finance.

2.5% and 3.5% of gross domestic product respectively – so that the deficit of the external current account was contained to about 6% of gross domestic product.

State enterprises were responsible for the bulk of the non-governmental financing deficit. However, their contribution to the financing deficit of the formal economy (defined to comprise enterprises submitting balance sheets to the Ministry of Finance) declined from 79% in 1997 to 55% in 1998. The adjustment of state enterprises did not succeed in compensating for the surge in the financing deficit of the private enterprises.

Non-governmental savings persisted at relatively low levels against the background of a structural shift towards the informal economy and away from the formal economy. In 1997 and 1998, the informal economy (defined to comprise households and the underground economy) consolidated its position as a net saver. The contribution of the informal economy to non-governmental savings surged from 51% in 1997 to more than 90% in 1998.

The increase of savings in the informal economy did not compensate for the drop of savings in the formal economy and the governmental sector. Romania seems to be caught in a vicious circle of savings. Worsening enterprise competitiveness leads to low savings in the formal economy and high real interest rates. In turn, the reduction of savings and the persistence of real interest rates at relatively high levels discourage investments in the formal economy and postpone the improvement of enterprise competitiveness. The vicious circle of savings tends to be associated with a prolonged economic recession.

Under the circumstances of declining aggregate savings, the size of the budget deficit that is consistent with the goal of macroeconomic stability shrinks. If the non-governmental financing deficit stays at the average level of the 1996-1998 period – about 3% of GDP – the budget deficit needed to contain the external current account deficit below 5% of GDP must amount to about 2% of GDP. As long as the non-governmental financing deficit widens, the budget deficit must shrink in order to maintain a sustainable external position.

Table 3: The Non-Governmental Savings-Investments Balance
(% of Gross Domestic Product)

	1997	1998
Non-Governmental Savings	13.3	14.4
Formal Economy*)	6.5	1.4
State Ownership	0.9	-0.1
Joint State and Private Ownership	0.6	-1.1
Private Ownership	5.0	2.6
Informal Economy**)	6.8	13.0
Non-Governmental Investments	15.8	17.8
Formal Economy*)	15.1	12.2
State Ownership	7.8	5.9
Joint State and Private Ownership	1.2	1.0
Private Ownership	6.1	5.3
Informal Economy**)	0.7	5.5
Non-Governmental Financing Balance	-2.5	-3.4
Formal Economy*)	-8.6	-10.9
State Ownership	-6.9	-6.0
Joint State and Private Ownership	-0.6	-2.1
Private Ownership	-1.1	-2.7
Informal Economy**)	6.1	7.5

*) Defined to Comprise Enterprises Submitting Balance Sheets to the Ministry of Finance, Including Commercial Banks and Insurance Companies **)Defined to Comprise Households and the Underground Economy
Source: Estimations on the basis of data released by the National Bank of Romania, the National Commission for Statistics and the Ministry of Finance.

The need for fiscal stabilization is usually justified on the basis of the finding that there is no sound evidence in favour of the Ricardian equivalence hypothesis, according to which the increase of the government savings is offset one-to-one by non-governmental savers. The relevance of the reasons for the failure of the Ricardian equivalence (borrowing constraints, uncertainty about future incomes and lack of forward-looking behaviour by private savers) tends to be rather strong in the economies undergoing systemic transformations. When fiscal stabilization boosts governmental savings, the non-governmental sector reduces its savings by only a fraction of the increase.

Increased governmental savings can reduce real interest rates. There is no sound evidence that lower real interest rates significantly reduce the flow of non-governmental savings. The non-governmental sector does not respond much to changes in real interest rates. Therefore, fiscal stabilization does not depress non-governmental savings through the real interest rate channel. Raising the governmental savings likely increases the aggregate savings and the resources for investments.

The impact on the external current account deficit is an even more convincing argument in favour of fiscal stabilization. Because fiscal stabilization raises the aggregate savings, a lower budget deficit reduces the external current account deficit as long as the domestic investments remain unchanged.

Fiscal stabilization may consist of tax increases and/or budget expenditure cuts. If the tax burden is relatively low, taxes can be raised. When current budget expenditures are wasteful, budget transfers sustain financially unviable social insurance systems and ineffective social assistance schemes. Capital appropriations also finance low-return projects. Hence, spending can be cut. However, increasing the tax burden on Romanian enterprises may be problematic, given their poor savings performance and significant financing deficits. A higher tax burden on enterprises would only exacerbate the vicious circle of Romanian fiscal policy.

3. The Vicious Circle of Fiscal Policy

The governmental failure to contain budget appropriations in accordance with the requirements of macroeconomic stability is the starting point of the vicious circle of the Romanian fiscal policy. To the end of keeping the budget deficit under control, Romanian governments resorted to ad-hoc tax increases and the arbitrary exclusion of appropriations during the process of implementing the budget. Because of the tax increases, the adjustment of enterprises failed positively to impact their financial standing. The arbitrary exclusion of appropriations negatively affected the efficiency of budget expenditures. The induced contraction of the formal economy entailed the shrinkage of the tax base which usually led to further ad-hoc tax increases.

To estimate the tax burden on enterprises, an indicator of economic activity must be used to normalise the flow of tax liabilities. One possibility would be to use the value added for normalisation. The ratio of the flow of tax liabilities to the value added appears to be a highly relevant measure of the tax burden. Value added is the source of incomes accruing to both the production factors and the government. An increase in the flow of tax liabilities to the government reduces factor incomes.

Table 4: Value Added Tax Burden: The Formal Economy*)
(%)

	1996	1997	1998
Ratio of Value Added to Turnover	29	30	29
Value Added**)	100	100	100
After-Tax Wages	24	21	18
Depreciation	8	7	7
Financial Costs	19	21	19
Other Costs***)	0	5	7
Annual Tax Liabilities	44	44	56
Retained and distributed profits	16	13	10
Losses	-11	-11	-17

*) Defined to Comprise Enterprises Submitting Balance Sheets to the Ministry of Finance, Excluding Commercial Banks and Insurance Companies **)Estimated on the Basis of Consumer Prices ***)Net of Subsidies
Source: Estimations based on data released by the Ministry of Finance.

The tax burden, as measured by the ratio of annual tax liabilities to annual value added, was significantly higher in 1998 as compared to 1996. At the level of the formal economy, annual tax liabilities accounted for 56% of value added in 1998, as compared to 44% in 1996. State enterprises were subject to a higher tax burden than private enterprises. However, the tax burden on private enterprises increased from 39% in 1996 to 42% in 1997, to subsequently surge to 52% in 1998.

Table 5: Value Added Tax Burden: State Ownership (%)

	1996	1997	1998
Ratio of Value Added to Turnover	35	36	40
Value Added*)	100	100	100
After-Tax Wages	38	31	27
Depreciation	12	10	7
Financial Costs	20	16	9
Other costs**)	-6	6	3
Annual Tax Liabilities	52	48	65
Retained and Distributed Profits	3	3	3
Losses	-19	-14	-14

*)Estimated on the Basis of Consumer Prices **)Net of Subsidies
Source: Estimations based on data released by the Ministry of Finance.

The tax burden on enterprises increased against the background of a quasi-constant ratio of value added to turnover and of declining after-tax unit labour costs. Throughout the period of 1996 to 1998, the ratio of value added to turnover at the level of the formal economy stayed stuck at about 29%. In the state sector, value added accounted for 40% of turnover in 1998, as compared to 35% in 1996. In the private sector, the ratio of value added to turnover was 23% in 1998, only slightly lower than in 1996.

Table 6: Value Added Tax Burden: Joint State and Private Ownership (%)

	1996	1997	1998
Ratio of Value Added to Turnover	32	33	36
Value Added*)	100	100	100
After-Tax Wages	27	25	24
Depreciation	8	8	8
Financial Costs	20	27	22
Other Costs**)	2	5	9
Annual Tax Liabilities	42	43	56
Retained and Distributed Profits	10	6	3
Losses	-9	-14	-22

*)Estimated on the Basis of Consumer Prices **)Net of Subsidies
Source: Estimations based on data released by the Ministry of Finance.

The ratio of value added to turnover was, paradoxically at first sight, higher in the state sector than in the private sector of the formal economy. The explanation of this apparent paradox refers to the expansion of the private sector, mainly in trade. Producer price valuation of commodities traded makes an important contribution to accounting costs and turnover in the private sector. However, value added by trade comprises factor incomes paid only from trade margins, so that its ratio to turnover is rather low by comparison to other activities.

Table 7: Value Added Tax Burden: Private Ownership (%)

	1996	1997	1998
Ratio of Value Added to Turnover	24	25	23
Value Added*)	100	100	100
After-Tax Wages	13	12	10
Depreciation	5	5	6
Financial Costs	19	23	22
Other Costs**)	4	5	7
Annual Tax Liabilities	39	42	52
Retained and Distributed Profits	29	24	17
Losses	-9	-11	-14

*)Estimated on the Basis of Consumer Prices **)Net of Subsidies
Source: Estimations based on data released by the Ministry of Finance.

The decline of after-tax unit labour costs was generalized across sectors. At the level of the formal economy, after-tax wages contributed 18% to value added in 1998, as compared to 24% in 1996. The contribution of after-tax wages to value added in the state sector sharply declined from 38% in 1996 to 27% in 1998. In the private sector, the share of after-tax wages in value added dropped from 13% in 1996 to 10% in 1998.

Under the circumstances of the quasi-constant ratio of value added to turnover and of the declining after-tax unit labour costs, the worsening trend of enterprise profitability at the level of the formal economy was largely determined by the higher burden of taxation. State enterprises successfully absorbed the tax burden increase without endangering their otherwise poor profitability because of the improvement in the ratio of value added to turnover. However, private enterprises were overwhelmed by the surge of the tax burden, their profitability having dramatically dropped in 1998 as compared to 1996.

Both the ratio of value added to turnover and after-tax unit labour costs are clear indications of enterprise adjustments. However, the adjustments could not materialize in the form of higher profits because of the increasing tax burden. Taxation thus appears to be the main explanation for the poor savings performance in the formal economy.

The succession of tax increases within the vicious circle of fiscal policy seems to have outpaced the speed of adjustment by enterprises. Had the enterprise adjustment been more rapid and more profound, the increase of the tax burden would have been better absorbed with milder impacts on profitability. In any case, the tax increases in excess of the adjustments by enterprises could only lead to a deterioration in their ability to save and, consequently, to invest. The vicious circle of fiscal policy thus contributed to initiating and, subsequently, consolidating the vicious circle of savings and economic decline.

Besides increasing the tax burden, the successive packages of revenue measures aimed at containing the budget deficit became by themselves the most important source of legislative instability and business uncertainty. Side-by-side with the failed attempts to stabilize inflation and the stop-and-go pattern of reforms, the vicious circle of fiscal policy played its role in determining the expansion of the informal economy.

4. The Vicious Circle of the Informal Economy

The prevailing opinion in Romania is that the aggravation of fiscal problems in 1997 and 1998 was the result of the failure to improve tax collection. Since the onset of the transformation process, tax collection has indeed remained relatively low, which has contributed to the accumulation of a significant stock of overdue debts to the budget. However, from the perspective of assessing the capacity, as well as the willingness to pay taxes, collection rates need to be estimated exclusively on the basis of flows, without accounting for the accumulated stock of overdue liabilities.

Calculated as ratios of annual tax payments to annual tax liabilities, collection rates in the formal economy appear relatively low indeed but show no sign of worsening throughout the 1996 to 1998 period. Rates of tax collection from the private sector of the formal economy have constantly been the highest. It is worth noting that, contrary to the consolidated view, direct taxes were largely better collected than indirect taxes.

This paradox might have been the outcome of the increasing barter transactions at the border between the formal and the informal sectors of the economy. Official toleration and even encouragement of various schemes for compensating payments arrears across the supplier-customer chains contributed to flourishing barter transactions. The compensation vouchers acted as privately issued money in clearing supplier-customer transactions. To the extent to which this private creation of liquidity replaced the official monetary liquidity in the cash flows of large taxpayers, their capacity to meet due tax liabilities was eroded.

In 1998, there were three major issuers of compensation vouchers: the electricity utility, the natural gas utility and the domestic petroleum company. The compensation vouchers issued by the electricity utility reached the outstanding face value of about USD 520 million. The transactions carried out through the compensation vouchers issued by the petroleum company succeeded to cover about 35-40% of its gasoline production. No reliable information is available with respect to the compensation vouchers issued by the natural gas utility. The intermediaries of the vouchers earned huge profits and reportedly benefited of political support. Not surprisingly, both industrial lobbies and political circles opposed strong resistance to attempts aimed at dismantling the system.

The quasi-consistency of flow collection rates proves that attempts to relate the fundamental cause of the mounting fiscal problems to worsening tax collection are largely misled, failing to recognize the central role of the tax increases in excess of the enterprise capacity to adjust. Under the circumstances of the vicious circle of fiscal policy, the capacity of enterprises in the formal economy to meet their tax obligations has been gradually eroded. By demonstration, more and more businesses have stopped to pay their tax obligations, preferring to go underground. The consequent relative expansion of the informal economy has undermined the efforts to significantly improve tax collection.

Table 8: Flow Rates of Tax Collection Rates*)
(%)

	1996	1997	1998
Formal Economy**)	75	76	76
State Ownership	68	64	68
Joint State and Private Ownership	69	71	66
Private Ownership	86	89	86
Profit tax	87	95	85
Wage tax	74	81	91
Value Added Tax	74	75	81
Excises	79	86	69

*)Estimated on the Basis of Annual Fiscal Liabilities, Excluding Liabilities Overdue from Previous Years
**)Defined to Comprise Enterprises Submitting Balance Sheets to the Ministry of Finance, Excluding Commercial Banks and Insurance Companies
Source: Estimations based on data released by the National Commission for Statistics and the Ministry of Finance.

Table 9: Formal Economy vs. Informal Economy: Contribution to Value Added and Tax Payments
(%)

	1996	1997	1998
Value Added*)	100	100	100
Formal Economy**)	69	66	57
State Ownership	26	23	15
Joint State & Private Ownership	15	16	13
Private Ownership	28	26	29
Informal Economy***)	31	34	43
Tax Payments	100	100	100
Formal Economy**)	83	81	83
State Ownership	32	26	21
Joint State & Private Ownership	16	19	17
Private Ownership	35	36	45
Informal Economy***)	17	19	17

*)Estimated on the Basis of Consumer Prices **)Defined to Comprise Enterprises Submitting Balance Sheets to the Ministry of Finance, Including Commercial Banks and Insurance Companies ***)Defined to Comprise Households and the Underground Economy
Source: Estimations based on data released by the National Commission for Statistics and the Ministry of Finance.

The vicious circle of the informal economy appears to have been induced by the vicious circle of fiscal policy. As long as tax increases remain the main solution for controlling the budget deficit, the informal economy will go on expanding, tax collection will stay low and fiscal problems will be further aggravated.

According to rather tentative estimations, the relative expansion of the informal economy in 1997 and 1998 was outstanding. In only two years, the share of the informal economy in total value added expanded 12 percentage points. In 1998, the formal economy accounted for 57% of total value added, but contributed 83% to total tax payments. By contrast, the informal economy contributed 43% to total value added, but only 17% to total tax payments (largely on account of taxes paid by households).

The interaction between the vicious circle of fiscal policy and the vicious circle of the informal economy is captured by the ratio of tax payments to value added, which cumulates the impacts of the value-added tax burden and the flow rates of tax collection. The ratio of value added to tax payments increased in the formal economy from 33% in 1996 to 42% in 1998. It declined in the informal economy from 14% in 1996 to 11% in 1998.

Table 10: Formal Economy vs. Informal Economy: Ratio of Tax Payments to Value Added*)
(%)

	1996	1997	1998
Total Economy	26	26	28
Formal Economy**)	33	33	42
State Ownership	35	31	44
Joint State & Private Ownership	29	30	36
Private Ownership	33	37	45
Informal Economy***)	14	15	11

*)Estimated on the Basis of Consumer Prices
**)Defined to Comprise Enterprises Submitting Balance Sheets to the Ministry of Finance, Including Commercial Banks and Insurance Companies
***)Defined to Comprise Households and the Underground Economy
Source: Estimations based on data released by the National Commission for Statistics and the Ministry of Finance.

At the aggregate level of the economy, the ratio of tax payments to value added increased slightly from 26% in 1996 to 28% in 1998. The significant surge of the ratio in the formal economy impacted the aggregate level only marginally because of the relative expansion of the informal economy.

5. Policy Implications

Romanian fiscal policy has largely been conducted with a short-term horizon, sacrificing sustainable economic growth and long-term structural changes to deal with immediate pressures mainly related to social costs. Although the reforms of taxation and budget management were intended and, at times, even initially designed to meet the requirements of the transformation to a market economy, their subsequent modification, implementation and enforcement were modelled on an ad-hoc basis by endogenous political economy considerations. A stop-and-go pattern infiltrated the Romanian reforms, ultimately leading to mounting fiscal tensions.

The political economy perspective appears to be fundamental in understanding the essence of the fiscal problems Romania is currently faced with. The Romanian political elite seems to have been unwilling to realize that in a market economy the definition of national interest presupposes prioritisation under explicit hard budget constraints. This is clearly illustrated by the crisis of the budget management system, which has become weaker and weaker at the level of both preparation and implementation.

Voted appropriations have been the result of ad-hoc and approximate negotiations rather than of widely accepted prioritisation of the national interest. The negotiations have been based on the budget of the previous year, augmented by broad-based demands for additional spending and subject to lax constraints imposed by the Ministry of Finance. In these conditions, the budget has appeared to be more an administrative act than a declaration of priorities in accordance with the national interest.

The voted budget has become no more than a distant reference to the financial management exercise. The budget implementation has been guided by the short-term availability of funds rather than by the voted authorizations. The numerous extra-budgetary funds have reduced the transparency of the public finances. Actually, the dispersion of the available resources into many extra-budgetary funds has become an essential prerequisite of the ad-hoc financial implementation of the voted budget.

It is fortunate that the Romanian government aims to address the fiscal problems within the framework of renewed agreements with the international financial organizations. It is, however, unfortunate that none of these agreements has, as of yet, set to prioritise the public expenditure review and the fiscal transparency as a means of rationalising budget appropriations. Instead, the programs likely to be agreed to by the international financial organizations seem to still be devoted to fiscal stabilization, mainly through tax increases.

The option of relying exclusively on the exchange rate to contain the external deficit seems unfeasible. The depreciation of the exchange rate, without an appropriate support on the fiscal side, ultimately contributes to accelerating inflation. To the extent to which inflation eroded the nominal depreciation, the external adjustment would likely be short-lived. The alternative utilization of the exchange rate is unfeasible too. Adopting the exchange rate as the nominal anchor of the stabilization program without imposing fiscal discipline leads to unsustainable deficits of the external current account.

Fiscal stabilization is thus unavoidable. However, a fiscal stabilization that relies heavily on the higher taxation of enterprises will only aggravate all of the three vicious circles Romania is deeply caught in. Enterprise competitiveness will further deteriorate and non-governmental savings will go on declining. The business incentives for going underground will get stronger. Tax collection will not improve because of the expansion of the informal economy. The induced external adjustment would be unsustainable.

These would-be developments bear a striking similarity to the 1980s when higher taxation of enterprises provided the bulk of the resources for the repayment of the external debt. The long-lasting damage done in the 1980s to the enterprise sector of the Romanian economy is today unanimously acknowledged. To get out of the three vicious circles, Romania seems to need a fiscal stabilization based not on tax increases, but on tax reforms and sustainable cuts of budget appropriations in accordance with a significantly revised role of the state in the economy. Both the tax reforms and the rationalization of budget appropriations fit into a long-term oriented approach, implying a major institutional adjustment driven by the quest for simplicity and transparency. Simple and transparent policy rules may be the answer to addressing the political economy factors of the stop-and-go reform pattern and the associated fiscal problems.