

## **The European Recovery Economic Plan and Quality of Public Finances – Instruments for Monitoring and Improving Fiscal and Economic Systems**

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**Abstract.** *“To promote a growth and employment orientated and efficient allocation of resources, Member States should re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives, and ensure the overall coherence of reform packages”. [The Lisbon Strategy, integrated guideline no 3].*

**Keywords:** growth potential synergies; corrective component; preventive component; the excessive deficit; budget stimulus; sustainability of public finances; structural reforms.

**JEL Codes:** E62, H62.

**REL Code:** 8K.

## **1. European plan for economic recovery and quality of public finances – tools for monitoring and improving the fiscal and economic systems**

Through manifestation of economic and financial crisis since 2008, the euro area and several Member States have entered a recession. The situation was further complicated by deferring investment and reducing purchases of consumer goods, leading to a vicious cycle of declining demand, business plans were revised and reduced, having held the job cuts. These has pushed the EU to a deep recession, possibly of long standing, the economy contracted and the unemployment could rise by several hundred thousand people, while the measures established by the European Recovery Plan will not find conditions to generate the desired results.

European Recovery Plan was presented, with enthusiasm, by Jose Manuel Barroso on 26 November 2008 in Brussels, under the motto "Now it is time to act", as European Commission's reaction to the economic situation of crisis.

By this, in addressing the financial crisis, the EU ensures that action at its own can be coordinated in accordance with national action in each Member State, depending on the development of relevant indicators to highlight the main negative impact (GDP) and monetary aggregates M1 and M2.

EU action related to domestic action, normally, can help all Member States to reduce the negative effects of global economic turmoil and emerge from the crisis.

Most of the means of economic policy, in particular those which can stimulate consumer demand in the short term, is at Member States hand. Each state has different starting points in terms of budgetary discretion, which gives great importance to effective coordination of the Fourth Commission.

Normally and binding on, all Member States have taken measures to counteract the crisis.

Corresponding coordinates national efforts may target different goals in parallel. Some actions can mitigate short-term recession, but each country should promote simultaneously the structural reforms necessary to help overcome the crisis without undermining long-term fiscal sustainability.

The strategic objectives of economic recovery plan, as they were made, are:

- rapid stimulation of demand and consumer confidence;
- reducing the effective management of human cost caused by economic downturn and its impact on the most vulnerable persons;
- continue the necessary structural reforms, support innovation and building a knowledge economy;

- accelerating the transition to a low carbon economy, which will create new green jobs and open up new opportunities in the rapidly growing global markets, will keep energy bills under control of citizens and businesses and reduce Europe's dependence energy from abroad.

The primary objective of the recovery plan is to avoid a deep recession by promoting an ambitious set of actions to support the real economy.

To support the real economy and confidence building, based on the forecasts of inflation reduction over the medium term, European Central Bank (ECB) for euro area, together with other European Union central banks reduced interest rates and have argued that reductions are possible additional. European Central Bank has already proved important in stabilizing the markets by lending banks and contribute to liquidity.

At the root of problems in the real economy is financial market instability.

A reliable and efficient financial sector is the premise of a strong economy, with growing. Therefore, to stabilize the banking system is the first step towards halting the economic slowdown and promote rapid and sustainable recovery. Currently, banks have to resume its normal role of providing liquidity and support investment in the economy. Since this action could take the form of loans and financing with risk sharing, could theoretically generate a positive mobilization of additional investments from private sources.

Also, in current circumstances, fiscal policy has played a more important role in stabilizing the economy and support demand.

Europe and countries can counter the trend expected to reduce demand, with negative side effects on investment and employment, only with a significant package of incentives budget without forgetting that they are closely linked to fiscal stimulus.

To maximize impact, budgetary stimulus should take into account the starting positions of each Member State. It is obvious that not all Member States are in the same position. Those that have used the good times to obtain reliable positions of public finances and improve its competitive position have a greater margin of maneuver now. For those Member States, especially those outside the euro area, which faces significant external imbalances, fiscal policy should essentially aim at correcting these imbalances.

A budget stimulus must be well designed and structured and based on the following principles:

1. To be timely, temporary, targeted and coordinated

National budgetary incentive packages should be:

- *convenient*, to support rapid economic activity in the period when demand is low, because the delay in implementation could mean that

the fiscal impulse would arrive only when the recovery is already ongoing;

- *temporary*, to avoid permanent damage to the budgetary positions that would undermine the viability and ultimately would require further funding by the sustained growth of taxes;
- *specific*, oriented origin of the economy problem (rising unemployment, business / households facing credit restrictions, etc.), because it optimizes the stabilizing effect of limited budgetary resources;
- *coordinated*, so as to multiply the positive impact and ensure long term budget sustainability.

2. Tools include both the revenue and expenditure instruments.

It is generally considered discretionary public spending will have a greater positive impact on demand, in the short term, compared with the reduction of taxes. This is because some consumers prefer to save rather than spend, unless the reduction in taxes is limited in time.

## **2. Quality of public finances as a tool for improving fiscal and economic monitoring**

Current economic risks increase the need for a greater emphasis on the quality of public finances in the economic and budgetary monitoring.

Quality of public finances can be seen as a multidimensional framework. It targets more than low levels of deficit and debt, which remains its central axis, including also all agreements and fiscal institutions that contribute to efficient resource allocation and supporting macroeconomic objectives, in particular long-term economic growth.

These dimensions of quality of public finances include:

- composition and efficiency of public expenditure;
- the structure and effectiveness of income tax;
- fiscal government;
- ability to effectively manage government stimulus system;
- public finance policies that affect the functioning of markets and global business environment.

Improving the quality of public finances can contribute to addressing the fiscal policy by means of two mutually reinforcing ways:

- directly, by increasing efficiency of revenue and expenditure, through a better use of public resources;

- indirectly, by reducing the social costs and distortions by fostering long-term economic prospects and strengthening the ability to adapt to shocks.

The main transmission channels of quality of public finances actions are:

- For some budget expenditures, public finances contribute to growth and economic viability of using the composition and the public expenditure efficiency and effectiveness.

Theoretical and empirical research indicates that growth can be supported when public spending is oriented towards investment, stressing also that a fiscal consolidation based on sales of investments, as was the case in some periods in some Member States, can be problematic long term.

Effects on growth is due, in general, to public investment in human capital (through spending on education and health), in technical progress (research and development expenditures) and public infrastructure.

These are key areas of European regional and cohesion policies. However, there is evidence that the link between money spent in these areas and economic growth is not automatic, it is generally subject to the ability to achieve expected results (eg. better results in education, more private investment in research and development) and to overcome existing market failures, without giving rise to new distortions. Currently, empirical estimates on the cost effectiveness of public education and health show major differences between Member States, there are ample opportunities for savings in the use of public resources or to improve the results. The first option would allow development of much needed tax base for other purposes, for example, to an aging population or tax cuts. A second option could help to establish growth through higher productivity of labor.

- *The structure and effectiveness of revenue* may also be a factor for long-term growth, mainly due to additional constraints on public policies pursued by increased competition for mobile tax bases and factors of production.

Tax structure affects the growth potential through its effects on supply and demand for labor, through investment measures, by taking risks and human capital formation. Since the overall tax burden is always desirable, it will be accompanied by reforms in spending.

Some researchers have concluded that the tax burden diminuation on labor by shifting to a broader tax base, such as VAT, could foster employment and growth. In the simulation models prepared for the euro area is estimated that in the long term, the transfer tax of 1% of GDP from pay income taxes to consumption taxes, will increase real GDP by about 0.2% and employment to

about 0.25%. The effects depend largely on institutional and structural factors, such as indexation of wages and transfer reaction. In principle, due to a shift of taxation from income tax to pay tax on consumption, income difference between the active and inactive increases.

- A good *tax governance* can enhance all dimensions of public finances.

Besides the role played by national fiscal rules and medium-term budgetary frameworks in terms of enhancing the performance budget, fiscal governance also help to encourage spending efficiency, improving public expenditure approach and supporting reforms in public finance. Implementation of long-term budget frameworks would exceed the theoretical considerations of political economy, in terms of policy development and implementation of tax revision and consolidation of economic growth, efficiency of government revenue systems by promoting tax schemes that have categories of taxes in their composition carecterizate by relatively low tax rates, applied to the widest tax base.

- *Government capacity* tends to influence government economic growth, being closely linked to other dimensions of public finances quality.

If the state of public finances is good, maintaining a relatively large public sectors and satisfactory economic growth can coexist. However, public sector can make progress harder if the economy is characterized by high tax burdens, higher public consumption, public spending and inefficient management and the effect is deficit and debt increasing.

- Public finances, through value size of allocations on budgetary and non-budgetary items, may also have effects on the *functioning of markets and business environment*.

Along with the mentioned roles on effectiveness of public expenditure and systems revenues, public finances also play a significant role through their impact on wage growth (eg. public sector wages), regarding participation and labor market mobility work (eg. benefit systems) and, more generally, the business environment (for example, by ensuring proper functioning of the judiciary and public infrastructure). In economies with less regulated legal tasks, the total productivity of factors of production, respectively skilled labor contribution to GDP growth, is hard to quantify. In fact, there are few governments which have standardized work, particularly skilled labor, from public sector, other than production or service against cost.

Aggregation of all facets of quality of public finances would allow the development of potential synergies of the main instruments of economic policy coordination for growth and employment.

Given the need to ensure sustainability of public finances, promoting long-term growth and proper functioning of the economies of Member States, greater attention should be paid to the efficiency and effectiveness of public spending.

Although the relationship between the level of general budget expenditure and economic growth is not straightforward, there is a clearer link between the results of public finance expenditure (eg. education, health) and economic performance. One of the promising methods to increase efficiency and cost effectiveness is the establishment or improvement of institutional mechanisms, aimed at both strengthening the link between policy priorities and resource allocation, and between resources and results.

Realization of regular budget review, including analysis of efficiency, is essential in terms of prioritizing spending.

Revenues is not only budgetary expenditure counterpart, because, through their structure and level, they affect economic efficiency, income distribution and growth. A review of the current structure of revenue systems and the main challenges for the design of tax systems, in particular the high tax burden on labor and the consequences of increased economic integration, points out that there are still possibilities of transferring the tax burden from labor to other tax bases, but that these bases must be large and stable.

In summary, fiscal reforms should be further developed so as to promote growth and reduce distortion, while helping to solve problems related to distribution.

This could be achieved through simple tax rules and the identification of broad tax base, avoiding regulatory gaps or coordination of the actions alleged by good fiscal governance, avoiding inefficient spending, eliminating special tax regimes and unnecessary exemptions.

A comprehensive strategy to revitalize European economies, including the modernization of social models, must be based on a comprehensive approach, using a wide range of economic policy instruments and a strong implementation of structural reforms under the growth and employment provided by the Stability and Growth Pact and the Lisbon Strategy.

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