

# EVALUATION OF THE FISCAL POLICY TRANSMISSION MECHANISM IN THE CURRENT ECONOMIC AND FINANCIAL CONDITIONS

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## **Abstract:**

*The proposed research aims to evaluate in a systematic way, the current transmission mechanism of the fiscal policy, based on theoretical-methodological and qualitative analysis reported to the concepts, principles and arguments required by the economic theory.*

*At this stage, the research makes use of empirical testing or simulations to determine the influence of fiscal policy transmission mechanism on general government. The methodology used is based on logical analysis, conceptual, in an attempt to identify some methodological issues and operational requirements of current transmission mechanism of fiscal policy.*

**Key words:** *fiscal policy; transmission mechanism; fiscal strategy; fiscal targets.*

**JEL classification:** *E62, H20*

## **1. Structural and functional elements of fiscal policy transmission mechanism**

Fiscal policy achieves its objectives through a specific tax mechanism that meets the structural and functional, the following basic elements: a) institutional authority; b) fiscal strategy; c) fiscal targets; d) fiscal targets; e) tax rules; f) channels for transmitting the tax signals. The logical relationship between these fundamental elements is as follows: institutional authority sets the strategy, the fiscal objectives and legal framework by which they can be obtained; the fiscal objectives can be achieved by modifying (extending) the fiscal targets (tax base), the instruments of fiscal policy and economic, and the fiscal signal „moves” between the institutional authority and fiscal targets through the transmission channels.

In this sense, the fiscal policy transmission mechanism can be defined as a gear composed of processes, tools and techniques of carrying and setting the fiscal policy, compared with the normal course of business process requirements and ensuring the necessary public funds for general consolidated budget. Its operation is the ability to ensure, from a technical point of view, the continuous and effective „communication” between the public and real economy. Effective operation of fiscal and budgetary mechanism strongly marked the economic activity and modern society, making it a prime component of the economic and social mechanisms.

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Next it is made a short presentation of each element of the transmission mechanism, with a thorough breakdown of fiscal policy transmission channels, respectively:

a) institutional authority – it is known that the main source of funding the state activities consists in the fiscal resources. These are provided by the state's fiscal activity that includes a legislative side - done by Parliament - and the executive activity- realized by the Government, which runs through specialized government institutions, formal institutions whose structure represents the fiscal apparatus. These include all the State's institutions that allow, through the law, the realization of taxation, tax collection, tax tracking and monitoring of compliance with the tax legality, in other words, the causal chain of tax boost, tax signal across, and fiscal targets.

The executive powers of the Government in the tax field are carried out through the Ministry of Public Finance (MPF), which is the public administration specialist. MPF includes central and territorial bodies. Its local bodies must be treated as a part of the fiscal administration. Created as a central public administration body, MPF's functions involve also the role of applying the governmental strategy and program for the public finances.

b) fiscal strategy – the regulatory authority have to draft the medium and long term fiscal strategy, in cooperation with representatives of political parties, employers, trade unions and civil society. The strategy should begin with the following assumptions:

- the transition state of the Romanian economy, competitive market mechanisms and socio-economic development level compared to developed countries, which are benchmarks and targets;
- the design of programs of actions, measures and mixes fiscal - monetary policy, to satisfy the requirement of achieving its objectives;
- fiscal strategy on medium term does not mean neglecting the short-term strategy components; they must converge quickly and efficiently as possible to the long-term goals in their logical chain objectives and means, ranked and correlated with based on extensive support to national and international forecasts.

c) fiscal targets - can be characterized by the following:

- coordinates must enroll in the national interest, to take into account the current state and future development of the economy so as to have finality;
- objectives must be consistent to achieve an objective that does not threaten the achievement of another goal;
- objectives should provide a relatively complete coverage of the fundamental aspirations of society, at least for the time horizon for which they were designed.

d) fiscal targets or recipients of the fiscal policy (there should be an indication that the trader is the actual tax target, but its activities generate economic flows) are represented by the phenomena, processes, measurable economic activities on which it can operate tax changes that will lead to the achievement of the fiscal objectives. The target is intermediate between the tax authority and fiscal policy objectives that can be shaped depending on the degree of achievement of objectives.

In tax practice there are three main categories (traditional) fiscal targets, namely:

- income as a result of exploitation of labor or capital;
- accumulated capital or purchased;
- expenditure (consumption).

Fiscal targets have the following characteristics:

- target is sensitive, meaning that the intervention has an effect on them and may modify the behavior of tax;
- target must have the character of continuity, of permanence order not to affect the final objective.

State intervention in economic and social plan is based with predilection on taxation. Compulsory levies may act structurally, when aiming to encourage certain behaviors or activities, or in a conjectural manner, when the purpose is to encourage or discourage demand or supply. Such interventions on medium and long term may be an inhibitor of economic subjects if these are not robust.

e) signals/rules are represented by the tax laws and governmental acts that provided a normative objective and certain features:

- are considered as a form of indirect intervention in the economy which aims at achieving the objectives of the real economy and the public finances;
- nature of the obligation or prohibition;
- achieving stability and growth;
- converge towards the same goals showing relatively high efficiency;
- also focused on distinct fiscal targets.

## **2. Some characteristics of the fiscal policy transmission mechanism**

In order to understand the mechanism it is useful the identification the essential features of the transmission channel. Transmission channel is a functional element that assures the connection between the fiscal rule and targets. Without this the mechanism cannot work. In this context, it is identified the following characteristics:

- the dependency of the tax rule is explained by the fact that each tax legislation creates its own transmission mechanism. There are times when tax rule changes due to unplanned deviations, which overlap the original rule, and preserve the initial communication channel or creates its own transmission channel giving it a relatively rigid nature;
- the transmission channel stability is seen in the light of budgetary stability and fiscal legislation to the extent that regulations include clear, precise, robust and linked together in such a way that assure a consistent and continuous process;
- the transmission channel length is given by the structural and organizational “environment” that must pass through it from the legislative authority to the fiscal target; this is represented by the organizational nodes through which passes the transmission channel, namely the hierarchy of the public authorities with fiscal responsibilities;
- the tightness of the transmission channel is given by the conservation degree of the tax signal, the entire length of the channel, and the degree of the tax distortion of the signal (at the time of its reception by the target of tax) compared to initial moment.

Thus, the transmission channel takes some attributes of structural elements that make up the transmission mechanism.

After this brief review of structural and functional elements, we can redefine the transmission mechanism of fiscal policy as that system of structures, rules and procedures that make messages (standards) issued by the legislative authority to reach the fiscal target with a lowest possible distortion.

## **3. Some constraints on the current fiscal policy mechanism of transmission**

The actual fiscal policy transmission mechanism contains elements of malfunctioning generators. In this sense we try to identify the elements that constrain the effectiveness of the current transmission mechanisms for the fiscal policy based on its structural and functional elements, and the current state of the economy. Thus, we identified the following constraints:

- heterogeneity of fiscal and budgetary system, focusing on excessive spraying of resources managed in the public sector without ensuring rational connection to facilitate linking of financial flows related to entry-exit system;

- restricting tax bases as a consequence of weakening the economic growth will increase unemployment and will accentuate the companies bankruptcies;
- lack of the financial markets depth (evident in Romania) when both government and businesses compete for the same limited amount of financial resources. A higher budget deficit must be financed by the market and if the government calls a larger share of the existing resources means that for the private investors remains a small part;
- fiscal citizenship degradation behavior of the taxpayers, which depends on both the individual and the economic environment. It corresponds to the search of the most adequate situation to meet the needs of the individual;
- risk of fraud and tax evasion; fraud is a violation of tax law while avoiding evasion is an ability to pay taxes through the use of the law;
- a pro-cyclical fiscal policy and a short term oriented in a time of crisis tend to pay attention only for a short period which will result in a greater effort on the part of monetary policy to stabilize prices and reduce inflation; therefore, the macroeconomic policy correlation is always negative;
- construction of the tax system should be a tool for stimulating economic activity, but not just as a tax revenue collection system;
- availability of equipment in the economy leads to low efficiency of the transmission mechanism in terms of achieving fiscal objectives;
- public debt and expenditure have a contribution in terms of stimulating economic growth on long term;
- existence of the economic interest groups that influence the normal development of the economic cycle;
- credibility of the state institutions, the degree of confidence that people have, the assets that facilitate the functioning of society in general and taxation in particular;
- tax competition in the Balkan area in which Romania has responded by introducing the flat income tax of 16% that produced a suboptimal level of public goods, a general erosion of the government revenue with inefficient efforts for budget deficit reduction, less flexible tax bases, and negative social effects;
- taxation has been and it still is interpreted by taxpayers as an aggression, becoming a factor that strain the economic relationship. Taxpayers have felt, whether it was the company, whether it was the individual taxpayer, a partnership relationship. First of all, the state has not changed much in the public service tax, but has developed a bureaucracy that has reached alarming levels.

All these constraints are likely to reduce not only the transmission mechanism performance, but they have influence especially in the action of the fiscal rule in the economy over the economic and tax objectives that where initially set.

Effectiveness of the fiscal transmission and rule is also affected by many atypical economic processes and phenomena in the Romanian economy; numerous inconsistencies in institutional practices and economic behavior of fiscal indiscipline make the decrease of the effectiveness of the fiscal transmission and often act to harm it.

#### **4. Some measures to increase the effectiveness of the transmission mechanism of current fiscal policy**

In our opinion, it must be identified and implemented a series of measures to improve/eliminate these constraints that hamper the functioning and strengthening of the fiscal transfer mechanism. Also, based on the current state of the Romanian economy should be taken into account the implementation of the fiscal stimulus - to

allow recovery from the fiscal crisis. This stimulus package should be well designed and based on the following principles:

a) to be adequate, temporary, specific and coordinated:

- adequate in order to support rapid economic activity in the period when demand is low because the implementation delay would mean that the fiscal impulse would arrive only when the recovery is already underway;
- temporary in order to avoid permanent damage of the fiscal positions that would undermine the viability and ultimately would require further funding by the sustained growth of taxes;
- specific because it must focus on the origin of the economic challenge in order to optimize the stabilizing effect of limited budgetary resources;
- coordinated so as to multiply the positive impact and ensure long-term budget sustainability.

b) include both income and expenditure instruments. It is generally considered that the discretionary public spending will have greater positive impact on demand in the short term, compared with the tax cut. This is because some consumers prefer to save rather than spend, unless the reduction in taxes is limited in time may consider the following measures:

- public expenditure have an impact on short-term demand. Measures can be applied and will most likely have an almost direct effect on consumption (growth and / or extension of unemployment benefit). It also can be achieved by bringing forward public investment projects which would benefit SMEs and could support public policy objectives such as improving long-term infrastructure facilities or combat climate change;
- subsidies and loan guarantees are effective to compensate the high current level of risk premium especially in an environment where credit is restricted. Also, grants can help offset the short term lack of capital which now constitute a problem for many companies;
- reducing taxes and social contributions - the reduction of employer's social contributions can have a positive impact on retention and job creation, tax revenues while reducing the purchasing power of wages may support particularly for low-income wage ;
- temporary reduction in the general VAT rate can be introduced rapidly and could provide a fiscal boost to support consumption.

c) should be used according to the Stability and Growth Pact

Budgetary policy should be conducted under the Stability and Growth Pact so as to provide a common and credible macroeconomic policy. Exceptional circumstances characterized by financial crisis and economic recession have created the opportunity accepted at the European Union level, that some Member States apply correction to overcome the deficit reference value of 3% of GDP. To achieve this, the fiscal stimulus must have the following characteristics:

- ensure the reversibility of the measures which enhance of short-term deficit;
- improve medium-term budget policy development, strengthening budgetary rules and strategy;
- ensure long term sustainability of public finances, particularly through reforms aimed to reduce age-related expenditure growth.

## 5. Conclusions

Fiscal policy transmission mechanism is the result of a combination of general economic characteristics (size, openness degree), on the one hand, and the pace and depth of structural and institutional reforms and macroeconomic stabilization in transition, on the other side.

The fiscal and budgetary mechanism that existed before the financial crisis is characterized by pro-cyclicality. It was focused on excessive spraying of resources managed in the public sector without ensuring rational connection to facilitate linking of financial flows related input-output system, the availability of equipment in the economy led to low efficiency of the transmission mechanism in terms of achieving fiscal objectives.

Characteristics of the fiscal and budgetary mechanism presented above had been an obstacle in the attenuation of the crisis effects on the economy and contributed to their national expansion as a result of the delay in the use of the fiscal stimulus.

All the measures to increase efficiency in the fiscal transmission indicated in the paper are becoming increasingly necessary, given that monetary policy, after integration, lost its importance and impact while fiscal policy acts as an important leverage to influence the economy and economic behavior.

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