

# **FISCAL RESPONSIBILITY WITHIN AN UNSTABLE ECONOMIC AND POLITICAL ENVIRONMENT**

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## **Abstract**

It is hypothesised that the economic and political environments from Romania are characterized by instability. Also, election cycles represent a major source of volatility for economic policies, particularly for fiscal policy. However, it is very difficult to observe accurately which fiscal proposals/changes have electoral motivations and which are backed by ideologies or technical considerations. The paper presents a theoretical analysis of fiscal responsibility and a conceptual analysis of economic and political stability. The paper is completed by a series of analyses and observations based on the situation of Romania, related to stability and responsibility.

**Keywords:** government, elections, stability, political party

**JEL Classification:** D72, E62, G18

## **1. Introduction**

An important hypothesis for this paper is that the election cycle is a major source of volatility for the economic policies, particularly for fiscal policy, which can be manipulated by the governing parties to gain election advantages. The manipulation of the fiscal policy with electoral purposes may lead to distortions concerning “fiscal responsibility”. As show before (Ciumara et al., 2015), there are many election cycles (parliamentary, presidential, local) that overlap in a manner that is not always synchronized. This situation induces significant difficulties in the process of analysing the impact of the election cycle on economic policies, and this makes it difficult to discern the potential political objectives of the economic measures and to determine the election cycle that can be their cause. Anyhow, it is interesting to notice what was observed (Mierau et al., 2007) that the gradual fiscal adjustments are influenced by the

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ideology of the governments and by the number of political parties from the governing coalitions, while the fast fiscal adjustments are influenced only by the impending elections.

Another starting hypothesis is that the economic and political environments from Romania are characterized by instability. It is assumed that a rational political actor doesn't necessarily make fiscal changes of one type or another during an election year taking into account the lag between the draft proposition, its implementation and its effects on the voters. Therefore, significant changes take place in the years proceeding the election year (we may thus consider, within this context, the major changes of the Romanian Fiscal Code in 2015).

Finally, it is obvious that it is extremely difficult, if not impossible, to notice accurately which fiscal proposals/changes have election motivations and which are backed by ideologies or technical considerations. It is clear, however, that an economic and/or political context characterized by instability, with ambiguities and undefined areas, favours behaviour lacking responsibility.

## **2. The concepts of fiscal responsibility and economic and political instability**

### **2.1 Fiscal responsibility**

There are many variants of defining fiscal responsibility, but our analysis relies on the manner in which the principle of fiscal responsibility is defined by the Romanian laws. Thus, the principle of fiscal responsibility concerns the duty of the Government to conduct in a prudent manner the fiscal and budgetary policy and to manage the budgetary resources and obligations, as well as the fiscal risks in a manner which ensures the sustainability of the fiscal position, on the medium and long-term, so that the Government can be able to administrate the financial risks and the unforeseen events without making significant adjustments of the expenditures, revenues and budget deficit, with destabilizing economic or social effects (Law 69/2010). The definition is rather broad and clear, and it doesn't require further clarifications. We should notice, however, the reference to economic and social stability, terms whose legal definition would be useful for our arguments. The responsible management of the fiscal policy is closely related to the observance of the rules set by the law, which are detailed in Lupu (2015).

Regarding this notion, we may also observe the initial intention of the initiators of the law (Government of Romania, 2010) which stated that the main principles of the fiscal-budgetary responsibility include:

- a) Maintaining a prudent level of the public debt, so as to maintain fiscal sustainability;
- b) Ensure the balance of the consolidated general budget throughout the entire economic cycle;
- c) Prudent management of the fiscal liabilities, assets and risks afferent to the public sector to avoid burdens for the following generations;
- d) Ensure the predictability of the taxation system;
- e) Maintaining an adequate level of fiscal reserves for the service of the foreign debt.

Some of these principles have been preserved in the final form of the law, with some changes, as “objectives of the fiscal and budgetary policy”; the one regarding the “economic cycle” was not maintained because of difficulties in its interpretation.

We discuss here the Fiscal responsibility law strictly with the purpose of using some definitions. The actual law, generous in its objectives, has some practical limitations. Corbacho and Schwartz (2007), noticed that the laws regarding the fiscal responsibility cannot be a replacement for a prudent fiscal policy.

The definition mentioned before has a serious blind spot, acknowledging the Government as the only institution with attributions in the field of fiscal responsibility. As we will discuss this at a later stage, the Parliament should be introduced as a key institution in this field. In our interpretation, it is possible that the executive is hindered in the fulfilment of its duties by the legislative, if laws are adopted which don't allow, for instance, the prudent administration of the fiscal resources. A similar point of view can be found in the paper of Lienert (2010).

There is a certain controversy regarding the role of the Parliament in the management of fiscal policy. There are many evidences, not only in Romania, but also worldwide, about the “parliamentary indiscipline and irresponsibility in budgetary matters” (Santiso, 2005). Of course, we don't mean that this is a permanent characteristic of the parliamentary activity. On the other hand, the literature also supports the idea that the Parliament has an essential

role in the development of the fiscal policy and in monitoring its implementation by the Government.

In addition to the previous researches we consider that there are distinct sources for the manipulation of economic variables with political purposes. Such sources can be the (central or local) Government and the Parliament. Formally, the economic policies are the actions undertaken by the Government in economy. Sometimes, the Government undertakes such actions following its own plans, while other times it is compelled to take measures to comply with the legislation adopted by the Parliament. And the composition of the Parliament is political by definition. The Government also has a well-defined political orientation, but sometimes it relies on technocrat merits.

Posner and Blöndal (2012) speak of the unprecedented fiscal challenges confronting the developed countries, which claim proactive initiatives and behaviour in this field. According to their opinion, there is dissociation between the political requirements and the requirements of the fiscal responsibility. On the other hand, Caceres et al. (2010) found limited empirical evidence regarding the connection between fiscal responsibility laws and the change of the fiscal behaviour. At the same time, Li and Webb (2011) showed that the political situation specific to each individual country influences the implementation of the fiscal responsibility laws.

## **2.2 Economic stability versus instability**

While not aiming to analyse extensively the notions of political and economic stability or instability, we think it is necessary to clarify the manner in which we interpret them in this paper.

Stability or instability are states of fact, unlike stabilization or destabilization, which are processes. Both stability and instability are states of fact which have both advantages and disadvantages. Generally, stability refers to the property of a particular element to revert to its original state of balance after being disturbed. Another possibility to interpret stability refers to the capacity of dissipating the imbalances, endogenous or exogenous, and to absorb the shocks using self-corrective mechanisms (GFDR, 2013).

The economic stability may be a state of the economic system in which there are just minor fluctuations of its main elements, irrespective of the causing stimuli. An economic system in which the gross domestic product, inflation, unemployment and other

macroeconomic indicators remain unchanged in time might be considered as “stable”. Obviously, such a state can seldom be considered as desirable. We would rather accept a definition in which the economic stability refers to an acceptable “tunnel” of fluctuations, the economic system displaying an evolution in which the economic parameters improve. If the fluctuations become too large, adverse effects may arise, such as deterred investments, because of the lack of system predictability. We can adopt a similar vision regarding the political system.

The relation between economy and the politics is more difficult, however. There is well defined research field dealing with this, popular mainly in the 90s, which studies the relation between political instability and the economic growth. Papers such as those of Barro (1991), Alesina et al. (1992) or Mauro (1993), noticed, predictably, an inverse relation between political instability and the economic growth. We may also notice the “unorthodox” opinions regarding the destabilizing role of the state for the economic environment (Cîțu, 2016).

Economic stability is rarely approached as such; usually economic stability it is considered equivalent with financial stability. Therefore, we analysed the manner in which the issue of financial stability is treated. The European Central Bank (ECB, 2016), considered financial stability as a state which prevents the build-up of systemic risk, while systemic risk is the risk that the supply of financial products and services necessary to the financial system is affected up to the point in which economic growth and welfare are affected significantly. According to the ECB, systemic risk can derive from three sources: endogenous build-up of financial imbalances possibly associated to a booming financial cycle, large aggregate shocks affecting the economy or the financial system, or contagion effects between markets, intermediaries or infrastructures. The National Bank of Romania (NBR) too, uses ECB definition, completing it with the idea that financial stability involves the capacity of efficient, spatial and intertemporal allocation of the economic resources, financial risks management and self-correction in the case of extreme shocks (NBR, 2015).

### **2.3 Political stability versus instability**

The issue of political stability is more difficult to capture. A definition suggested by Ake in 1975, indicated political stability as the

regular flows of political exchanges. Thus, Ake considered that there is political stability if these exchanges are regular, or if the members of the society limit to the behavioural patterns that fit within the limits set by their expectations regarding the political role. Ake tried to develop a quantitative pattern of interpreting political stability which, although interesting, exceeds the object of this paper. We may wonder, however, whether some concerted actions of the main political actors from Romania, fit the “legitimate expectations” of the voters.

There are, of course, other approaches of political stability or instability. Alesina et al. (1992) defined political instability as the inclination towards the change of the executive power using constitutional or unconstitutional means. The literature provides several distinct approaches of political stability (Hurwitz, 1973, Dowding and Kimber, 1983):

1. Stability as absence of violence;
2. Stability as governmental longevity or resilience;
3. Stability as existence of a legitimate constitutional order;
4. Stability as absence of structural changes;
5. Stability as multifaceted societal attribute;
6. Stability as behavioural pattern.

### **3. Analyses and observations in the case of Romania**

Regarding the case of Romania, our analysis starts from three questions: 1) Is the fiscal policy designed and administrated in a responsible manner? 2) Is the Romanian economy stable? 3) Is the political environment in Romanian stable? The responses to these questions will help us answering the basic question of the research project: what interdependencies exist between economic and political stability and the application of the fiscal policy while observing the principle of fiscal responsibility.

Some notes are necessary when analysing the situation in Romania. We started the research with the hypothesis that the economic and political environments from Romania are unstable. This instability is, however, relative, so that it could have been preferable to describe it in the hypothesis as precarious stability.

The interpretation of political (or economic) environment fluctuations can be done (I) observing the evolution of the domestic context or (II) observing the global context and determining the place of the national system within the international framework. For each of

these two perspectives we may have the following structure of the analysis:

1. Elements of political stability;
2. Elements of political instability;
3. Elements of economic stability;
4. Elements of economic instability.

### **3.1 Economic stability in Romania**

First, we try to evaluate the economic stability or instability in Romania based on its limited definition which refers to the absence of significant fluctuations. Below are just several significant macroeconomic evolutions. Obviously, in-depth analyses are possible, but we consider that these few elements are enough to show that, at least during the past decade, the economic evolution of Romania fluctuated between growth and decline and vice versa. Given the amplitude of these fluctuations we may say that, at least for the mentioned interval, the Romanian economy was characterized by a rather high level of instability.

(I) In the first approach, if we look at the domestic situation of the recent years, we may notice both elements of stability and instability:

1. Elements of economic stability:
  - a. The national economy had a rather constant path, if we monitor shorter time intervals;
  - b. At the regional level, or in the different economic branches, there is a high capacity of detachment from the elements that induce instability;
2. Elements of economic instability:
  - a. The sustained economic growth from the years before the crisis, followed by a period of decline and by fresh start of economic growth (at a rate that may be unsustainable). In 2007, Romania reported 8.5% GDP growth rate, followed the next year by a 7.1% decline. After a period of rather small rates of growth and decline, a high growth rate was reported for 2016. Most predictions give a lower rate of GDP growth for the subsequent years. This shows that GDP evolution fluctuated during the past decade.
  - b. Inflation decreased strongly, with some oscillation of the CPI over the last decade, from 6.6% in 2006, to a maximum of 7.9% in 2008 and -0.6% in 2015. The prognoses show a resumed growth towards 3% in 2018.

c. The RON/EUR exchange rate fluctuated from 3.52 in 2006, to 3.34 in 2007, and 4.45 in 2015. The fluctuations of the RON/USD exchange rate were even wider.

d. The unemployment rate fluctuated between 5.2% in 2006, 4% in 2007, 7.8% in 2009 and 5% in 2015.

e. After the strong increase, particularly in 2016, the prognoses (European Commission, 2016), show a significant lower rate of increase in public and private consumption.

f. Currently strong economic growth is recorded, largely based on consumption, which may cause macroeconomic imbalances, such as higher commercial deficit or higher inflationist pressure.

g. The fiscal policy is changed frequently.

h. The expenditure for investments decreased for the last few years, which erodes the resources for future economic growth.

i. Significant macroeconomic imbalances can be caused by the net international investment position, which is negative, by the limited exporting capacity, by the vulnerabilities of the banking sector, by the risks generated by the internal legislative evolutions (European Commission, 2015, 2016).

j. The political environment interfered into the economic environment both through legislative means, and by actions pertaining to corruption.

(II) In the second approach, if we look at the economic and politic situation of Romania within the international context:

1. Elements of economic stability:

a. The evolution of the national economies of the main foreign partners of Romania is generally (barely) positive, which consolidates the particular national sectors that are involved.

2. Elements of economic instability:

a. Romania is a small actor on the international scene, the turbulences on the international financial markets being able to have significant effects on the national economy.

b. Romania deploys efforts to integrate within a European Union which is currently experiencing a process of “disintegration”.

c. Most banks from the Romanian banking system have foreign capital, which is a significant vulnerability if financial crises occur.

d. The low prices of the raw materials supported the economic growth, but this situation is not predicted to continue on the long term.

### **3.2 Political stability in Romania**

The discussion of the political environment stability in Romania is based on the theoretical definition of the concept. The analysis of economic stability was evaluated on a span of 10 years. The same interval, with some exceptions, will also be used for the analysis of the political stability. Some observations can be, nevertheless, made to evaluate the situation according to the previous definitions. Beyond these general considerations, we considered that the interpretation of the fluctuations of the political environment in Romania can be done (I) looking at the evolution of the domestic context or (II) looking at the global context and determining the place of the national system within the international framework.

(I) In the first approach, if we look at the domestic situation of the recent years, we may notice both elements of stability and instability:

1. Elements of political stability:

a. There are several cycles of peaceful political succession, with free elections and with a, generally, good organisation. This shows the existence of a sustainable democratic environment.

b. There were no violent attempts to overturn the political order, and the extent of the manifestations and strikes is generally low. We may consider that the political environment in Romania is not characterized by (physical) violence. However, significant elements of violence can be traced in our recent history – the 1989 revolution, the changes or attempts to change the government by the miners, the street fights from Târgu Mureş and Bucharest in 1990.

c. The governmental longevity expands, sometimes, throughout the entire election cycle, but the change of several governments has been also noticed during this interval.

d. For the past 27 years there has been a legitimate constitutional order.

e. There is a rather clear separation of the powers within the state.

2. Elements of political instability:

a. There are situations in which the governments are changed under „street pressure” (for instance, the Ponta government, in 2015).

b. Political succession, by the alternative governance of parties with different political views, which shows a state of instability. The electoral struggle makes the governing parties or the parties

having parliamentary majority to attempt imposing populist economic measures, which are extremely relevant within the context of analysing the fiscal responsibility.

c. There have been political movements labelled as attempted coup d'état (July 2012).

d. There are semi-permanent conflicts between the main political institutions (Presidency, Government and Parliament).

e. There is at least one flagrant situation of disregarding the popular will expressed by referendum (2009).

f. The trust of the population in the political institutions is very low.

(II) In the second approach, if we look at the politic situation of Romania within the international context:

1. Elements of political stability:

a. Romania consolidated a system of political and military alliances and joined the European Union.

b. Romania was not involved in direct military conflicts with other states.

2. Elements of political instability:

a. Brexit – British exit from the European Union is an event of major importance that will likely affect Romania too.

b. Regional geopolitical tensions – relations such as Russia-Ukraine, Russia-Turkey, Russia-Baltic States, Russia-European Union, Russia-NATO, Russia-Romania, Russia-Moldova, Hungary-European Union, Hungary-Romania.

c. Terrorist attacks in Europe, which cause deep changes both domestically and in the relations between states.

d. The refugees' crisis.

e. Attempted coup d'état in Turkey.

f. Political polarization in Europe and the USA (an updated and detailed description can be found in World Bank, 2016).

Beyond these observations, several other elements can be used to describe a political environment understood to be unstable. For instance, in a classification of political stability conducted by The Global Economy, Romania is on position 95 out of 191 countries, with a score of +0.08 (Lichtenstein is on the top position, with a score of +1.54, while Syria is on the last position, with a score of -2.76. In this case, the indicator of political stability measures the perceptions regarding the possibility of political instability occurrence using

different sources, and includes elements such as manifestations and riots, acts of terrorism, civil war or interstates war.

### **3.3 Fiscal responsibility in Romania**

We know well that the populist economic measures taken in the elections year 2008, just before the economic crisis broke out in Romania, had adverse and long-lasting economic and social consequences. The elections year 2016 is a good platform for comparison, making it easier to see how strong the inclination of the political environment to manipulate the economic policies is.

The effects of the populist and electoral measures are most often ambiguous and difficult to analyse. Therefore, the investigation of the relation between the election cycles (and the election years, particularly) and the impact of the changes in the economic policies done with political purpose, is a rather complex effort. Such attempt has been done in Ciumara, Lupu and Criste (2015).

Attempts have been made to impose fiscal responsibility, for instance, through legislative measures. This was certainly a step forward, but the use of derogations is a common governmental practice, which makes the limitations imposed by law to be rather useless. To implement the fiscal policy particularly, and the economic policies in general, it is not enough to have a responsible Government, which carry out the legal fiscal requirements; a Parliament acting in a responsible manner is also necessary.

In defining the notion of fiscal responsibility, the idea of ensuring the sustainability of the fiscal position has also been introduced. It was recently noticed (Dumitru, 2016), that a third of the pensions paid in 2016 are covered by borrowed money. In other words, the young generations start in life with the financial burden of the fact that their forerunners lived on debt. If this is the state of facts, a proof of responsibility would be at least assuming the situation, covering the current deficits by dedicated loans and resetting the system so that these adverse evolutions can stop.

The fiscal responsibility law in Romania refers to the obligation of the Government to administer in a prudent manner the fiscal policy and to manage the budgetary resources and obligations, as well as the fiscal risks, in a manner that supports the sustainability of the medium and long-term fiscal position. Thus, the Government must legally meet a set of fiscal-budgetary policy objectives:

- a) Maintaining the public debt at a sustainable medium and long-term level;
- b) Prudent administration of the resources and obligations assumed by the public sector and of the fiscal-budgetary risks;
- c) Maintaining, at an adequate level, the budget resources covering the payment of the public debt service;
- d) Ensuring the predictability of the rates and bases of taxation.

However, the theory (in this case, the law) is often contradicted by the reality (or practice), and the Government frequently fails to operate in a manner fitting the definition of the principle of responsibility, both due to reasons pertaining to own mechanisms and to conditions imposed by additional laws. In support of this statement, the 2015 Annual Report of the Fiscal Council of Romania noticed that elements in flagrant contradiction with the principles of the fiscal responsibility law were introduced in the budget framework for 2016-2018. It also noticed that the Government frequently failed to present in a proper manner the fiscal problems for analysis within the Council.

For instance, the fiscal responsibility law stipulates, under article 15, that when proposing legislative initiatives whose adoption involves increasing budget expenditures, the initiators must also describe the financial effects of the particular initiative, taking into consideration the expected changes in the budgetary revenues and expenditures for the subsequent 5 years, as well as realistic proposals to cover the increased expenditure or the lower revenues (Law 500/2002, art. 15). Furthermore, the initiators must also include a statement according to which the additional expenditure is compatible with the strategic objectives and priorities specified in the fiscal-budgetary law, with the annual budget law and with the ceilings of expenditure stated in the fiscal-budgetary strategy (Law 69/2010, art. 15). However, the analysis of the legislative propositions shows that the members of the Parliament systematically ignore the legal requirements mentioned above.

Looking at these matters within the context of elections, we also notice the very important problem of article 17 from Law 69/2010, which stipulates that normative acts that lead to higher expenditures with personnel or with the pensions from the budgetary sector can be promoted with at least 180 days before the mandate of the acting Government expires, in agreement with article 110,

paragraph 1 from the Constitution of Romania, republished. To exemplify, the mandate of the current Government lasts up to the date of validation of the 2016 elections, which will take place in December. Thus, according to the law, such normative acts should have not been promoted starting with June.

Taking a brief look at the actions of the last year, we may notice that the legislative process was confronted with several proposals that had a significant potential impact on the economy and which are susceptible of having an election and populist dimension.

The year 2016 raised additional challenges to the responsible management of the fiscal policy, given the elections. As far as we know, the politicians were not interested by the possibility provided by the fiscal responsibility law to calculate the financial impact of the policies proposed in the electoral programs of the political parties. However, besides the electoral programs of the parties, which require dedicated analysis, many legislative proposals have been submitted in 2016, whose content affects fiscal policy and which may also be interpreted in an electoral key. Part of them reached the stage of implementation.

It is not our opinion that all of these legislative proposals are incorrect, but the manner of their formulation might have preponderant electoral motivations and only in (small) part are based on coherent economic policies. We should understand the context in which these legislative proposals are developed. Some of them are in clear breach of legislation or are susceptible of affecting substantially the economic and social development of Romania, but these facts do not determine their initiators to submit the proposals accompanied by proper impact analyses. Some of these proposals were submitted even though their initiators were well aware that they cannot be adopted, the only purpose being to add to the resume of the initiators, which is to be shown to the voters during the elections campaign. It is a sure fact that these proposals target “receptive” electoral segments, which the initiators perceive as being ready to give their votes to people offering them something concrete, even though at a disproportionate cost for the rest of society.

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