

STRUCTURAL BUDGET BALANCES IN THE STABILITY AND GROWTH PACT FRAMEWORK

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European Monetary Union has changed the fiscal policy framework for EU Member States. Fiscal policy has become more important, since national policy-makers can no longer rely on a monetary policy tailored on national needs nor on exchange rate adjustments. Moreover, stabilisation policies are to be carried out without breaching the 3 per cent of GDP limit set for the deficit and taking the level and dynamics of the debt into account. There is a need to combine budgetary discipline and fiscal flexibility. The Resolution of the European Council on the Pact indicates a solution: the *“adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the value of 3% of GDP.”* In other words, to have adequate room for manoeuvre during recessions, governments should aim for surpluses or nearly balanced budgets in other periods.

The new EMU framework enhances the importance of structural budget balances, which assess the budgetary position net of the cyclical component and provide an indication of the available room for manoeuvre. Structural balance estimates are essential for the effectiveness of the multilateral surveillance mechanism introduced by the Maastricht Treaty and completed by the Stability and Growth Pact. Past experience indicates that policy-makers often let the structural deficit increase in periods of relatively high economic growth. In other words, part of the improvement of budgetary balances stemming from the cycle was used to carry out expansionary discretionary policies. Thus the success of monetary union

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appears to require substantial changes in the policies implemented in good times. This requires, *inter alia*, also instruments allowing an accurate monitoring of budgetary situations.

Figure 1, in which the overall budget balance and its cyclical and discretionary components are pictured against the output gap, stylises the fiscal policy framework underlying the Pact and highlights the role of structural balance budgets. The figure is drawn by assuming that the government maintains a balanced budget position when the output gap is zero, a neutral discretionary policy and a cyclical sensitivity of the budget of 0.5, which is the average for the EMU countries. If we split the budget balance in two parts, the structural and the cyclical component, the Pact calls for a balanced (or nearly balanced) structural budget. The cyclical component of the balance moves up and down with the output gap, that is with the gap between the actual level of GDP and the level consistent with trend GDP growth. The structural balance is stable. In good times there is an overall surplus. In recessions there is a deficit. The comparison of

Fig. 1

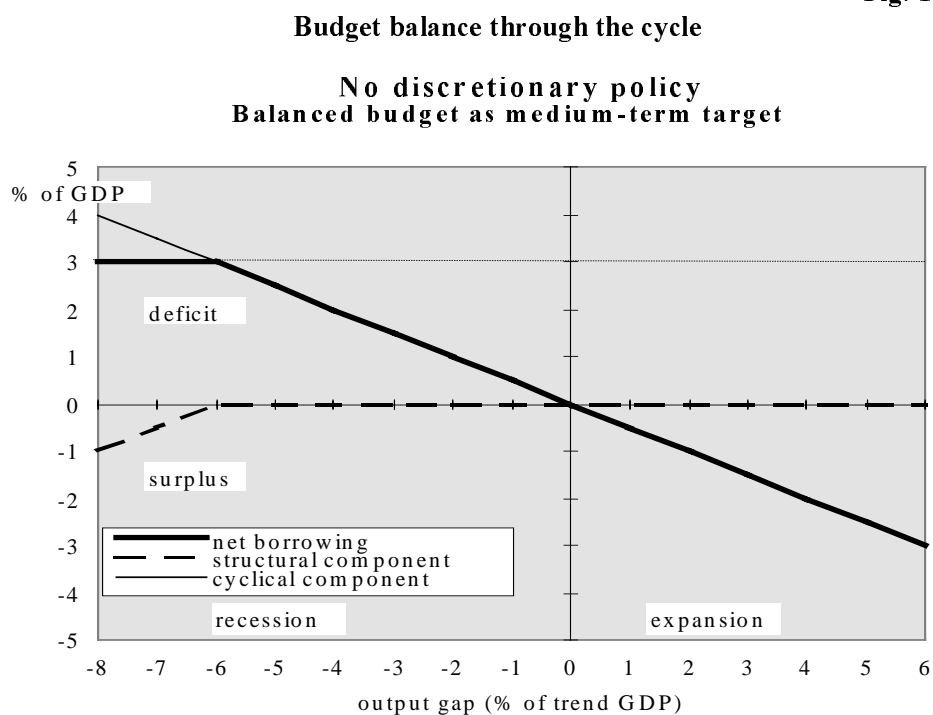


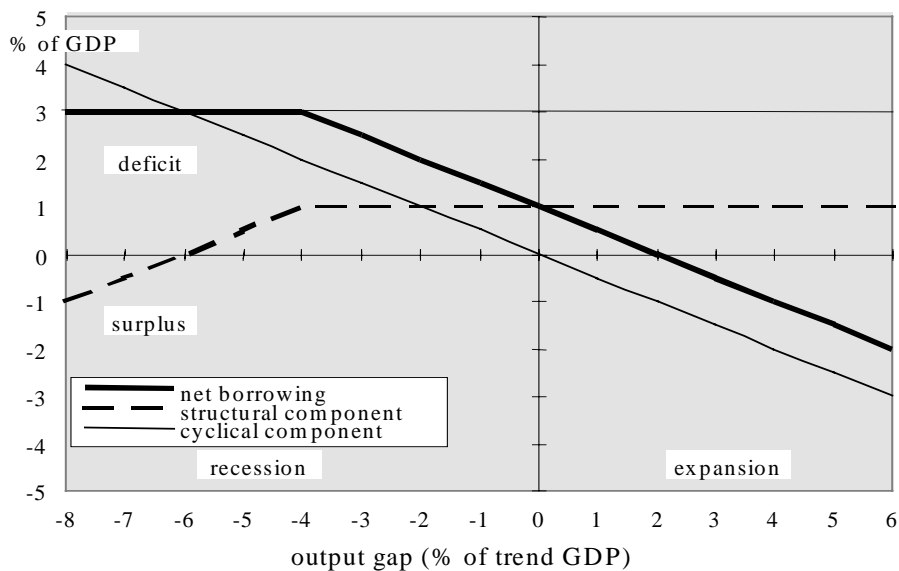
Figure 1 and Figure 2, the latter assuming a 1 per cent structural deficit, points to a clear trade-off: the higher the structural deficit the more likely it is that the 3% limit is reached and the country has to decide whether to implement pro-cyclical policies or be sanctioned.

Underlying the Pact there is a rational policy design that, in principle, allows to combine stabilisation policies with fiscal restraint. The evaluation of the structural balance is at the core of this design. This is clearly stated in the Opinion by the Monetary Committee on the *Content and format of Stability and Convergence Programmes*, which was endorsed by the European Council on October 12, 1998: “It is therefore clear that the assessment of the appropriateness of Member States’ medium-term objectives and the examination of their fulfilment has to take explicit account of the cyclical position and its effect on the budget. The time frame for interpreting the medium-term would be the length of the business cycle.”

Fig. 2

Budget balance through the cycle

No discretionary policy
1% deficit as a medium-term target



The adjustment of budget balances to cyclical conditions is a widely used technique that allows to evaluate the structural budget situation. The automatic effects of economic fluctuations on expenditure and revenues are filtered out in order to assess whether the government is taking action towards consolidation or has an expansionary discretionary policy. A number of methodological and empirical problems, which pertain both to the evaluation of the output gap and the elasticity of the budget to the cycle, suggest a great deal of caution in interpreting structural balances. They also point to the need for further analysis of the issue.

The present volume contributes to the debate on structural budget indicators with a set of essays produced by experts from the European System of Central Banks, the European Commission, IMF and OECD. The preliminary drafts of the papers were presented at a workshop organised by the Bank of Italy on November 28-29, 1998, in Perugia. The workshop allowed ESCB and international organisation experts to review the main methodological issues, to discuss the advantages and disadvantages of alternative indicators, to highlight the problems and the possible solutions.