

COMMENTS ON SESSION 1 FISCAL STABILISATION

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The Banca d'Italia public finance workshop typically brings together a wealth of excellent research papers, with the right blend of theory, empirics and practice. Participating in this workshop is a stimulating and intellectually rewarding experiment, and I would like to thank Daniele Franco and the Banca d'Italia for giving me this year the opportunity to discuss this first session on fiscal stabilisation.

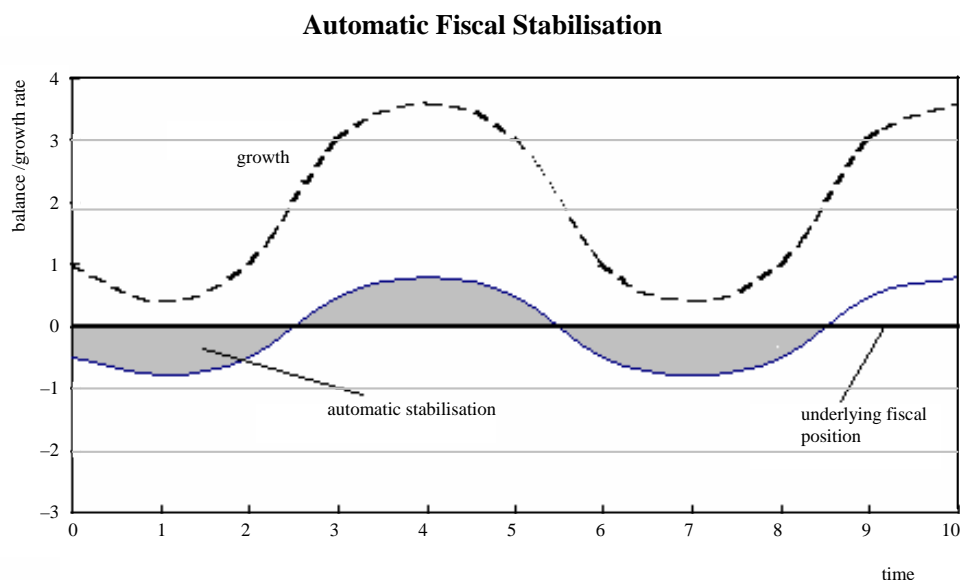
Reading the seven excellent papers covering most key issues in fiscal stabilisation, the first question that came to my mind was: what do economists really know about fiscal policy and economic fluctuations? I also came to the conclusion that there is quite a difference between theory and practice when dealing with fiscal stabilisation. Reflecting on my own experience and background as a theorist rather than an applied economist, I would qualify my learning process as an unpleasant journey from theory to practice.

Theory certainly is an economist's seventh heaven, in which economic developments are easy to explain. Automatic fiscal stabilisation mainly results from features of taxation and social transfers, which are built into tax codes and social legislation. The resilience of the main government spending components with respect to economic fluctuations, which are precommitted in annual budgets or even in multi-annual expenditure rules, also contributes to smoothing out economic fluctuations. Chart 1 depicts an imaginary economy – one that is typically analysed by theorists – with cyclical fluctuations of real GDP growth around trend and shows how macroeconomic fluctuations translate into a cyclical pattern of the budgetary balance. In this example, the underlying budgetary position – the so-called structural or cyclically-adjusted budget balance – reflected by the thick line is unchanged and balanced by assumption. This would be a government's fiscal position in the absence of economic fluctuations. The shaded area indicates the impact of automatic stabilisers on the actual budgetary balance marked by a "cyclical breathing" around the balanced position. Automatic stabilisers thus cause the budgetary balance to follow the same pattern as output growth.

There is a clear and unequivocal distinction between discretionary fiscal policy and automatic stabilisation in theory. A fiscal consolidation strategy aimed at achieving a close-to-balance budgetary position can easily be represented on a similar chart. On Figure 2, the thick line reflects the consolidation path, which leads to medium term balanced budgets, while the thin line reflects a possible example of the nominal annual budget targets. The latter also takes into account automatic stabilisation following the cyclical conditions as reflected in Figure 1. The bracket

* European Central Bank. The views expressed in this comment are my own and do not necessarily reflect those of the European Central Bank.

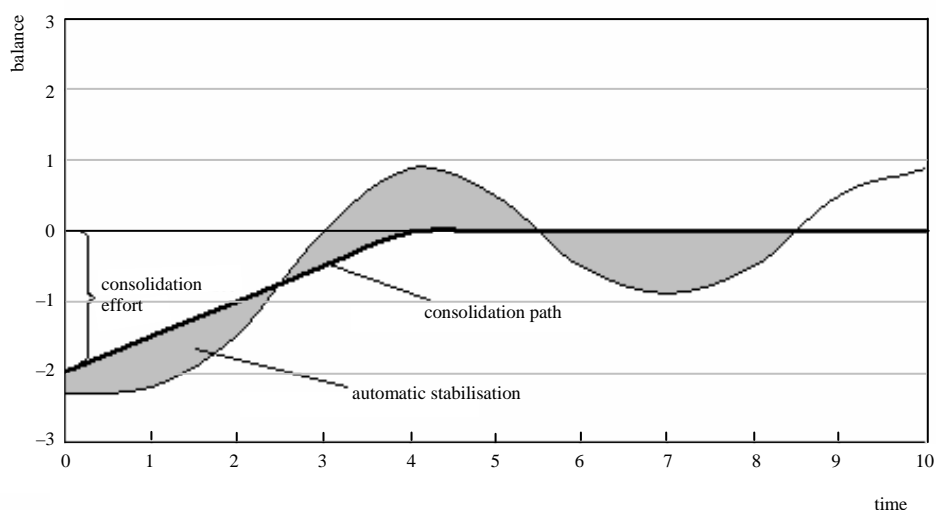
Figure 1



Source: ECB, Monthly Bulletin, April 2002.

indicates the necessary consolidation effort, while the grey area again depicts the effect of expected cyclical developments on the actual budgetary position. The example illustrates a linear consolidation path and shows that the annual nominal adjustment is smaller in times of low growth (here at the beginning of the adjustment period) and greater when growth is near or above trend. What is of course remarkable on this theoretical example of a fiscal consolidation strategy is the clear distinction between consolidation effort and the budgetary impact of the cycle.

Let me now move from theory to practice, and briefly review the economists' toolkit for fiscal policy analysis and surveillance. Fiscal surveillance requires disentangling the role of discretionary fiscal policy measures from the budgetary impact of economic cycles. The contributions to this session provide a rather comprehensive list of tools used in fiscal policy analysis, ranging from regression models and VARs to model-based simulations. When reading them, I felt at crossroads. The different contributions to this session to some extent reflect the tension between the difficulty to reach an unequivocal assessment of actual fiscal policies with the help of the economist's toolkit and the willingness to further refine this toolkit with a view to making such an assessment. This also raises another important question: to which extent should one trust the economist's toolkit in fiscal surveillance?

Figure 2**Discretionary Fiscal Policy and Automatic Stabilisers**

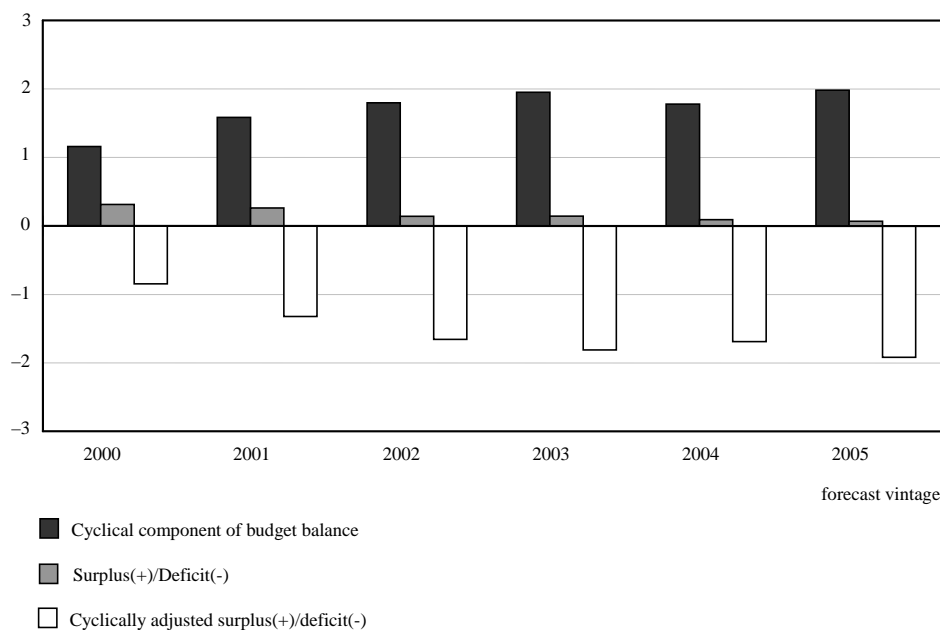
Source: ECB, Monthly Bulletin, April 2002.

Are estimates of underlying budgetary positions reliable in real time? Reliability of cyclically-adjusted budgetary indicators can be easily assessed on the basis of a visual inspection of Figure 3. Figure 3 shows the successive Commission's estimates of the euro area cyclically-adjusted balance (CAB) for 2000. In 2000 the euro area cyclically-adjusted deficit was estimated at 0.8 percent of GDP. Five years later, in 2005, the 2000 cyclically-adjusted deficit was estimated to be just below 2 percent of GDP. This difference is mainly attributable to revisions in the estimates of the cyclical component of the 2000 budget balance, ultimately to revisions in output gap estimates, with a limited impact from revisions in government finance statistics.

While the year 2000 was perhaps exceptional – being a turning point in the business cycle – uncertainty related to measurement in real time may also be rooted in more systematic measurement errors. Chart 4 suggests that there could be a systematic underestimation of output gaps in real time, mechanically leading to an overestimation of CABs in real time. One should certainly not conclude from this that real time indicators are useless for fiscal policy surveillance. However, they should be assessed with caution, and complemented with expert judgment.

Figure 3

Euro-area Cyclically-adjusted Budget Balance, 2000
(percent of GDP)



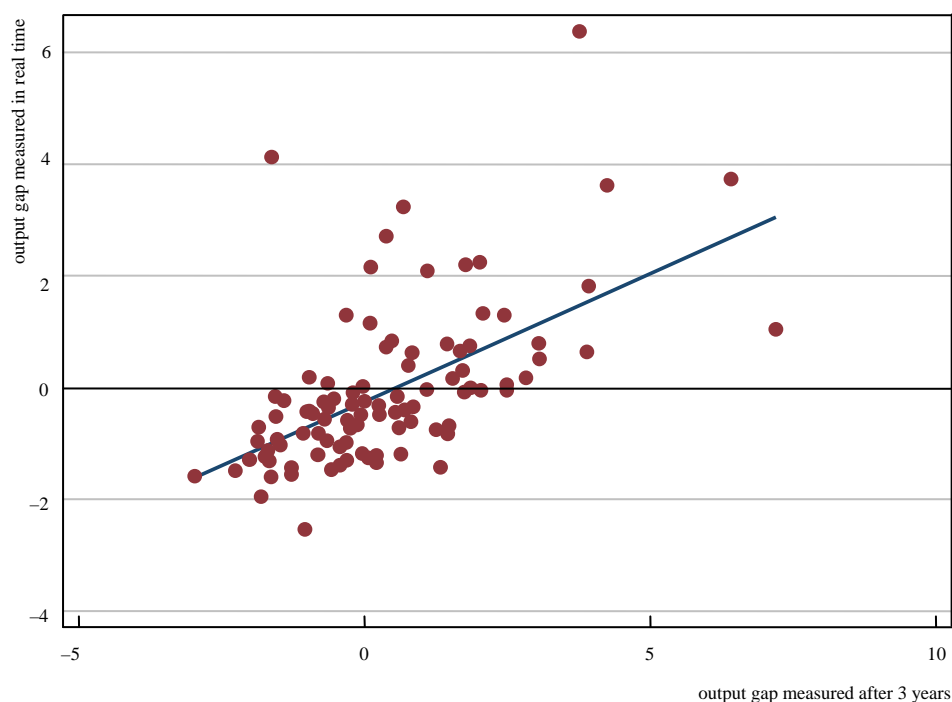
Source: European Commission, Ameco database.

When assessing fiscal policy, one should be aware that in practice fiscal experts are confronted with a wealth of uncertainties. To calculate cyclically-adjusted budget balances, for example, one also needs estimates of budgetary sensitivities, which measure the impact of macroeconomic developments on budget balances. Budgetary sensitivities may well be imperfect estimates of the budgetary impact of economic fluctuations. Imperfection calls for refinements and exploration of new research avenues. Calculating cyclically-adjusted balances based on output gaps ignores the budgetary effects of the composition of growth. To account for such effects Bouthevillain *et al.* (2001)¹ have proposed a disaggregated method for the calculation of cyclically-adjusted budget balances. Macroeconomic tax bases also are very imperfect proxies, and could be refined by accounting for asset price developments (Morris and Schuknecht, 2007).² When confronted with

¹ Bouthevillain, C., P. Cour-Thimann, G. van den Dool, P. Hernández de Cos, G. Langenus, M. Mohr, S. Momigliano and M. Tujula (2001), "Cyclically-adjusted Budget Balances: An Alternative Approach", ECB, Working Paper, No. 77, <http://www.ecb.int/pub/pdf/scpwps/ecbwp077.pdf>

² Morris, R. and L. Schuknecht (2007), "Structural Balances and Revenue Windfalls: The Role of Asset Prices Revisited", ECB, Working Paper, No. 737, <http://www.ecb.int/pub/pdf/scpwps/ecbwp737.pdf>

Figure 4

Real-time and *ex post* Output Gaps of Euro-area Countries, 1996-2003

Source: ECB calculations, based on European Commission's Ameco database.

the limitations of indicators, a natural inclination is to call for further refinements. Refinements may however bring about more complexity.

I would like to conclude this discussion by stressing that this call for further refinements and increased complexity of tools used in fiscal surveillance might unfortunately come at a cost. This cost stems from the traditional trade-off between enforcement and complexity. From the standpoint of economic analysis, I have no doubt that more refined, sophisticated indicators are needed and would ultimately increase our understanding of fiscal policies. In real time, cyclically-adjusted indicators are by nature surrounded by significant uncertainty. They are therefore not able to give unambiguous signals on the underlying fiscal positions or the fiscal stance. In a rules-based framework, ambiguous indicators, which are subject to significant revisions *ex post*, presumably raise monitoring costs and reduce pressure on fiscal policy makers to comply. In this respect headline government finance statistics are more transparent and easier to understand for the public at large than cyclically-adjusted budgetary figures; they are also less subject to revisions. This

lends support to the prominent role of the government deficit and debt reference values of 3 and 60 percent of GDP, respectively, as nominal anchors in EU budgetary surveillance.

The papers, and research results presented in this session, point to four key challenges for EU fiscal surveillance, which I would like to put forward as issues for discussion:

How to reconcile the wide margins of uncertainty surrounding cyclically-adjusted budget indicators and their role in EU fiscal surveillance;

Can further refinements to cyclically-adjusted budget indicators improve their reliability in real time?

Can expert judgment alleviate the shortcomings of cyclically-adjusted budget indicators?

Overall, the key question is, how to make the best use of the economist's toolkit in real-time fiscal surveillance? This implies to find the right trade-off between the sophistication of economic analysis and enforcement of fiscal rules.