The operation of automatic fiscal stabilisers in the euro area

Automatic fiscal stabilisers are the reaction of the budget to economic fluctuations in the absence of any government action. These stabilisers, if well designed, provide timely and symmetrical adjustments which cushion cyclical fluctuations. However, the full benefits of automatic stabilisers can only be secured if, at the same time, countries preserve the sustainability of public finances through prudent fiscal positions and low debt.

This article argues that fiscal stabilisation and sustainability are fully compatible. They are complementary aspects of a fiscal strategy seeking to achieve a medium-term budgetary position close to balance or in surplus, as required by the Stability and Growth Pact. In such a strategy, the nominal targets for budgetary balances which Member States set in their stability programmes should reflect both an appropriate medium-term consolidation path, if imbalances persist, and the impact of the economic cycle. Actual outcomes may be permitted to deviate from targets to reflect automatic stabilisation when expected economic developments do not materialise. Nevertheless, sound budgetary positions or the underlying consolidation path should be maintained and excessive deficits must be avoided.

Such a strategy of attaining and preserving safe budgetary positions while allowing for automatic stabilisation also supports a stable, growth-enhancing macroeconomic environment. By comparison, there are considerable doubts about the effectiveness of discretionary fiscal fine-tuning as a way of achieving cyclical smoothing. However, decisive discretionary government action is necessary for the structural adjustment of public finances and fiscal consolidation.

1 The importance of economic stability

A stable and predictable economic environment contributes to social and economic welfare. In the short run, households prefer to have economic stability with continuous employment and stable incomes, allowing them to maintain relatively stable consumption over time. In the long run, large unexpected shocks and economic fluctuations can reduce growth, for example, by heightening the risks associated with investing and innovating. A highly volatile economic environment might induce people to choose less risky (but perhaps also less productive) education profiles and career paths. By maintaining a stable macroeconomic environment, economic policy thus contributes to economic growth and welfare.

Fiscal policy can contribute to stability in the short term by smoothing economic fluctuations. This article focuses on the way fiscal stabilisation operates and how stability can best be achieved. The short-term stabilising function of fiscal policy can become more important for individual countries when they enter into a monetary union. In such a union, short-term nominal interest rates are not adapted to the situation of individual countries, but are attuned to the conditions of the union as a whole. Of the instruments that remain under the control of individual governments, fiscal policy then is important for stabilising domestic demand and output in the short term.

Fiscal policies are also important for the long-term stability of the economy. Fiscal policies that try to boost economic activity by increasing expenditure can result in higher spending-to-GDP ratios, and this subsequently requires either raising the tax burden or accepting growing deficit and debt ratios. If such policies reduce the availability of financing to the private sector and undermine the sustainability of public finances, long-term interest rates will rise and growth prospects will decline. Moreover, persistent deficits undermine the stabilising role of public finances. When countries continuously incur additional liabilities, governments lose the necessary room for manoeuvre to let public finances react appropriately to macroeconomic fluctuations over the business cycle. Countries with unsustainable deficits thus face unavoidable and disruptive large-scale adjustments in the future.

The sustainability of public finances and the stabilising role of fiscal policies are closely linked. If people expect sustainability problems in the future then they can change their behaviour today and, for example, reduce investment, thereby undermining economic stability in the short run. In a monetary union, high deficits and rising debt levels in one or several countries can have further costs. They could raise long-term interest rates and inflationary expectations for the area as a whole, thereby creating negative externalities and undermining monetary policies oriented towards price stability.

The next section explains the operation of automatic stabilisers, their limitations and the appropriate role for discretionary fiscal policy. It also outlines some characteristics of public finances in the euro area over the past 30 years. Section 3 explains the objectives of the Maastricht Treaty and the Stability and Growth Pact to attain and maintain sustainability, and the stabilising role of public finances. Section 4 then discusses an appropriate fiscal strategy consistent with these two objectives. The final section summarises the article and presents the conclusion.

2 The role of fiscal policy in stabilising economic activity

Fiscal policy instruments can contribute to the stabilisation of the economy in several ways. They can stabilise output, incomes and demand during an economic downturn by maintaining or even increasing government expenditure, or by reducing tax revenue. By the same token, they can moderate activity during periods of strong growth. Stabilisation can result from discretionary policy-making, where governments actively decide to adjust spending or taxes in response to changes in economic activity. By contrast, changes in government revenue and expenditure which occur without requiring new decisions by policy-makers and result from the impact of economic fluctuations on budgetary components are called automatic fiscal stabilisers.

Automatic stabilisation of demand and output via public expenditure and revenue

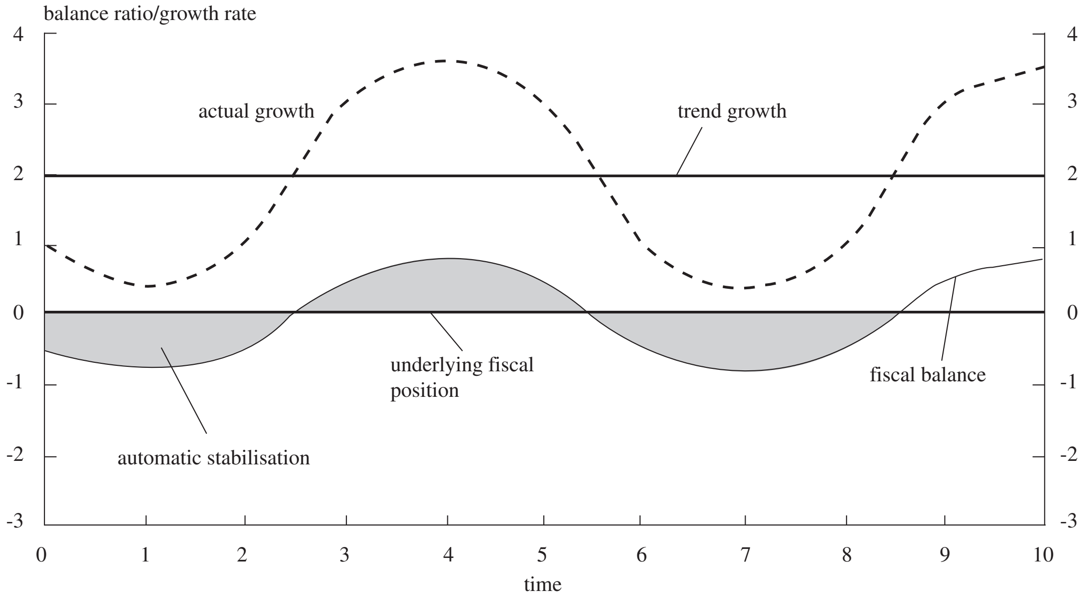
Automatic fiscal stabilisation results from certain features of taxation and social transfers that are built into tax codes and social legislation. At the same time, it stems from the resilience of major spending components with regard to economic fluctuations, since these components are pre-committed in annual budgets or even in multi-annual expenditure rules.

To illustrate this mechanism, consider a government planning to have a balanced budget in a given year. Now suppose that economic activity turns out to be weaker than the government had projected, owing to lower consumer demand, for example. Most of the income received by the government (mainly taxes) would then decrease more or less in proportion to the lower growth of the economy. Most of the government's expenditure, which translates into income for households and enterprises, would remain unaffected (mainly pensions, public sector wages and subsidies), or could even increase (unemployment-related outlays). For the government, the consequence is a deterioration of its budgetary balance, whereas households and enterprises can stick more closely to their original spending plans, thereby supporting total demand and cushioning the slowdown in economic activity.

Chart 1 depicts a hypothetical economy with regular and symmetrical cyclical fluctuations

Chart 1

The operation of automatic stabilisers over the cycle



of GDP growth around a trend and shows how macroeconomic fluctuations translate into a cyclical pattern of the budgetary balance. In this example, the underlying fiscal position represented by the lower thick line is unchanged and balanced by assumption over the cycle. The shaded area indicates the impact of automatic stabilisers on the budgetary balance marked by "cyclical breathing" around the balanced position. Automatic stabilisers thus cause the budgetary balance to follow the same pattern as growth.

Trade-off between the size of automatic stabilisers and efficiency

With a given cyclical pattern of the economy, the amplitude of budgetary fluctuations reflects the size of automatic stabilisers which, in turn, is largely determined by the tax and expenditure system. Normally, the larger the public sector, the larger the automatic fiscal stabilisers. The higher the public spending-to-GDP ratio, the more the economy is effectively shielded from economic fluctuations. On the revenue side of the budget, fiscal stabilisation increases with the progressivity of the tax system. Box 1 gives an explanation of the extent to which the budget is sensitive to the cycle in euro area countries, and of how a measure of the underlying fiscal position – the so-called cyclically adjusted or structural balance – can be constructed.

Higher public spending also requires higher revenues, and here is where the first main trade-off of large automatic stabilisers comes in. A high tax burden and generous social payments reduce incentives to work, invest and innovate and thereby weaken economic activity (see the article on fiscal policies and economic growth in the August 2001 issue of the Monthly Bulletin). Moreover, sizeable automatic stabilisers can delay the adjustment of an economy. Generous unemployment benefits, for example, reduce the incentives for laid-off workers to seek new employment, to accept different employment conditions or to retrain. High taxes coupled with subsidies for ailing industries can similarly make it less profitable for firms to adjust to changing economic opportunities, leading to a significant loss of efficiency.

Discretionary fiscal policies are normally not suitable for short-term demand management

Discretionary fiscal policies consist of changes in revenue and expenditure resulting from government action, such as changes in tax rates or social transfers, increases in the number of civil servants or in public sector wages, and adjustments in government investment. Past attempts to manage aggregate demand through discretionary fiscal policy-making – or fiscal fine-tuning – have been widespread but often counterproductive.

First, discretionary policies can undermine the healthiness of budgetary positions, as governments find it easier to increase spending in times of low growth than to reduce expenditure and tighten fiscal policy during economic upturns. This induces a tendency for continuous increases in deficits and the tax burden. By contrast, automatic stabilisers operate symmetrically over the economic cycle, moderating overheating in boom periods and supporting economic activity during economic downturns, in principle without affecting the underlying soundness of budgetary positions as long as fluctuations remain balanced.

Box 1

Cyclically adjusted budget balances

Cyclical adjustment facilitates the monitoring and analysis of fiscal policies

Fiscal policy cannot be easily assessed on the basis of developments in actual government balances, since these reflect the impact of the cycle via the operation of automatic stabilisers, interest expenditure and new policy measures approved by the government. These factors need to be disentangled if fiscal developments are to be monitored accurately.

The fiscal balance adjusted for the impact of automatic stabilisers is the cyclically adjusted or structural budget balance. One approach to computing the structural balance is to first estimate budgetary sensitivities, which measure the automatic impact of a 1 percentage point change in output on the fiscal balance. Empirical studies by various organisations suggest that budgetary sensitivities in the euro area range from 0.3 to 0.7 for individual Member States. In the euro area on average, a 1 percentage point increase (or decrease) in real GDP growth therefore improves (or worsens) the budget balance by 0.5 percentage point of GDP owing to the operation of automatic fiscal stabilisers. As a second element, some measure of trend (or potential) output is required in order to gauge the cyclical position of the economy. The cyclical component can then be estimated and subtracted from the actual balance to obtain the structural budget balance, which indicates the consolidation needs or efforts of a country. A high cyclically adjusted deficit, for example, suggests that a country still has to make considerable adjustment efforts before a safe budgetary position is attained.

Suppose, for example, that a country has a budgetary sensitivity of 0.5, the surplus has improved from 1% of GDP in the previous year to 2% in the current year, and actual growth is reported to be 3%, 1 percentage point above potential growth. In this scenario, half of the budgetary improvement of 1 percentage point can be attributed to the effect of automatic stabilisers (the budgetary sensitivity of 0.5 multiplied by the 1 percentage point difference between actual and trend growth), with the other half resulting from fiscal consolidation and changes in interest payments. Thus, while the actual budget balance is up by 1 percentage point, the cyclically adjusted budget balance would only improve by 0.5 percentage point, reflecting the country's active consolidation efforts.

Consequently, the cyclically adjusted budget balance is one measure of the fiscal policy stance. In addition, interest expenditure can be subtracted to obtain cyclically adjusted primary balances. Some observers argue that this is the more appropriate measure for assessing a government's fiscal policy stance, insofar as interest expenditure is the consequence rather than the cause of expansionary fiscal policies or consolidation efforts.

Caution is required when interpreting the estimates

Cyclically adjusted figures are imperfect indicators of the medium-term budgetary position and of consolidation efforts and needs. First, there are methodological problems in estimating budgetary sensitivities and trend growth. Second, temporary factors affecting the budget still need to be considered when interpreting cyclically adjusted budgetary figures. Changes in cyclically adjusted balances are more useful for measuring annual consolidation efforts, since they are less sensitive to the choice of methods and less volatile over time than levels. The table below illustrates this point by comparing cyclically adjusted budget balances and their annual changes in 2001, as recently estimated by three international organisations.

Estimates of euro area cyclically adjusted budget balances in 2001

(in percentage points of GDP)

	Changes		Levels	
	2001 spring	2001 autumn	2001 spring	2001 autumn
European Commission	-0.2	0.0	-0.9	-1.3
OECD	-0.1	0.0	-0.7	-0.9
IMF	-0.1	0.0	-0.6	-0.7

Sources: European Commission: European Economy, Supplement A, March/April 2001 and October/November 2001; OECD: Economic Outlook, June 2001 and December 2001; IMF: World Economic Outlook, May 2001 and October 2001.

Second, such policies may be less flexible in reacting to economic conditions than automatic stabilisers. Automatic stabilisers are directly linked to the structure of the economy and therefore respond in a timely and foreseeable manner, helping economic agents to form correct expectations and enhancing confidence. They also react with an intensity that is adapted to the amount to which economic conditions deviate from what was expected when the budget plans were approved. These features of automatic stabilisers are almost impossible to replicate with discretionary reactions by policy-makers. For instance, tax changes must usually be adopted by parliament and their implementation typically lags behind the budget-setting processes. Not surprisingly, therefore, discretionary fiscal policies aimed at aggregate demand management have tended to be pro-cyclical in the past. They often only became effective when cyclical conditions were already reversing, thereby possibly exacerbating macroeconomic instability.

The scope for discretionary fiscal policies

Discretionary policies are needed to implement structural changes in public finances and to deal with exceptional situations, particularly when the economy experiences extraordinary shocks. First, discretionary policies reflect the changing priorities of public spending, its level and composition, and the rates and characteristics of different taxes. These policies determine the structure of public finances, which in turn substantially affects the functioning of the economy and, as mentioned above, the features of a country's automatic stabilisers.

Second, discretionary fiscal policy decisions are needed to preserve the sustainability of public finances in the medium term. This is the precondition for automatic stabilisers to operate freely. In particular, when sustainability is in doubt, expansionary measures and even automatic stabilisers may not have the desired effect on output as people adjust their behaviour to expectations of a likely future fiscal crisis. Consolidation measures may then restore confidence and improve expectations about the long-term outlook for public finances. Such "non-Keynesian" effects are likely to reduce the negative economic impact of fiscal consolidation. Active fiscal consolidation using discretionary policies is therefore appropriate when budgetary positions are unsound or when there are risks to fiscal sustainability arising from high debt and future fiscal obligations (e.g. owing to population ageing).

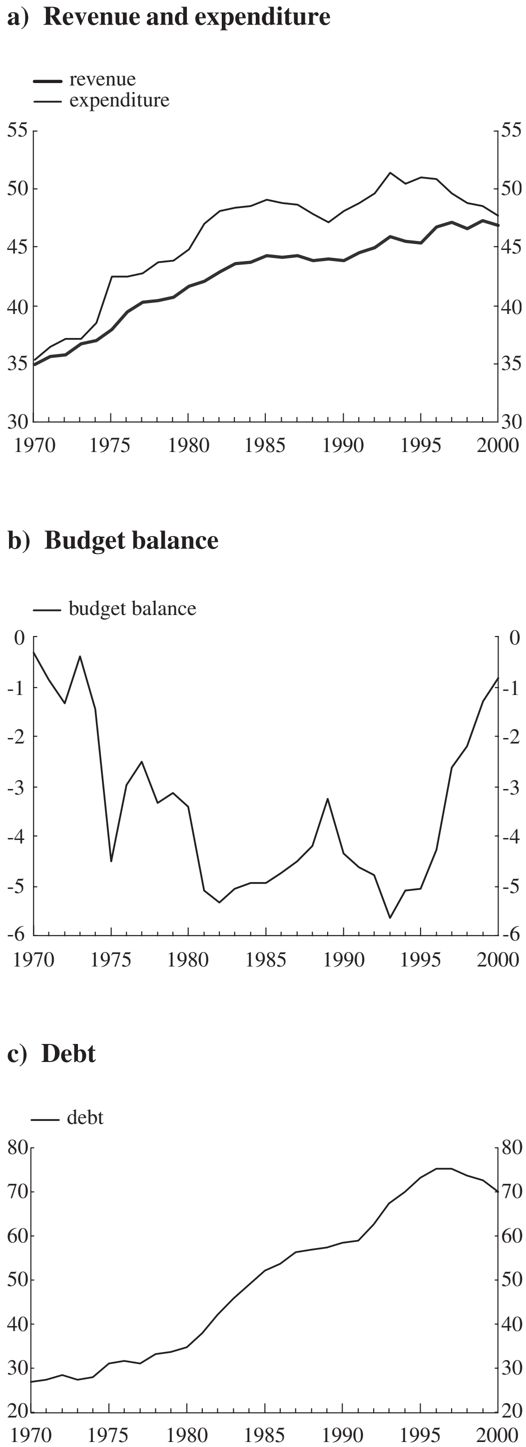
Finally, although automatic fiscal stabilisers are effective in dampening normal cyclical fluctuations, there are situations where active policy decisions might be needed. Automatic stabilisers alone might not be sufficient to stabilise the economy when economic imbalances do not stem from normal cyclical conditions or are considered irreversible. Discretionary policies in such situations may also have desirable supply-side effects. However, the benefits to be gained from expansionary policies in a recession must still be assessed against the risks to long-term sustainability, persistent adverse effects on the structure of public finances, such as a permanently higher tax level, as well as the economic costs of an eventual policy reversal.

Lessons from the past

A number of studies have found that public finances in euro area countries from the mid-1970s to the mid-1990s performed poorly in stabilising their economies. During some episodes, fiscal policies even exacerbated economic fluctuations rather than moderating them. Often, fiscal contractions took place in periods of low growth, with fiscal expansions occurring during economic booms. Consequently, these discretionary fiscal policies were frequently pro-cyclical, overriding automatic stabilisers and possibly contributing to economic instability. In addition to this lack of timeliness, discretionary fiscal policy

Chart 2

General government revenue and expenditure, budget balance and debt for the euro area (as a percentage of GDP), 1970-2000



Sources: European Commission (Ameco) and ECB calculations.
Note: Euro area data exclude Luxembourg. They also exclude proceeds from the sale of UMTS licences.

adjustments have shown two types of asymmetries that have undermined the sustainability of public finances.

First, fiscal policies behaved asymmetrically insofar as expenditure increases in times of fiscal relaxation were not followed by expenditure cuts, but rather by tax hikes during periods of fiscal tightening. This resulted in strong increases in the tax burden and the share of government expenditure in GDP (see Chart 2a). Average spending and tax rates gradually increased in the euro area to the extent that they are now much higher than in most other industrialised countries. Second, in some Member States, budget balances did not improve during upswings by as much as they deteriorated during downturns, pointing to asymmetrical reactions of fiscal policy to economic fluctuations. A significant deficit bias emerged, with chronic deficits peaking above 5% of GDP on average for the euro area in the early 1990s (see Chart 2b).

These policies undermined the sustainability and growth-enhancing role of public finances. The chronic high deficits together with the negative effects of a rising tax burden on investment and growth produced a very rapid and continuous build-up of public debt ratios until 1996. Average debt ratios increased strongly during downturns. They even rose moderately and occasionally stabilised without ever reversing during periods of strong growth (see Chart 2c). In several countries, growing debt and debt-servicing costs began to cast doubt on fiscal sustainability and reduced the scope for automatic fiscal stabilisation. Only in recent years have deficits come down significantly, and public debt ratios started to decline when the fiscal provisions of the Maastricht Treaty and subsequently the Stability and Growth Pact were implemented.

3 The Maastricht Treaty and the Stability and Growth Pact: stabilisation and sustainability

The adverse implications of unstable and unsustainable fiscal policies were among the main concerns when the fiscal institutional framework was designed in the run-up to Economic and Monetary Union (EMU). Attaining and preserving the sustainability of public finances became the principal aim of the fiscal provisions of the Maastricht Treaty, while the basic rationale of the Stability and Growth Pact is to restore the stabilising role of fiscal policies within this framework of fiscal discipline.

Promoting fiscal sustainability via consolidation

In order to ensure fiscal discipline and to preserve the sustainability of public finances, the Maastricht Treaty and the Stability and Growth Pact establish rules for prudent fiscal policy-making. The Treaty states that countries should avoid excessive deficits (Article 104). Countries with a deficit level above 3% of GDP or a debt-to-GDP ratio above 60% for the general government are in an "excessive deficit" position, unless specific conditions apply.

Under the Stability and Growth Pact, which refines the fiscal provisions of the Maastricht Treaty, countries commit themselves to respecting the budgetary objective of a position close to balance or in surplus for the general government in the medium term. A consistent implementation of this principle implies that fiscal accounts are on average balanced over the business cycle. At the same time, public debt ratios would fall on average over the cycle, although the speed of reduction may vary from one year to the next.

Safeguarding the stabilising role of public finances

The Stability and Growth Pact contains two instruments guaranteeing the flexibility required to fulfil the stabilising role of public finances while preserving fiscal discipline. First, by maintaining a budgetary position close to balance or in surplus over the medium term, countries are able to let budget balances improve and worsen in line with the cyclical position of the economy. This "breathing of fiscal balances with the cycle" helps stabilise the economy without breaching the 3% deficit limit under normal cyclical conditions.

Second, the Pact contains an "escape clause". This avoids an inappropriate policy reaction as a result of an overly rigid adherence to the 3% limit in case of a severe recession. Deficits above 3% of GDP will be regarded as excessive unless they are expected to be temporary and have occurred in exceptional circumstances. In any case, the deficit has to remain close to the reference value. Circumstances are qualified as temporary and exceptional if the deficit overshoot is driven either by an unusual event beyond the control of the Member State or by a severe recession. A deficit above 3% resulting from a severe economic downturn will, as a rule, only be considered to be exceptional by the Commission when preparing its report to the Council, if there is an annual fall in real GDP of at least 2%. The Council shall decide on the existence of an excessive deficit. A smaller decline in real GDP can only be considered as exceptional by the Council, on the initiative of the Member State concerned, when this is suggested by supporting evidence, in particular on the abruptness of the downturn or the accumulated loss of output relative to past trends. In evaluating whether or not an economic downturn is severe, Member States will, as a rule, take an annual fall in real GDP of at least 0.75% as a reference point.

Ensuring implementation

An elaborate surveillance mechanism ensures the implementation of and compliance with the EU's fiscal framework via three principles: transparency, peer pressure and the possibility of sanctions. In regular stability programme updates, euro area countries present their short and medium-term targets for the fiscal balance and public debt, as a nominal ratio to GDP, along with the underlying economic assumptions and policy measures planned to achieve these targets, and an analysis of how changes in the main economic assumptions would affect the budgetary and debt positions. Moreover, countries have to report their budgetary outcomes and projections to the European Commission twice a year. This enhances the transparency of fiscal developments.

Transparency facilitates peer pressure, which is exercised in the annual review of stability programmes and in various other EU fora. If public finances in a euro area country deviate from the criteria set out in the Maastricht Treaty and the Stability and Growth Pact, a number of procedural steps can be taken to promote compliance. These culminate in the excessive deficit procedure which can result in sanctions being taken against a euro area country if no corrective action is taken. Pecuniary sanctions cannot be imposed on EU Member States not participating in EMU (see the article on the implementation of the Stability and Growth Pact in the May 1999 issue of the Monthly Bulletin for a more detailed discussion).

4 Automatic stabilisers –a practical guide for an appropriate fiscal strategy

A two-track strategy: fiscal stabilisation is consistent with sustainable public finances

The previous discussion on the operation of automatic stabilisers and the Stability and Growth Pact suggests a two-track strategy: to promote the sustainability of public finances on the one hand, and ensure the stabilising role of public finances on the other. To achieve the first objective of sustainability, governments have to attain and maintain a safe budgetary position close to balance or in surplus over the medium term. Such a budgetary position makes it possible to reduce the debt ratio, but this may not always be enough for the debt to diminish at a satisfactory pace. In that case, an additional effort, beyond balanced budgets, is necessary. This is particularly important for those countries where public debt exceeds the 60% reference value.

If countries report budgetary positions close to balance or in surplus, they can also achieve the stabilisation objective by letting automatic stabilisers operate freely. This makes it possible for them to stabilise output without incurring the risk of breaching the 3% deficit limit under normal cyclical conditions. Countries whose budgets are highly sensitive to cyclical fluctuations, however, need to achieve more ambitious medium-term fiscal positions than those experiencing only minor cyclical fluctuations in their budgets. If they fail to adopt an appropriate position, they may face a higher risk of breaching the 3% reference value.

There is normally no need to engage in additional discretionary fiscal policy-making for stabilisation purposes. In specific circumstances, discretionary measures may be needed when countries are hit by severe recessions or when there is a case for making structural changes to public finances. However, these measures should be clearly targeted and effective in addressing the underlying causes.

Consolidation strategies are fully compatible with automatic stabilisation

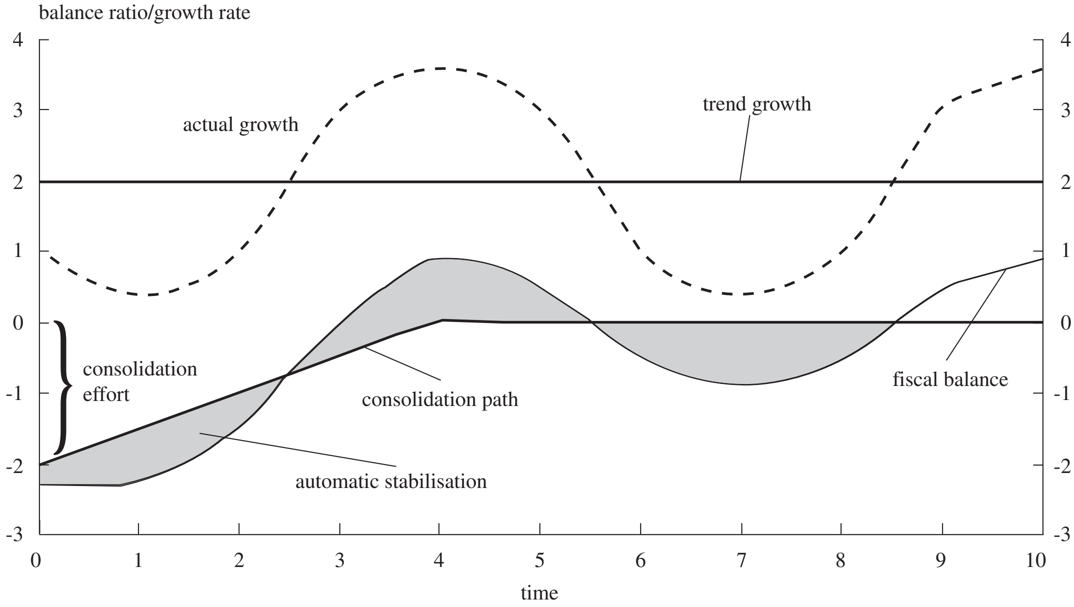
The fiscal strategy to attain safe budgetary positions and to allow automatic stabilisers to operate is also applicable to countries with significant remaining imbalances. These countries should formulate medium-term deficit and debt targets based on an ambitious and credible consolidation strategy. Their annual targets and the implementation of fiscal policy during this consolidation period can then reflect cyclical conditions via the working of automatic stabilisers. In such a strategy, sustainability and stabilisation are normally fully compatible objectives that can be pursued in both good and bad times.

The strategy crucially hinges upon achieving an appropriate speed of convergence to the desired medium-term fiscal targets. A balance needs to be struck here. On the one hand, if adjustment is too slow then confidence in attaining a sustainable path may be undermined and the scope for the operation of automatic stabilisers may be too restricted to prevent an excessive deficit. On the other hand, consolidation by definition consists of discretionary measures and attenuates demand, meaning that overly fast consolidation with excessive short-term retrenchment could also risk policy reversal if the political costs of consolidation become too high. If the right balance on timing can be struck and if the strategy is well conceived and credible, then positive confidence effects may counterbalance or even outweigh direct demand effects.

According to the Stability and Growth Pact, Member States have to formulate deficit and debt targets in nominal terms (as a percentage of GDP). The strategy of consolidation plus automatic stabilisation is reflected in

Chart 3

The operation of automatic stabilisers over the cycle in conjunction with a medium-term consolidation strategy



the overall budget balance, as illustrated in Chart 3. The scenario presented there is a variation on the one illustrated in Chart 1, showing the situation where a close-to-balance position has already been attained.

The lower thick line reflects a possible consolidation path for a country that has not yet attained a safe budgetary position, and leads to a cyclically adjusted balanced budget in the medium term. The thin line reflects a possible example of nominal annual budget targets. The latter also takes into account automatic stabilisation in line with the cyclical conditions, similar to Chart 1. The bracket indicates the necessary consolidation effort, while the grey area again depicts the effect of expected cyclical developments on the actual budgetary position. This example illustrates a linear consolidation path, but one could also argue in favour of a more ambitious adjustment the closer the nominal deficit ratio is to 3%. Moreover, this example 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. In fact, automatic stabilisers may fully countervail consolidation efforts if growth is very low. This is the case in Chart 3, where the nominal balance initially does not change even though the underlying adjustment path is appropriate.

The strategy of smoothly converging to a medium-term position can usefully be applied symmetrically in cases where countries have room to loosen fiscal policies. This room for manoeuvre should be used in a manner that does not result in economic overheating and large pro-cyclical expansionary impulses. Large-scale fiscal expansion is especially inappropriate in good times, just as very significant fiscal contraction is normally not suited to economic downturns.

Automatic stabilisation can result in outcomes deviating from targets

It is important not only to evaluate the appropriateness of (ex ante) budgetary targets, but also the (ex post) outcomes. This is particularly critical in situations where the assumptions made about economic developments have not materialised and growth turns out to be significantly weaker or stronger than projected. If the original targets reflected safe budgetary positions or a credible consolidation path then there is no reason to oppose deviations from targets that stem from automatic stabilisers. Indeed, countries with margins for expansionary policies may even miss their targets by more than can be justified by automatic stabilisation, as long as this does not result in an inappropriate expansionary impulse to an already strong economy and imbalances are not reintroduced. However, countries with remaining imbalances and credible medium-term strategies must avoid slippages beyond those resulting from automatic stabilisation, since these would delay the attainment of sound budgetary positions and increase the risk of running up an excessive deficit.

The most difficult situation is where the original targets were not ambitious enough, and these unambitious targets are subsequently missed. In such cases, automatic stabilisers might be required to operate less than fully in budget years when there is a significant deviation from the consolidation path, and certainly when there is a risk of an excessive deficit. Budgetary overruns beyond automatic stabilisation must be strictly rejected in this scenario. Governments may actually want to make additional efforts to limit deviations from original targets resulting from the action of automatic stabilisers if there are large benefits to be gained from strengthening the credibility of their consolidation commitments in this way.

Consolidation should focus on expenditure restraint

The fiscal strategy needs to be translated into figures for revenue and expenditure. Again, it is worth distinguishing between consolidation and stabilisation. As noted above, discretionary measures are necessary to achieve consolidation. There is abundant empirical evidence that expenditure restraint is more appropriate than tax increases for this purpose. Expenditure-led consolidations, especially those focusing on transfers and wage payments, tend to be more persistent and successful in reducing debt levels than revenue-driven consolidations. The credibility factor and the prospect of lower future taxes induced by expenditure restraint also tend to have more positive effects on private consumption and investment. Consolidation via expenditure restraint can also help governments to implement structural expenditure reforms. Only with expenditure restraint can both consolidation and further tax cuts be achieved and the trend of growing public sectors be reversed.

The working of automatic stabilisers should also be appropriately reflected in revenue and expenditure developments. As expenditure commitments largely remain unchanged over the business cycle, except for unemployment benefits, overall nominal expenditure could be kept unchanged, provided its medium-term path is in line with the attainment and maintenance of a position close to balance or in surplus. Thus, any cyclical changes in fiscal balance targets should rather reflect revenue fluctuating with the cycle.

Implementation and monitoring of the fiscal strategy requires sound underlying statistical and institutional factors

There are a number of practical challenges when seeking to implement the strategy for fiscal consolidation and automatic stabilisation described above. The Maastricht Treaty and the Stability and Growth Pact define deficit and debt targets as nominal unadjusted ratios to GDP, and, in line with the medium-term thrust of the Pact, outcomes are then assessed taking cyclical circumstances into account.

In order to assess whether nominal deficit ratios are close to balance or in surplus, a number of factors need to be considered. In particular, one has to ascertain whether the budgetary position is safe when abstracting from cyclical factors. The cyclically adjusted budget balance can serve as a gauge, albeit an

Box 2

Monitoring fiscal developments

When analysing fiscal developments, the following type of chart is regularly used to depict the fiscal stance and changes in the budget composition that underlie current developments. This is done, for example, in the "Fiscal developments" section of the quarterly issues of the Monthly Bulletin.

Chart A: Annual changes in the average euro area budgetary position and underlying factors
(in percentage points of GDP)

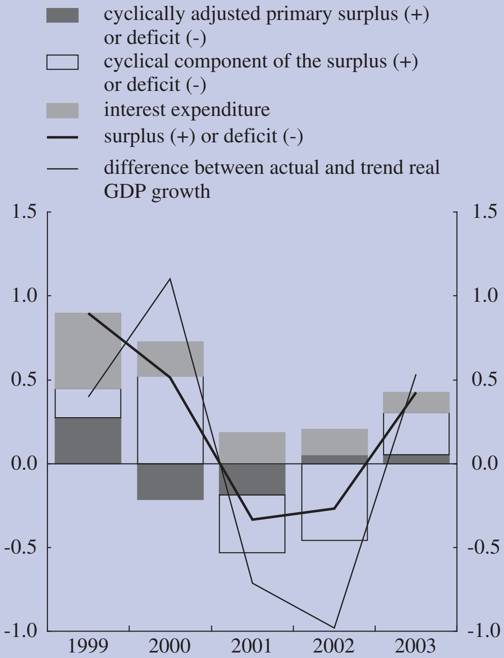
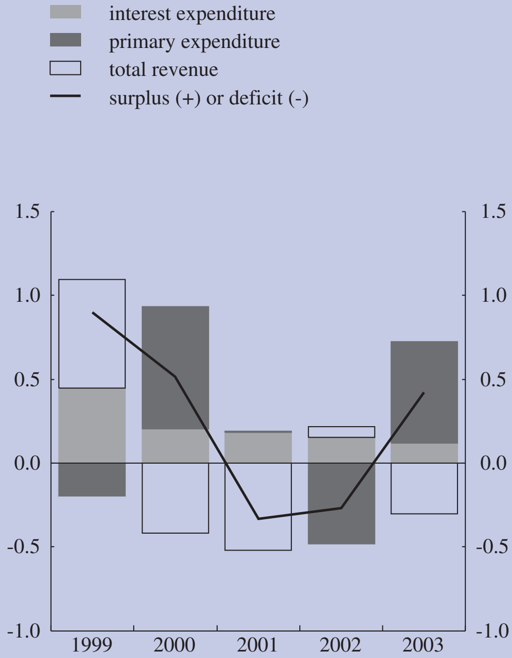


Chart B: Annual changes in the average euro area budgetary position – contributions of revenue, primary expenditure and interest expenditure
(in percentage points of GDP)



Sources: European Commission, autumn 2001, and ECB calculations.
Notes: Positive values indicate a contribution to a decrease in deficits, while negative values indicate a contribution to their increase. Data exclude proceeds from the sale of UMTS licences.

The left-hand chart presents a breakdown of the development of the overall fiscal balance in order to highlight the changes in the non-cyclical component of the budget which approximates governments' consolidation efforts. These efforts are shown as they would appear without the impact of cyclical fluctuations via automatic stabilisers and the contribution of interest expenditure. The bars in this chart therefore depict the extent to which changes in the cyclically adjusted primary balance, the cyclical component and interest expenditure affect the overall balance as a percentage of GDP. Positive values (as implied by declining interest expenditure, for example) indicate a contribution to a decrease in the deficit. The lines show the change in the overall fiscal balance (which is also equal to the sum of the bars) and the difference between actual and trend growth (which underlies the calculation of the cyclical component).

For example, this chart, based on European Commission estimates and forecasts, reveals that the average fiscal balance in the euro area deteriorated in 2001 and is projected to fall further in 2002. The deterioration is largely related to the economic downturn and the operation of automatic stabilisers. Fiscal policy moderately contributed to the deterioration in 2001 (through a relaxation), but will remain largely neutral in 2002 as indicated by the changes in the cyclically adjusted primary balance. Interest expenditure contributes positively to the fiscal balance in both years.

Moreover, the composition of the flows underlying the changes in the budgetary balance is of interest, since this affects the overall tax burden and the quality of public finances. Thus, the right-hand chart shows the contribution of revenue, primary expenditure and interest expenditure (in the form of bars) to the development of the overall fiscal balance. The chart shows that the deterioration in 2001 and 2002 stems from different sources. While revenue reductions (relative to GDP) account for the deterioration of the balance in 2001, it is primary expenditure increases (relative to GDP) that drive the deterioration in 2002.

imperfect one. Box 2 illustrates how the ECB monitors and analyses fiscal developments with the help of fiscal indicators, including cyclically adjusted budget and primary balances.

It is not enough simply to calculate the cyclical adjustment. It is also worth examining whether fiscal balances are robust enough to withstand unexpected changes in output or interest rates without exceeding or even coming close to 3% of GDP. Such an analysis can be carried out by "stress testing" fiscal accounts, applying different growth and interest rate scenarios. Finally, other indicators are helpful to capture other aspects of sustainability not reflected in the cyclically adjusted balance or in the stress testing. In particular, these calculations do not take into account additional consolidation needs arising from very high public debt or from future liabilities that are not yet visible in budget figures. Expenditure growth resulting from population ageing in the areas of pensions, health and long-term care, for example, is expected to put very significant pressure on public finances in the long term. Therefore, the figures for debt and future liabilities must also be carefully monitored to identify a need for further reforms and sustainability impasses.

The successful implementation and monitoring of the strategy also require a sound statistical and institutional basis. First, it is essential to ensure strict compliance with the requirements set out in the Stability and Growth Pact. This includes the timely provision of high-quality stability programmes and fiscal data. Only then can the EU institutions and governments enforce and monitor the rules of the Pact and exert peer pressure on countries that do not (or do not yet) fully comply with their obligations. The European System of National and Regional Accounts (ESA 95) provides a conceptual and practical framework for economic and financial accounts, including for the statistical treatment of government transactions. In some cases the treatment of particular transactions within the framework needs careful judgement. Member States should not risk undermining the credibility of the Stability and Growth Pact by arranging government transactions in such a way as to exploit flexibility in the accounting framework with a view to presentational advantage.

Second, countries can further enhance their chances of attaining a safe budgetary position by setting up the appropriate national budgetary institutions. In particular, past experiences of expenditure overruns driving up deficits and keeping taxes higher than otherwise needed suggest the importance of introducing or reinforcing expenditure control mechanisms in many countries. There is considerable evidence that appropriate budgetary processes and legal fiscal restraints support fiscal discipline. Expenditure restraint across different levels of government can also be strengthened, e.g. by creating internal stability pacts.

5 Conclusion

This article has argued that automatic fiscal stabilisation and sustainability are fully compatible objectives. They are in fact complementary aspects of a fiscal policy strategy aimed at keeping medium-term budgetary positions close to balance or in surplus. First, by achieving or maintaining medium-term fiscal positions close to balance or in surplus, as required by the Stability and Growth Pact and the reference values for deficits and debt, it is possible to secure sustainability through broadly balanced fiscal accounts and declining debt ratios. Second, both safe budgetary positions and a sufficiently ambitious consolidation strategy are fully compatible with the operation of automatic stabilisers. This secures the stabilising role of public finances and minimises the likelihood of excessive deficits.

The expected impact of automatic stabilisers can be taken into account in the formulation of annual budget targets whenever sound budgetary positions are achieved or when an ambitious consolidation path has been defined, since they would not affect the underlying fiscal position. Automatic fiscal stabilisers can also result in unexpected deviations between budget targets and outcomes.

Automatic stabilisers are the appropriate way to stabilise output, as they have foreseeable, timely and symmetrical effects. Nevertheless, there are drawbacks and limits to automatic stabilisation as well. Sizeable stabilisers reflecting large public sectors can undermine efficiency because of highly distorting tax rates and can delay adjustment to a changing economic environment. In countries where fiscal policies are inappropriate or sustainability is in doubt, non-Keynesian effects can countervail the stabilising impact.

Discretionary fiscal policies are often inappropriate demand management tools except in extraordinary circumstances. They suffer from implementation lags and are difficult to reverse. However, consolidation or fiscal structural reform, by definition, requires discretionary policy choices.

Putting into practice the strategy for consolidation and automatic stabilisation poses additional challenges. Transparency, peer pressure and full implementation of the institutional framework should not be taken for granted. Appropriate statistical information and high-quality data for budgetary targets at different time horizons are essential for the careful monitoring and assessment of fiscal strategies. In addition, strict compliance with the regulations contained in the Stability and Growth Pact and the strengthening of complementary budgetary institutions seem essential to ensure the sustainability and stabilising role of public finances in the long run.