BLOG POST

Why structural balances should be scrapped from EU fiscal rules

A prominent team from DG ECFIN of the European Commission challenged some of the criticisms of the EU's methodology for estimating potential output and output gaps, as well as their role in the EU fiscal framework. In this post, I conclude that their responses to the criticisms they considered are questionable. More importantly, they overlook serious problems with the EU's potential output methodology.

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The EU fiscal framework strongly relies on the concept of the structural budget balance of the general government, which is an intuitive concept. It is the budget balance cleaned from temporary effects, such as smaller tax revenues and larger unemployment benefit payments in a recession, and one-off budgetary measures like bail-out of banks or temporary tax measures.

However simple the intuition, the structural balance is not observable and its estimation implicates difficulties, uncertainties and controversies. In particular, it requires the quantification of potential output, i.e. the output that could be produced if all resources were employed at their long-term sustainable levels. Potential output is not observed either. There are various alternative methods for estimating potential output; see the description of the EU's methodology here. The EU's methodology has been subject to debate by experts from all EU member states since it was launched two decades ago. The methodology has been endorsed by the ECOFIN Council and implemented by the European Commission. Hence, I'll speak about the "EU's methodology" and the "Commission's estimates".

The gap between actual GDP and potential output is the output gap, which can indicate the degree of overheating (if actual GDP is larger than potential output) or slack (the reverse). The structural budget balance is estimated on the basis of the output gap estimate. EU countries have to achieve a certain level of structural balance in the medium term. If they are not yet there, the annual fiscal adjustment should be 0.5% of GDP increase in the estimated structural balance in the benchmark case. (Larger than 0.5% adjustment is required in 'good times' or in 'normal times' if the public debt is over 60% of GDP, while in 'bad times' lower adjustment is required; see page 38 here.)

Several crucial criticisms of the EU's potential output methodology have been voiced. In a recent article, Buti *et al* (2019) aim to refute some of the criticisms. While they focus on assessing how the method does in assessing the current cyclical position, they do not discuss the criteria used to select the criticisms they consider and make the general statement "*this column argues that much of the criticism is both conceptually and empirically inaccurate*".

In this post I conclude that their response to the criticisms is highly questionable. More importantly, I argue that they do not mention the most serious problems with the EU's potential output methodology, such as the very large revisions in output gap and structural balance estimates, the pro-cyclicality the methodology creates, the implausibility of an inverted U-shaped estimated potential output level, and the various problems associated with identifying the potential level of labour, capital and productivity. As regards the fiscal framework as a whole, they do not discuss the implications of its complexity much.

Let me start with the three issues Buti *et al* aim to address:

- The puzzle of 'missing inflation' in the euro area: low inflation despite a significant improvement in the estimated output gap
- The link between external imbalances and the output gap
- The puzzle of estimating the same (close to zero) output gap for Germany and Italy

The missing inflation puzzle

Figure 1 shows that the Commission's estimate for the euro-area output gap increased from -3.1% of potential output in 2013 to +0.5% in 2018. Despite this significant improvement in the estimated cyclical position of the euro area economy, core inflation remained stuck practically at 1%. This is indeed a great puzzle and could question the plausibility of the output gap estimate.

Figure 1: Inflation and estimated output gap in the euro area