

## The cyclically-adjusted budget balance in EU fiscal policy making: A love at first sight turned into a mature relationship

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This paper brings together insights, reflections and lessons related to the use of cyclically-adjusted budget balance (CAB) in the EU fiscal surveillance framework. Despite its many downsides, which were laid bare almost twenty years ago by Blanchard (1990) and others, the CAB remains to date one of the key indicators for the analysis and conduct of fiscal policy making, in particular in the EU fiscal surveillance framework. The users of the instrument, who abound in both the academic and policy making arena, tend to waver between blind love and deep dissatisfaction.

The main beauty of the CAB lies with its aspiration to measure, at low costs, the underlying budget balance, that is, the fiscal position net of temporary factors that can be expected to even out over time. It is used for several purposes in the analysis and conduct of fiscal policy: (i) to separate the contribution of discretionary fiscal policy to a given change in the headline deficit from the effect of the economic environment, (ii) to assess fiscal impulse; and (iii) to examine whether a given fiscal policy is sustainable

The prominence and use of the CAB in policy making, especially but not exclusively in the EU, has strongly increased over the years. Before the Stability and Growth Pact (SGP) was revised in 2005, the CAB had mostly been used as an analytical tool to better analyse the fiscal situation of the EU Member States. With the reform of the Pact, the CAB has moved to centre stage of the EU fiscal surveillance framework. All key fiscal requirements to be met by Member States under the provisions of the revised Pact are expressed and assessed net of cyclical conditions and one-off and other temporary measures.

However, the ascent of the CAB has also attracted increasing attention on a number of shortcomings which would have been easily pardoned to a purely analytical tool, but which raised pressing questions when the instrument started to play a crucial role for deriving concrete policy conclusions. In particular, the conceptual beauty of the indicator hides a

number of practical issues, notably the uncertainty attached to the measurement of cyclical conditions in real time as well as the assessment of short-term fluctuations in the tax content of GDP.

Thanks to the intense and gradual work on the CAB carried out at the EU level, a much better and disillusioned understanding prevails today about the virtues and vices of the indicator. Progress has been made in the identification and measurement of Member States' fiscal efforts, the measurement of cyclical conditions in real time and the assessment of tax developments. Some of these improvements have officially been incorporated in the surveillance framework, such as the concept of conditional versus unconditional compliance with fiscal adjustment or the understanding that fiscal adjustments need to be assessed net of one-off measures and other temporary measures. Other methodological advances, notably the assessment of composition effect of government taxes and the use of complementary indicators for the real-time assessment of the output gap have as yet an informal status: they are still being discussed in the competent Council committees with the Member States but are used by the Commission services to form a comprehensive and well-informed view about budgetary developments.

Overall, the experience with the EU rules-based fiscal surveillance testifies that the CAB, like most simple indicators, is far from perfect. The fact that rising awareness of the limitations of the CAB rather than leading to a rejection of cyclically-adjusted fiscal indicators triggered useful technical work at EU level to improve the measurement and the reading of the CAB figures is to be considered an achievement.