6 Conceptual issues surrounding the measurement of fiscal space

Recommendations for the conduct of budgetary policies frequently refer to countries' "fiscal space". For example, on 5 December 2016 the Eurogroup highlighted that "there are considerable differences across Member States in terms of fiscal space and budgetary consolidation needs".[30] Accordingly, policy recommendations often refer to how fiscal space can be generated, for example through the implementation of growth-friendly structural reforms.[31]

Fiscal space generally describes governments' scope for budgetary manoeuvre while preserving overall fiscal soundness. However, there is no commonly agreed approach to measure it. Instead, estimates of "fiscal space" differ, depending on the method or model used. Different approaches have evolved in recent policy discussions. They can be grouped into three broad categories, depending on whether they account for possible constraints on fiscal policies arising from (i) existing fiscal frameworks, (ii) risks to debt sustainability or (iii) so-called "debt limits", i.e. estimates of debt ratios beyond which governments' ability to honour debt obligations becomes questionable.[32] This box reviews and assesses these different concepts in the context of the EU's fiscal governance framework.

Starting with the first constraint, EU Member States' fiscal space derives from the Stability and Growth Pact (SGP) and from national fiscal frameworks. The provisions of the SGP guide countries towards sustainable budgetary positions over the medium term. These are captured by so-called "medium-term budgetary objectives" (MTO), which are defined as structural budget balances, i.e. corrected for the impact of the economic cycle and temporary measures. MTOs are country-specific and set by the government, and are conditional on respecting minimum values that are calculated according to a common methodology.[33] Against this background, the simplest measure of fiscal space within the SGP is the distance of a country's structural balance to the MTO. According to the European Commission's 2017 winter forecast, only three euro area countries (Germany, Luxembourg and the Netherlands) are expected to outperform their MTOs in 2017 (see the table). For countries that have not yet met their MTOs, the SGP recommends an appropriate effort to do so.[34] Compared with the country-specific recommendations for 2017, structural efforts towards achieving sound budgetary positions are expected to fall short of commitments under the SGP in many countries (see the table). Thus, only a

30 See the main results of the Eurogroup meeting on 5 December 2016.

31 See, for example, "Priorities for structural reforms in G20 countries", staff background paper for G20 surveillance note, IMF, Washington, 2016.

32 For another way to categorise existing approaches, see "Using the fiscal levers to escape the low-growth trap", *Economic Outlook*, OECD, November 2016.

33 According to the SGP, MTOs are designed to serve three goals: (i) Member States maintain a safety margin that prevents them from breaching the 3% Maastricht Treaty deficit reference value during cyclical downturns; (ii) Member States' debts are sustainable, taking into consideration the economic and budgetary impact of ageing populations; and (iii) Member States have room for budgetary manoeuvre, particularly when it comes to preserving public investment.

34 For details, see the box entitled "The effectiveness of the medium-term budgetary objective as an anchor of fiscal policies", *Economic Bulletin*, Issue 4, ECB, 2015.

few countries are likely to have any – limited – fiscal space relative to the adjustment requirement this year.

The EU's fiscal framework is asymmetric. Countries falling short of adjustment requirements are asked to step up consolidation efforts. In addition, in some countries, the national fiscal frameworks may impose fiscal adjustments that are more demanding than those under the SGP. By contrast, the SGP does not require countries with room for budgetary manoeuvre to use it.

Table
Indicators of fiscal space

	Structural balance (2017)	Medium-term budgetary objective (MTO)	Structural effort in 2017 (change in the structural balance in percentage points of GDP)	Structural effort commitment under SGP (in percentage points of GDP)*	Fiscal space			
					Distance to MTO	Shortfall vis-à-vis structural effort commitment	Debt criterion: distance to 60% reference value	Debt sustainability – overall EC assessment**
SGP preventive arm								
Belgium	-2.0	0.0	0.6	0.6	-2.0	0.0	46.5	HIGH
Germany	0.4	-0.5	-0.3	-	0.9	0.0	5.5	LOW
Estonia	-0.4	0.0	-0.7	-	-0.4	0.0	-49.9	LOW
Ireland	-1.4	-0.5	0.5	0.6	-0.9	-0.1	13.6	MEDIUM
Italy	-2.0	0.0	-0.4	0.6	-2.0	-1.0	73.3	HIGH
Cyprus	-0.7	0.0	-1.3	-0.6	-0.7	-0.7	43.2	HIGH
Latvia	-1.6	-1.0	-0.9	-1.0	-0.6	0.1	-23.5	LOW
Lithuania	-1.4	-1.0	-0.4	-0.2	-0.4	-0.2	-16.5	LOW
Luxembourg	0.4	-0.5	-1.8	-	0.9	0.0	-36.9	LOW
Malta	-0.7	0.0	0.7	0.6	-0.7	0.1	-2.0	LOW
Netherlands	0.0	-0.5	-0.1	-	0.5	0.0	0.2	LOW
Austria	-0.8	-0.5	0.1	0.3	-0.3	-0.2	21.3	MEDIUM
Slovenia	-2.1	0.25	-0.2	0.6	-2.4	-0.8	18.9	HIGH
Slovakia	-1.3	-0.5	0.7	0.5	-0.8	0.2	-8.2	LOW
Finland	-1.5	-0.5	-0.3	0.6	-1.0	-0.9	5.6	HIGH
SGP corrective arm								
Spain	-3.6	0.0	0.2	0.5	-3.6	-0.3	40.0	HIGH
France	-2.3	-0.4	0.2	0.9	-1.9	-0.7	36.7	HIGH
Portugal	-2.3	0.25	-0.1	0.6	-2.0	-0.7	68.9	HIGH

Sources: European Commission's Winter 2017 Forecast and Debt Sustainability Monitor 2016 (see https://ec.europa.eu/info/publications/debt-sustainability-monitor-2016_en).
Notes: The table excludes Greece, which is subject to a financial assistance programme. *The structural effort requirements refer to those outlined in the country-specific recommendations for 2017; they may be lower if countries are granted flexibility for, inter alia, the implementation of structural reforms or government investment. In turn, adjustment requirements are higher for countries whose debt reduction benchmark is the binding requirement under the SGP. This aims to ensure sufficient progress in reducing high debt levels towards 60% of the GDP debt reference value. **This grouping into risk categories refers to the risks identified in the Commission's "medium-term" debt sustainability analysis. The Commission's sustainability framework includes a comprehensive "medium-term" analysis (over a ten-year horizon), along with the "S1" indicator. Two additional indicators are used by the European Commission to capture risks: the "S0" indicator (for risks over the short run) and the "S2" indicator (for risks over the (very) long run). In particular, "S2" calculates the upfront fiscal adjustment required in order to stabilise the debt-to-GDP ratio over the infinite horizon, including financing for any additional expenditure arising from an ageing population.

The availability of fiscal space under the EU's fiscal rules also reflects economic and other developments. A number of provisions in the SGP explicitly allow for cyclical developments and other factors. Following the Commission's January 2015 communication on flexibility within the EU's fiscal framework, adjustment requirements under the SGP's preventive arm have been made dependent on the output gap. Adjustment towards the MTO may also be carried out more slowly in the event countries implement structural reforms or raise investment.[35] Regarding debt reduction requirements, various relevant factors such as low inflation and growth may reduce the necessary adjustment needs.[36] Furthermore, the "general escape clause", which has so far never been applied, in principle allows amendments to fiscal adjustment in the event of a severe economic downturn, provided debt sustainability over the medium term is not endangered.

Turning to the second constraint above, available fiscal space can be derived from the comprehensive analysis of debt sustainability. There is no single measure of whether, in practice, debt is sustainable. Comprehensive debt sustainability analysis (DSA) presents both projected debt dynamics and the level at which debt stabilises in a central scenario (benchmark) and in the presence of various adverse shocks. DSA also takes into account other relevant indicators, such as a government's gross financing needs, its fiscal framework, the maturity structure of government debt, the scope for contingent liabilities, the quality of institutions and political risks.[37] Given the need to project debt developments over long horizons, any DSA is sensitive to the assumptions applied. According to the European Commission's latest Debt Sustainability Monitor[38], a sizeable number of countries are facing elevated or high risks to debt sustainability over the medium term (see the table)[39]. Most euro area countries thus have very little or no room for budgetary manoeuvre under this methodology. As the table shows, the results following this approach are closely related to those derived from rules-based fiscal space: generally, countries with elevated or high risk-to-debt sustainability are also those whose debt ratios exceed the 60% of GDP reference value by the greatest margin and whose structural budgetary position is furthest from the MTO.[40]

Regarding the third constraint, the concept of fiscal space in relation to "debt limits" captures the room for budgetary manoeuvre as the distance between current debt ratio and a level beyond which sovereigns risk not honouring their debt obligations.[41] The specification of such debt limits is either directly linked to the government's ability to raise revenue, or it is gauged more broadly as the point where political fatigue is estimated to prevent the consolidation measures necessary to stabilise rising debt. Different approaches model the shocks assumed to hit

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35 For details, see the box entitled "Flexibility within the Stability and Growth Pact", *Economic Bulletin*, Issue 1, ECB, 2015.

36 See also the articles "Government debt reduction strategies in the euro area", *Economic Bulletin*, Issue 3, ECB, 2016 and "The euro area fiscal stance", *Economic Bulletin*, Issue 4, ECB, 2016.

37 See, for instance, Bouabdallah O., Checherita-Westphal, C., Warmedinger, T., de Stefani, R., Drudi, F., Setzer, R. and Westphal, A., "Debt sustainability analysis for euro area sovereigns: a methodological framework", forthcoming Occasional Paper, ECB, 2017.

38 See https://ec.europa.eu/info/publications/debt-sustainability-monitor-2016_en and the table.

39 No euro area country is facing high risks in the short run according to the results based on the "S0" indicator, while only one country is facing high risks over the (very) long run according to results based on the "S2" indicator.

40 In principle, a low interest rate environment increases a government's fiscal space derived both from the SGP and from constraints associated with the level of debt: lower interest payments improve structural balances and debt sustainability.

41 See, for example, Gosh, A.R., Kim, J.I., Mendoza, E., Ostry J.D. and Quereshi, M., "Fiscal fatigue, fiscal space and debt sustainability in advanced economies", *Economic Journal*, Vol. 123, 2013. Another approach is related to capturing the steady-state debt level, i.e. the debt-to-GDP ratio towards which an economy tends to converge in the long term. It is operationalised by discounting historical primary balances by a positive interest-growth differential. In Gosh et al., estimates of sustainable debt ratios captured like this range from 62% to 74% of GDP across euro area countries.

economies, governments' track records of budgetary policies and their responses to increasing debt. Generally, given that they vary significantly with the underlying assumptions, the model-based and empirical results for debt limits are subject to a high degree of uncertainty. This places a question mark over their concrete applicability for policy advice.

For policy purposes, the rules-based fiscal space is directly relevant for euro area countries' budgetary planning and less exposed to extreme revisions than other measures. It therefore satisfies the need for fiscal policies in Economic and Monetary Union to err on the side of caution. At the same time, the review of the different concepts for measuring fiscal space all imply that room for budgetary manoeuvre can be generated with the help of well-designed policies.[42] These range from additional consolidation to a growth-enhancing composition of budgetary policies, as well as structural reforms to increase potential output growth. All euro area countries have scope in this regard.

[42] See also Box 3 in Bankowski, K. and Ferdinandusse, M., "Euro area fiscal stance", *Occasional Paper Series*, No 182, ECB, January 2017.