

GLOSSARY of Public Finance Terms (from Public Finances in EMU – European Commission)

Automatic stabilisers Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in percent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Budget balance The balance between total public expenditure and revenue in a specific Year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses *general government* aggregates. See also *structural budget balance*, *primary budget balance*, and *primary structural balance*.

Budgetary rules Rules and procedures through which policy-makers decide on the size and the allocation of public expenditure as well as on its financing through taxation and borrowing.

Close-to-balance requirement A requirement contained in the 'old' *Stability and Growth Pact*, according to which Member States should, over the medium term, achieve an overall *budget balance* close to balance or in surplus; was replaced by country-specific *medium-term budgetary objectives* in the reformed *Stability and Growth Pact*.

Convergence programmes Medium-term budgetary and monetary strategies presented by Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. Prior to the third phase of EMU, convergence programmes were issued on a voluntary basis and used by the Commission in its assessment of the progress made in preparing for the euro. See also *stability programmes*.

Cyclical component of budget balance That part of the change in the *budget balance* that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the *output gap*. See *automatic stabilisers*, *tax smoothing* and *structural budget balance*.

Cyclically-adjusted budget balance See *structural budget balance*.

Discretionary fiscal policy Change in the *budget balance* and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of *automatic stabilisers*. See also *fiscal stance*.

Early-warning mechanism Part of the preventive elements of the *Stability and Growth Pact*. It is activated when there is significant divergence from the budgetary targets set down in a stability or convergence programme.

Effective tax rate The ratio of broad categories of tax revenue (labour income, capital income, consumption) to their respective tax bases.

ESA95 / ESA79 European accounting standards for the reporting of economic data by the Member States to the EU. As of 2000, ESA95 has replaced the earlier ESA79 standard with regard to the comparison and analysis of national public finance data.

Excessive Deficit Procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in order to assess and/or correct the risk of an excessive deficit in each Member State. Its application has been further clarified in the *Stability and Growth Pact*. See also *stability programmes* and *Stability and Growth Pact*.

Expenditure rules A subset of *fiscal rules* that target (a subset of) public expenditure.

Fiscal consolidation An improvement in the *budget balance* through measures of *discretionary fiscal policy*, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal impulse The estimated effect of fiscal policy on GDP. It is not a model-free measure and it is usually calculated by simulating an econometric model.

Fiscal rule A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof. See also *budgetary rule*, *expenditure rules*.

Fiscal stance A measure of the effect of *discretionary fiscal policy*. It is defined as the change in the *primary structural budget balance* relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

General government As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure*, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Government budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, government borrowing, or changes in the monetary base. In the context of EMU, the ability of governments to finance spending through money issuance is prohibited. See also *stock-flow adjustment*, *sustainability*.

Government contingent liabilities Obligations for the government that are subject to the realization of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are

contingent liabilities, since the government obligation to pay depend on the non-ability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e., depend upon the occurrence of uncertain future events.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are the value added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Interest burden *General government* interest payments on public debt as a share of GDP.

Maastricht reference values for public debt and deficits Respectively, a 60 % *general government* debt-to-GDP ratio and a 3 % *general government* deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also *Excessive Deficit Procedure*.

Maturity structure of public debt The profile of total debt in terms of when it is due to be paid back. Interest rate changes affect the budget balance directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *public debt*.

Medium-term budgetary objective (MTO) According to the reformed *Stability and Growth Pact*, *stability programmes* and *convergence programmes* present a *medium-term objective* for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Non-Keynesian effects Supply-side and expectations effects which reverse the sign of traditional Keynesian multipliers. Hence, if non-Keynesian effects dominate, fiscal consolidation would be expansionary.

Old age dependency ratio Population aged over 65 as a percentage of working age population (usually defined as persons aged between 15 and 64).

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position. See also *structural balance*.

Output gap The difference between actual output and estimated potential output at any particular point in time. See also *cyclical component of budget balance*.

Potential GDP The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method* and *output gap*.

Primary budget balance The *budget balance* net of interest payments on *general government* debt.

Primary structural budget balance The *structural budget balance* net of interest payments.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by increasing the *structural primary deficit* during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the *cyclically-adjusted budget balance* unchanged over the economic cycle but lets the *automatic stabilisers* work. See also *tax-smoothing*.

Public debt Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Size of the public sector Typically measured as the ratio of public expenditure to nominal GDP.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997). See also *Excessive Deficit Procedure*.

Stability programmes Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also *Convergence programmes*.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance The actual *budget balance* net of the *cyclical component and one off and other temporary measures*. The structural balance gives a measure of the underlying trend in the budget balance. See also *primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Tax smoothing The idea that tax rates should be kept stable in order to minimise the distortionary effects of taxation, while leaving it for the *automatic stabilisers* to smooth the economic cycle. It is also referred to as neutral *discretionary fiscal policy*. See also *cyclical component of fiscal policy*.