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The Importance of the Budget Deficit Decomposition into a Structural and a Cyclical Component*

Abstract

Within a budget deficit, a structural and cyclical component can be separated. The cyclical component of the budget deficit is the result of the cyclical run of economic processes and does not influence public finance balancing over the business cycle. The structural deficit means that the public finance is permanently imbalanced due to the applied systemic solutions. The determination of the structural deficit allows a more precise assessment of public finance balancing.

Maintaining the balanced structural budget enables to combine stabilizing anticyclical policy with medium-term public finance balancing. Due to this, the concept of deficit adjusted for cyclical fluctuations can be used to apply the rules of fiscal policy. The Stability and Growth Pact that regulates fiscal policy in the Economic and Monetary Union is largely based on the concept of the structural deficit. In accordance with the Stability and Growth Pact, countries that belong to the Economic and Monetary Union should maintain balanced structural budgetary positions.

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Introduction

A structural component and a cyclical component can be separated within a budget deficit. The cyclical component of deficit is a measure of impact of business cycle fluctuations on the size of the budget deficit. During the recession, alongside with the decline in production, employment and revenues of population and firms, budget income is also decreasing. Whereas the size of public spending related to unemployment during the period of recession is increasing. As a result, given an unchanged fiscal policy, the budget deficit is increasing during the recession and decreasing at the time of economic boom.

The structural deficit is a hypothetical value that informs what the size of deficit would supposedly be, if real production was equal to potential production. Therefore, the structural deficit eliminates an impact of cyclical factors on the size of deficit. Apart from using the term „structural deficit", also the term „deficit at high employment" and „cyclically adjusted budget deficit" are used.

In this article, the importance of the budget deficit decomposition into a structural and a cyclical component is analysed. In its first part, the importance of the structural deficit as a measure of imbalance in public finance is discussed. It is followed by the analysis of the role of the cyclical component of budget deficit as an automatic stabilizer of business cycle. In the further part of the article, the rules of fiscal policy based on the deficit decomposition into a structural and cyclical part are discussed, with a special consideration given to the importance of the structural deficit in the Stability and Growth Pact that regulates fiscal policy in the Economic and Monetary Union.

1. The structural deficit as a measure of the public finance balancing

An interest of economists in the concept of deficit adjusted for cyclical fluctuations dates back to the 1930s. This means it falls on the period when the consequences of the Great Depression became apparent and the Keynesian theory appeared.

Myrdal (1939) and Hansen (1941) depict how the business cycle affects the budget balance. They point to the fact that business cycle fluctuations exert their opposite influence on budget revenues and spending which leads to the appearance of the budget deficit during the period of recession and, as a result, makes maintaining the balanced budget impossible during the recession. Hansen

(1941) also shows the concept of the balanced budget over a business cycle, according to which the aggregate of deficits during the recession period cannot be bigger than the aggregate of surpluses during the boom period.

In the 1940s, there appears the concept of the full employment surplus that was defined as a budget surplus calculated on the basis of budget revenues and spending that would take place if production was equal to potential production, that is production at stable prices and with the use of capital and labour in the conditions of full employment (cf. Blinder, Solow 1974; Herber 1975). In his proposed economic programme, M. Friedman claims that the rule of balancing actual revenues and spending of the government would be replaced with the rule of balancing revenues and spending at a hypothetical level of revenue (Friedman 1948). As Friedman indicates, the application of the rule of balancing budget revenues and spending at a hypothetical level of revenue would result in tax income and spending on unemployment benefits fluctuations depending on the actual business cycle, which would level off some fluctuations in global demand (cf. Belka 1986). In the USA, the size of the full employment surplus began to be estimated by the Committee for Economic Development since 1947 (Herber 1975). The impact of business cycle fluctuations on the budget balance in US economy, based on the concept of the hypothetical surplus given the conditions of full employment, was analysed in the studies of, among others, Brown (1956), Lewis (1962), and Blinder and Solow (1974)[1].

In the 1980s, the notion „the full employment budget balance" has started to be replaced with the term "the structural deficit" or "the cyclically adjusted budget balance" (cf. Musgrave, Musgrave 1989). This results from the fact that over the 1980s the estimates of potential production that form the basis for the construction of the structural deficit began, to a larger extent, to be grounded on the investigation of tendencies in the size of production rather than the unemployment rate that ensures full employment (Kosterna 1995). In addition, over the 1980s one began to abandon determining the structural deficit on the basis of potential production defined as „top cycle average" production to the concept of potential production defined as „mid-cycle average" production (cf. Kosterna 1995). As Price and Muller (1984) indicate, defining potential GDP as mid-cycle average production means that the cyclical component is equal to zero not at the top of the cycle, but in the middle of the cycle. As a result, over the cycle the cyclical components compensate against each other, which means that the cyclical budget deficits do not build up.

Over the 1980s and the 1990s the importance of the structural deficit as a means of the assessment of public finance balancing has been growing. An

[1] Brown (1956) and Blinder, Solow (1974) point to a considerable impact of the Great Depression on the deterioration of the real budget balance in the 1930s.

increase in the importance of the structural deficit as a means of the assessment of fiscal policy balancing is connected with a change in the method of public finance assessment that has been taking place over the last 20 years. This change consists in the replacement of the short-term assessment with the medium-term assessment based on the size of deficit adjusted for cyclical fluctuations (Momigliano 1999).

The growing role of the structural deficit as a measure of public finance balancing is shown in the provisions of the Stability and Growth Pact that regulates fiscal policy of the Economic and Monetary Union. The estimates of the structural deficit are presently published on a regular basis in the reports of international organisations (the European Commission, the International Monetary Fund, the OECD), as well as by a growing number of countries including all the countries that form the Economic and Monetary Union.

The importance of the structural deficit as a measure of public finance balancing is to a large extent due to the fact that the adjustments for cyclical fluctuations made to the deficit allow to make an assessment whether fiscal policy applied over the cycle leads to the balancing of public revenues and spending. Therefore, the adjustment of the budget deficit for the influence of cyclical fluctuations makes it possible for the public finance balancing to be assessed (cf. Franco 1999).

The separation of the structural and cyclical components in the budget deficit enables to identify where the budget deficit has its origin and to specify whether it results from changes in the business cycle or from systemic solutions (Murchison, Robbins 2002). The cyclical deficit has a temporary nature and results from the current economic situation. Whereas the structural deficit means that the public finance is permanently imbalanced due to the applied systemic solutions.

Changes in the size of the structural deficit are used as a measure of the discretionary fiscal policy (cf. Chalk 2002). The structural deficit reflects to a greater degree than the actual deficit the impact of discretionary activities of the government on the budget deficit, through eliminating changes in the deficit that result from economic fluctuations.

The size of deficit not adjusted for cyclical fluctuations may give incorrect information on the nature of the pursued fiscal policy. The cyclical deficit arises even with an unchanged fiscal policy, which implies that an increase in the budget deficit during the recession does not necessarily mean the loosening of the policy. If a restrictive fiscal policy that reduces the structural deficit, is carried out during the recession, and at the same time tax revenues sensitive to cyclical fluctuations decrease, this means that despite the tightening of fiscal policy, an increase in non-adjusted deficit will imply its loosening.

On the other hand, as previous experience shows, the structural deficit had often accumulated at the time of rapid economic growth (Franco 1999). That made an improvement in the budget balance resulting from the economic boom was partly levelled off by a discretionary expansionary fiscal policy. Therefore, the limitation of the actual budget deficit was often going hand in hand with the growth of the structural deficit that is with the actual loosening of fiscal policy.

In case of not separating the structural and cyclical component, the level of the budget deficit may additionally give wrong information on the influence of fiscal policy on economy. Because the budget deficit results both from discretionary measures of the government (then expansionary fiscal policy leads usually to growth in GDP) and the influence of automatic stabilizers of business cycle (during the recession when GDP decreases), therefore without the separation of the structural policy one may come to false conclusions about the influence of expansionary fiscal policy on economy. For example, Easterly, Rodriguez and Schmidt-Hebbel (1994) point to the positive correlation between the rate of GDP growth and the budget balance in OECD countries. However, it does not mean that a growth in deficit through expansionary fiscal policy leads to a decline in the rate of GDP growth.

The separation of the structural deficit facilitates an assessment of the nature of the existing deficit and medium-term public finance balancing. However, it does not mean that the structural deficit is an ideal measure to assess public finance.

According to Momigliano (1999), the structural deficit is not a precise indication of public finance stability, as the accurate assessment of public finance stability calls for knowledge on future possible developments of structural deficits, or at least for a specification of all transitional factors that determine the size of deficit.

In case of determination of the structural deficit for particular elements of the sector of public finance, it should be also remembered that changes in the size of the structural deficit may result from changes in transfers between particular elements of the sector of public finance. When this is the case, an increase in the structural deficit of one of the elements of the sector is connected with an analogous decrease in the structural deficit of another element of the sector, and these changes are neutral from the viewpoint of medium-term balancing of the entire sector of public finance.

As Wojtyna (2003) indicates, the structural deficit cannot be assumed to be an ideal measure of whether a loosening or a tightening of fiscal policy takes place, because the structural deficit may also be influenced by non-cyclical autonomous changes (e.g. an increase in the differentiation of revenues that leads to a growth of revenues due to a progressive tax system), and the effects of decisions made in previous years additionally affect the current situation.

Bailey (1995) also shows the incidents when changes in the structural deficit do not result from a discretionary policy of the government and to this end he presents the influence of changes in oil prices on the budget deficit. However, he reckons that the size of the structural deficit is basically connected with the discretionary policy in use. Also Chalk (2002) points to the fact that the size of the structural deficit results not only from the discretionary fiscal policy, but also from structural shocks independent of fiscal policy, e.g. from changes in oil prices, inflation or exchange rate. Therefore, Chalk (2002) analyses a structural and a discretionary component of the budget deficit separately.

In addition, even when no structural shocks take place, a change in the size of deficit adjusted for structural fluctuations does not necessarily have to be connected with changes in fiscal policy in use. This is particularly well seen in case of budget spending. It is usually assumed that the majority of budget spending (spending not connected with unemployment) is not dependent on business cycle fluctuations. In such case, any change in the size of these spending in relation to GDP results in the change in the size of the structural deficit in relation to GDP. As Murchison and Robbins (2002) claim, this does not have to be the result of dicretionary decisions of the government. Public spending usually grows alongside with an increase in the number of population, inflation, or in the level of technology of some services, eg. health service. If these variables are growing at a different rate than that of GDP, this automatically entails changes in the relation of public spending to GDP. This brings about changes in the structural deficit in relation to GDP, although it does not result from changes in fiscal policy.

Changes in the level of the structural deficit do not inform precisely on the influence of fiscal policy on economy, either. For instance, an impact of changes in the structural deficit on the aggregate level of demand depends on whether they take place as a result of changes in revenues or public spending (cf. Wojtyna 2003). Due to this, Murchison and Robbins (2002) differentiate between the two following indicators: deficit adjusted for cyclical fluctuations and fiscal policy stance. The deficit adjusted for cyclical fluctuations informs about the size of the budget deficit independent of business cycle fluctuations and resulting from systemic solutions, whereas the fiscal policy stance provides information about the influence of fiscal policy on economy. Changes in the fiscal policy stance can be calculated by means of attribution to particular budget categories the weights that specify their influence on the size of global demand. Murchison and Robbins (2002) propose to use the notions of expansionary and restrictive fiscal policy for the analysis of the fiscal policy stance. Whereas for the analysis of changes in the size of deficit adjusted for cyclical fluctuations that reflect changes in public finance balancing in the medium term, one can talk about a deterioration or improvement of fiscal policy.

2. The cyclical deficit and automatic stabilizers of business cycle

The cyclical budget deficit constitutes the difference between the actual budget deficit and the structural deficit. The separation of the structural component of deficit enables to determine the cyclical component of the budget deficit. When production is higher than the potential level, then a cyclical budget surplus occurs. Otherwise, there appears a cyclical budget deficit. Changes in the size of the cyclical component of the budget balance that arise as a result of business cycle fluctuations affect in a stabilizing way on economy through the influence exerted by automatic stabilizers of business cycle.

The impact of automatic stabilizers of business cycle on smoothing of business cycle fluctuations is exerted through the influence of fluctuations in taxes and public spending on the size of disposable revenue, and consequently on the size of consumption. Therefore, the occurrence of the cyclical deficit fosters smoothing of consumption and GDP (cf. Musgrave, Musgrave 1989; Buiter 1990).

Through their influence exerted on production, automatic stabilizers also affect the labour market. Studies conducted in the USA show that maintaining the rule of the balanced budget and restraining the automatic stabilizers of business cycle from marking their influence would mean an increase in unemployment by additional 1.5 million persons during the period of recession (Wojtyna 2003).

The influence of automatic stabilizers of business cycle, except for their reduction of short-term fluctuations in production and employment, also prevents frequent changes in the tax system and may lead to the rise of the long-term path of GDP (cf. van den Noord 2000).

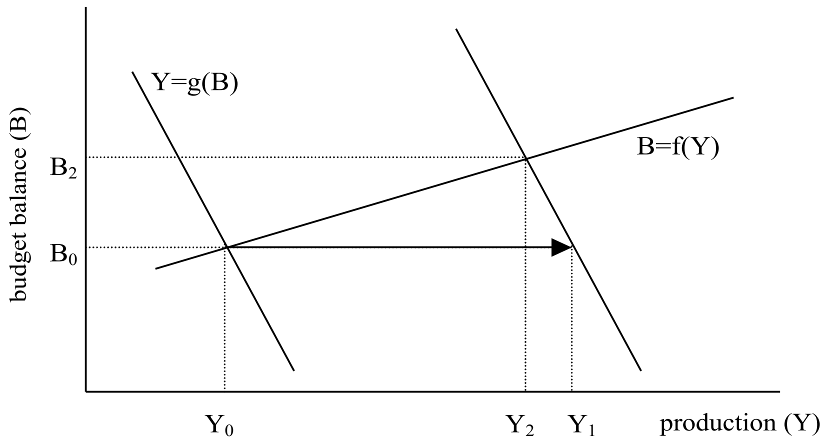
The size of the cyclical budget deficit determines to a considerable extent the strength of the influence of automatic stabilizers of business cycle. This is because the influence of automatic stabilizers of business cycle on smoothing the fluctuations in GDP is dependent on:

- the size of the cyclical component of deficit resulting from GDP fluctuations,

– the impact of changes in the budget deficit by 1% of GDP on the level of production.

Thus, the higher the cyclical budget deficit, the stronger the smoothing effect of automatic stabilizers of business cycle. There is an interaction between the level of business cycle fluctuations and the size of the budget deficit. Business cycle fluctuations bring about the appearance of the cyclical component of the budget deficit, which in turn acts as an automatic stabilizer of business cycle and reduces the scale of fluctuations in GDP (Murchison, Robbins 2002). The interaction between GDP fluctuations and the budget balance is shown in Figure 1.

Figure 1. The interaction between GDP fluctuations and the budget balance



Source: Murchison, Robbins 2002.

Due to the influence of business cycle fluctuations on the level of the cyclical component of the budget deficit, the budget balance depicted in Figure 1 depends on the size of production (B=f(Y)). On the other hand, the level of production is influenced by the size of the budget deficit, and a growth in deficit brings about an increase in global demand (Y=g(B)).

A growth of GDP that results from cyclical fluctuations causes the shift of the curve Y=g(B) to the right and an increase in production from Y_0 to Y_1. At the same time, the growth of production leads to the appearance of the cyclical budget surplus and an improvement of the budget balance from B_0 to B_2.

An improvement in the budget balance as a result of the influence of automatic stabilizers of business cycle causes, in turn, a limitation of production from Y_1 to Y_2. Therefore, the influence of automatic stabilizers of business cycle is marked by means of a reduction of fluctuations in GDP, thereby limiting the size of the cyclical component of the budget deficit.

The existence of interaction between the cyclical deficit and the size of GDP fluctuations implies that the effects of automatic stabilizers of business cycle reduce the strength of the influence of the discretionary fiscal policy on economy. In order to raise GDP by a specified size, an increase in government spending has to be higher when automatic stabilizers of business cycle exist compared with the situation of their non-appearance (Musgrave, Musgrave 1989).

The description of effectiveness of automatic stabilizers of business cycle in smoothing GDP fluctuations is presented, among others, in the papers by van den Noord (2000) and by Brunila, Buti and in't Veld (2002). When investigating the influence of automatic stabilizers of business cycle on GDP formation, it is assumed that the level of production is in the short term an upward function of the budget deficit (cf. Buti, Giudice 2002), or the influence exerted by changes in particular elements of budget revenues and spending on GDP is examined separately. Admitting the assumption that the production size is an upward function of the budget deficit in the short run means the reliance on the assumption that a growth in spending causes the same effect as an increase in tax revenues. According to Brunila, Buti and in't Veld (2002), a growth in production that results from the rise in spending is stronger than a growth that follows tax cuts. In addition, they point to the existence of essential differences in the influence exerted by automatic stabilizers of business cycle that depends on which categories of budget revenues and spending undergo alterations. A separate analysis of the impact of changes in particular budget revenues and spending on GDP formation provides a more accurate assessment of the influence of automatic stabilizers of business cycle on smoothing GDP fluctuations.

The assessment of the influence exerted by automatic stabilizers of business cycle on smoothing cyclical fluctuations is hindered due to cyclical alterations in discretionary decisions of the government. Governments tend to react systematically to business cycle fluctuations, which can be described as „a function of the government's response". As the results of survey undertaken by the European Commission show, fiscal policy is not symmetrical over the cycle – structural deficit is usually decreased during recessions (European Commission 2000). As a result, the actual stabilizers of business cycle can be smaller than automatic stabilizers of business cycle, which would take place in the event of no actions undertaken by the government. Also van den Noord (2000) indicates that in some countries actions undertaken in order to prevent from an excessive deficit resulted in a tightening of fiscal policy, which led to the weakening, or even elimination, of the effects of automatic stabilizers of business cycle.

The potential threat for public finance balancing connected with the use of automatic stabilizers of business cycle results from the fact that automatic stabilizers of business cycle exert their influence both in case of cyclical changes and in case of structural changes in economy (van den Noord 2000). If in case of a slower growth of potential GDP, automatic stabilizers of business cycle are allowed, this will lead to the increase of the structural deficit. Additionally, in order to prevent from the growth of the structural deficit and from the accumulation of public debt, automatic stabilizers of business cycle should be used symetrically during the time of recession and economic boom.

3. The rules of fiscal policy based on the decomposition of the budget deficit into a structural and a cyclical part

A structural budget deficit is of durable nature, while the cyclical deficit is by definition a temporary phenomenon. In case the structural deficit appears, systemic changes are necessary to balance public finance. These include a limitation of some spending and better effectiveness of the tax system. Whereas the budget deficit that occurs during the recession is compensated by the cyclical budget surplus during the boom. This means that the cyclical component of deficit does not influence public finance balancing in longer term. In addition, the occurrence of the cyclical deficit fosters smoothing GDP fluctuations by means of the influence exerted by automatic stabilizers of business cycle.

As the reasons and effects of the structural and cyclical deficits are different, the predominance of the one of these two types of the deficit components in the budget deficit is decisive for the shape of optimal fiscal policy. An increase in the budget deficit that results from cyclical factors does not require a tightening of fiscal policy in order to restore public finance balancing in the medium term. Whereas in case of the growth of the structural component of deficit, a change in fiscal policy is necessary to bring back the former level of the budget deficit (Murchison, Robbins 2002). This means that a high structural deficit calls for an introduction of systemic solutions in order to consolidate public finance. While the systemic changes being introduced in order to eliminate also the cyclical component of deficit may result in excessively restrictive fiscal policy and deeper fluctuations of business cycle.

Keeping the balanced structural budget (this means the appearance of the budget deficit merely as a result of business cycle fluctuations) enables to combine stabilizing anticyclical policy with medium-term public finance balancing (cf. Franco 1999). Due to this, the concept of deficit adjusted for cyclical fluctuations can be used to apply the rules of fiscal policy.

The idea to use deficit adjusted for cyclical fluctuations as a fiscal rule appeared in the 1930s. As Myrdal (1939) indicates, the budget deficit during the recession is justified. However, any rule that would allow producing a surplus during the economic boom should be in force. According to him he main technical problem of fiscal policy over the business cycle is to work out the rules for public finance that would provide some space for finance spending out of deficit during the depression, through securing the accumulation of appropriate surpluses over the prosperous years (Myrdal 1939). Also according to Hansen (1941), the occurrence of the budget deficit during the recession and the budget surplus during the boom is justified. He presents the concept of the balanced budget over the business cycle, in which the aggregate of deficits during the recession cannot be higher than the aggregate of surpluses during the boom. As an illustration of attempts to maintain budget balancing over the cycle, Hansen (1941) gives an example of Sweden where in 1937 the practice of annual budget balancing was officially abandoned and replaced with budget balancing across the cycle (see also Burkhead 1954).

In the USA, an influence of fiscal rules based on the concept of deficit adjusted for cyclical fluctuations on fiscal policy in use dates back to the late 1940s. In l947 M. Friedman presented his economic programme in which he advocates an introduction of the rule of balancing budget revenues and spending, given the hypothetical level of revenues that ensures a high level of employment (cf. Belka 1986). Moreover, in the second half of the 1940s, the US Committee for Economic Development gave his recommendation to use the rule of budget balancing at full employment (cf. Friedman 1948; Herber 1975). In accordance with the rule of budget balancing at full employment, that is the rule of balancing the budget adjusted for cyclical fluctuations, the full employment budget should be in balance or a small surplus (cf. Herber 1975).

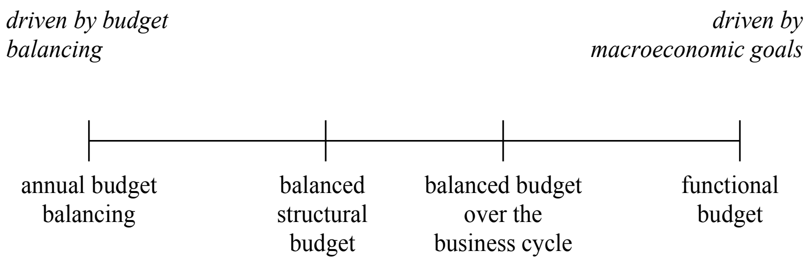
Currently, the concept of deficit adjusted for cyclical fluctuations also affects the shape of fiscal rules. In Great Britain, both the so called golden rule (according to which the government is allowed to increase public debt only for the needs of financing investment expenditures) and the public debt rule (according to which public debt should be kept at a stable and safe level specified as 40% of GDP) refer to the average level of a given variable that is achieved over a full cycle (cf. Kell 2001).

Among rules based on the decomposition of deficit into a structural and cyclical component two types of rules can be distinguished: the rule of the balanced budget adjusted for cyclical fluctuations and the rule of the balanced budget over the business cycle.

The rule of the balanced budget adjusted for cyclical fluctuations consists in maintaining a balanced structural budget over each year of the cycle. The requirement to maintain a balanced structural budget means that during the period of economic boom it is necessary to produce a budget surplus that is equal to the cyclical component of the budget balance. Therefore, the main task of this rule falls into the period of quick economic growth, when an increase in revenues of the sector of public finance may present an apparent occasion to politicians to increase spending. Whilst in the period of recession, the rule of the balanced budget adjusted for cyclical fluctuations allows the existence of the budget deficit (however, not higher than a cyclical component of the deficit).

The difference between the rule of the balanced budget over the business cycle and the above mentioned rule of the balanced budget adjusted for cyclical fluctuations consists in the fact that the limitation on the deficit does not apply for each budget year, but on the period of full business cycle. Thus, the rule of the balanced budget over the business cycle enables an unrestricted formation of the deficit in a given year on the condition that over the entire business cycle the aggregate of budget deficits does not exceed the aggregate of budget surpluses. As a result, the rule of the balanced budget over the business cycle leaves some space for a discretionary fiscal policy while ensuring long-term liquidity of public finance.

Figure 2. The orientation of fiscal policy to budget balancing and to macroeconomic goals and the rules of fiscal policy



Source: based on Herber 1975.

Herber (1975) regards both the rule of the balanced budget over the business cycle and the rule of the balanced budget adjusted for cyclical fluctuations as rules between the rule of budget balancing in each year and the functional budget (cf. Figure 2).

The rule of annual budget balancing is completely oriented towards maintaining of the budget control, whilst the application of the functional budget means that fiscal policy should be driven by macroeconomic goals. Both the rule of the balanced budget over the business cycle and the rule of the balanced budget adjusted for cyclical fluctuations are oriented both towards meeting macroeconomic goals and budget balancing. At the same time, as Herber (1975) indicates, the use of the rule of the balanced budget over the business cycle or the rule of the balanced budget can be problematic in practice due to institutional difficulties concerning the production of the budget surplus.

As compared with the deficit limitation, the rule of the balanced budget adjusted for cyclical fluctuations is a step forward towards an extension of possibilities to stabilize the aggregate demand in economy. However, this makes things more complicated and may influence the decrease in effectiveness of this rule. In case of low effectiveness of anticyclical passive fiscal policy, the rule of the deficit limitation seems to be more recommendable, as it is more transparent than the rule based on the concept of the structural deficit. Whilst the application of the rule of the balanced budget adjusted for cyclical fluctuations seems to be justified when automatic stabilizers of business cycle bring about a considerable limitation to GDP fluctuations, as this rule allows the automatic stabilizers of business cycle to fully exert their influence.

Te rule of the balanced budget over the business cycle enables not only to use automatic stabilizers of business cycle, but also to run an active anticyclical policy. The application of this rule is particularly justified when discretionary actions are equally effective as automatic stabilizers of business cycle. However, automatic stabilizers of business cycle have usually an advantage over discretionary actions, as they exert their infuence quicker and their effects are more foreseeable (cf. Wojtyna 2003). In addition, the application of the rule of the balanced budget over the business cycle that admits discretionary actions may appear poorly effective due to difficulty to precisely determine the business cycle duration and due to the lack of limitations to fiscal policy in subsequent years of the business cycle.

4. The importance of the structural deficit in the Stability and Growth Pact

The Stability and Growth Pact that regulates fiscal policy in the Economic and Monetary Union, is to a large extent based on the idea of the balanced structural budget.

During the first years of the Stability and Growth Pact being in force, the requirement to balance the structural budget was included merely *implicite.* As it was assumed at the time when the Stability and Growth Pact was created, EU Member States should adopt the medium-term objective of budgetary positions close to balance or in surplus (cf. Momigliano, Staderini 1999).

Both at the level of individual governments and at the level of the European Commission, a standard practice was the assessment of fulfillment of the provision included in the Stability and Growth Pact about the medium-term objective of budgetary positions close to balance on the basis of the structural deficit (Momigliano, Staderini 1999). According to the accepted interpretation, the assessment of medium-term objectives of Member States as well as the examination of fulfillment of these objectives has to make allowance for a position of a given country over the cycle and the related effect for the budget balance. Whereas the medium term should be interpreted as the period of business cycle (Franco 1999).

In 2002 the European Commission accepted *explicite* that the assessment of fiscal policy should be based on the size of the structural balance (cf. European Commission 2002). The importance of the level of the structural deficit when making an assessment of fiscal policy was clearly expressed in the guidelines of the European Commission for the years 2003–2005. According to these guidelines, maintaining budgetary positions close to balance or in surplus should concern the cyclically adjusted budget balance (European Commission 2003). Thus, the fiscal stablization in the Economic and Monetary Union according to the provisions of the Stability and Growth Pact should be based only on automatic stabilizers of business cycle that result from the existence of the cyclical deficit (cf. Brunila, Buti, Veld 2002)[2].

In the year 2003, it was additionally assumed that those countries which did not achieve yet the balanced budget adjusted for cyclical fluctuations should decrease the size of their deficit adjusted for cyclical fluctuations by at least 0.5% of GDP per annum (cf. European Commission 2003).

[2] According to Wojtyna (2003), an institutional balance between the requirements of long-term stability of public finance and short-term anticyclical elasticity in the Stability and Growth Pact is breached in favour of the long-term stability of public finance.

Summary

Within a budget deficit, a structural and cyclical component can be separated. The separation of the structural and cyclical components in the budget deficit enables to identify where the budget deficit has its origin and to specify whether it results from changes in the business cycle or from systemic solutions.

The cyclical component of the budget deficit is the result of the cyclical run of economic processes. The cyclical budget deficit that occurs during the recession is compensated by the cyclical budget surplus during the boom. This means that the cyclical component does not influence public finance balancing over the business cycle. In addition, the occurrence of the cyclical deficit fosters smoothing GDP fluctuations by means of the influence exerted by automatic stabilizers of business cycle.

The structural deficit means that the public finance is permanently imbalanced due to the applied systemic solutions. The determination of the structural deficit (that is the deficit adjusted for cyclical fluctuations) allows a more precise assessment of public finance balancing.

Maintaining the balanced structural budget (this means the appearance of the budget deficit merely as a result of business cycle fluctuations) enables to combine stabilizing anticyclical policy with medium-term public finance balancing. Due to this, the concept of deficit adjusted for cyclical fluctuations can be used to apply the rules of fiscal policy.

The Stability and Growth Pact that regulates fiscal policy in the Economic and Monetary Union is largely based on the concept of the structural deficit. In accordance with the Stability and Growth Pact, countries that belong to the Economic and Monetary Union should maintain balanced structural budgetary positions. Therefore, after the accession to the Economic and Monetary Union, Poland will also be subject to the requirements that concern maintaining balanced structural budgetary positions. For fiscal policy in Poland, in order to fulfil the requirements of the Stability and Growth Pact, reforms of the public finance system aimed at the removal of the systemic excess of public spending over revenues will be necessary.

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