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COVER NOTE

From:	General Secretariat of the Council
To:	Permanent Representatives Committee/Council
Subject:	Assessment of Effective Action under the Excessive Deficit Procedure

Delegations will find attached the third part of the note on Improving the Assessment of Effective Action in the Context of the Excessive Deficit Procedure – A Specification of the Methodology.

Therefore the change in the structural revenues can be decomposed in three terms which can be interpreted in the following way:

- The first term is equal to the effect of discretionary revenue measures, expressed as a percentage of actual output.

- The second term corresponds to the revenue windfall/shortfall, expressed as a percentage of actual output. Indeed, the difference between the change in total revenue and the discretionary measures can be written as $\Delta R_t - DM_t = \eta_t^R . y_t . R_{t-1}$, where η_t^R is the apparent revenue elasticity to GDP in year *t* (cf. Vademecum Annex 5, *Computing the adjusted fiscal effort*). Therefore, the revenue windfall/shortfall term reflects the fact that the apparent elasticity η_t^R can depart in the short term from the long-term elasticity η^R used in the computation of the revenue semi-elasticity ε_R (e.g. due to changes in the composition of growth or in the tax collection).

- The third term captures two different effects. First, it reflects the fact that the nominal output growth y_t is generally different from the change in the output gap ΔOG_t, which is expressed in real terms. Second, it takes into account the difference between $\frac{R_{t-1}}{Y_t}$ and the revenues-to-GDP ratio $\frac{R_0}{Y_0}$ that is used as a weight in the computation of ε_R. Therefore, item (iii) can be further developed as:
$(\eta^R - 1).\left[\frac{R_{t-1}}{Y_t} y_t - \left(\frac{R_0}{Y_0}\right).\Delta OG_t\right] = (\eta^R - 1)(y_t - \Delta OG_t).\frac{R_{t-1}}{Y_t} + (\eta^R - 1)\left(\frac{R_{t-1}}{Y_t} - \frac{R_0}{Y_0}\right).\Delta OG_t$

c) Derivation of the β parameter

The revenue windfall/shortfall that is observed *ex-post* on the basis of actual data may differ from the value forecasted *ex-ante* by the Commission in its recommendation. The difference between both values, the so called "revenue gap", is a forecast error and is outside of the direct control of the authorities. When assessing government's actions, this error can corrected by subtracting the following term from the *ex-post* value of ΔCAR_t (based on the above decomposition):

$$\frac{(\Delta R_t - DM_t - \eta^R\ y_t . R_{t-1}) - (\Delta R_t - DM_t - \eta^R\ y_t . R_{t-1})^{rec}}{Y_t}$$

where the superscript *rec* denotes the values underlying Council recommendation. The above term is very close to the β parameter that has been used so far. The numerator of the term is identical to the one used in β, while the denominator is actual output rather than potential output. This refinement makes the parameter more in line with the theoretical foundations.

However, the above term corrects only for the item (ii) of the decomposition presented above, the "elasticity effect" and it is useful to consider whether the other elements do not merit also being taken into account in the correction of revenue developments.

As to item (i), the ratio of discretionary revenue measures to GDP, is the reflection of policy action and does not require correction.

As to item (iii) and its decomposition presented above, the second element - that is to say $(\eta^R - 1)\left(\frac{R_{t-1}}{Y_t} - \frac{R_0}{Y_0}\right).\Delta OG_t$ - equals virtually 0, since it is the product of three very small terms. On the contrary, the first element $(\eta^R - 1)(y_t - \Delta OG_t).\frac{R_{t-1}}{Y_t}$ is not negligible and should be taken into account in the correction. In economic terms, this item can be interpreted as the automatic response of the revenue level to inflation and to potential growth.[1] It has been ignored in the current computation of the revenue windfall/shortfall, but the simulations show that its value can be above an insignificant level and it is useful to integrate it in the calculations.

Integrating this exposition of item (iii) into the decomposition of ΔCAR presented above yields:

$$\Delta CAR_t = \frac{DM_t}{Y_t} + \frac{\Delta R_t - DM_t - [y_t + (\eta^R - 1).\Delta OG_t].R_{t-1}}{Y_t} + (\eta^R - 1)\left[\frac{R_{t-1}}{Y_t} - \left(\frac{R_0}{Y_0}\right)\right].\Delta OG_t$$

The first term remains unchanged. The second term is the refined version of revenue windfall/shortfall expressed as a ratio to actual output and the third one is a technical term that takes into account the difference between $\frac{R_{t-1}}{Y_t}$ and $\frac{R_0}{Y_0}$ and that is virtually equal to 0. A similar reasoning to the one developed in the previous section leads to a refined version of β:

$$\boxed{\beta_t^{new} = \frac{\left(\Delta R_t - DM_t - [y_t + (\eta^R - 1).\Delta OG_t].R_{t-1}\right) - \left(\Delta R_t - DM_t - [y_t + (\eta^R - 1).\Delta OG_t].R_{t-1}\right)^{rec}}{Y_t}}$$

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[1] $y_t - \Delta OG_t \simeq y_t^{(real)} + \pi_t - \Delta OG_t \simeq \pi_t + y_t^*$ where π_t and y_t^* respectively are the inflation rate and the (real) potential growth.