Structural budget deficit

The level of a country's budget deficit is largely influenced by the position of the economy relative to the economic cycle. For example, budget revenues from an overheating economy will lead to a low budget deficit, but this could hide significant imbalances in the budgetary-fiscal position. For these reasons, it is important to distinguish between the origin of budget deficits. In general, the budget deficit is the result of discretionary budgetary-fiscal policy decisions, but part of the deficit is determined by the state of the economic cycle. Respectively, the actual budget deficit consists of the structural deficit and the cyclical deficit (calculation formula 1).

$$D_{actual} = D_{structural} + D_{cyclical} \tag{1}$$

where the structural deficit persists even when the economy is functioning at the potential level and the cyclical deficit occurs due to economic recession or expansion.

In order to separate the impact of discretionary budgetary-fiscal policy measures on the actual budget deficit from that of economic developments, the level of the structural deficit is determined. In other words, the structural deficit is the component of the budget deficit that is not determined by the economic cycle, but by permanent budgetary-fiscal policies (the level of expenditures and revenues set by laws and public policies).

The determination of the structural deficit implies the cyclical adjustment of budget revenues and expenditures, which eliminates the component generated by the deficit or excess demand. The estimation of the impact of the economic cycle on budget revenue and expenditure can be done by two methods:

- Aggregate method – where elasticities are used to measure the sensitivity of total revenue and expenditure to the deviation of GDP;
- Disaggregated method – where elasticities are applied to different types of budget revenue and expenditure.

The choice of the adjustment method depends on the purpose pursued and the availability of the data. The aggregated method requires a minimum set of data and is a relatively simple exercise. The structural deficit estimated by the aggregated method is represented by the calculation formula 2:

$$D_{str} = R^{CA} - G^{CA} \tag{2}$$

where,

D_{str} – structural deficit;
R^{CA} – total cyclically adjusted budget revenue;
G^{CA} – total cyclically adjusted budget expenditure.

Adjusted cyclical budget revenues and expenditures are determined by adjusting them to the effect of the potential GDP from actual GDP, using elasticity to define the force of the cyclical effect (3 and 4 formulas).

$$R^{CA} = R \times \left(\frac{Y*}{Y}\right)^{\varepsilon_{R,Y}} \tag{3}$$

$$G^{CA} = G \times \left(\frac{Y*}{Y}\right)^{\varepsilon_{G,Y}} \tag{4}$$

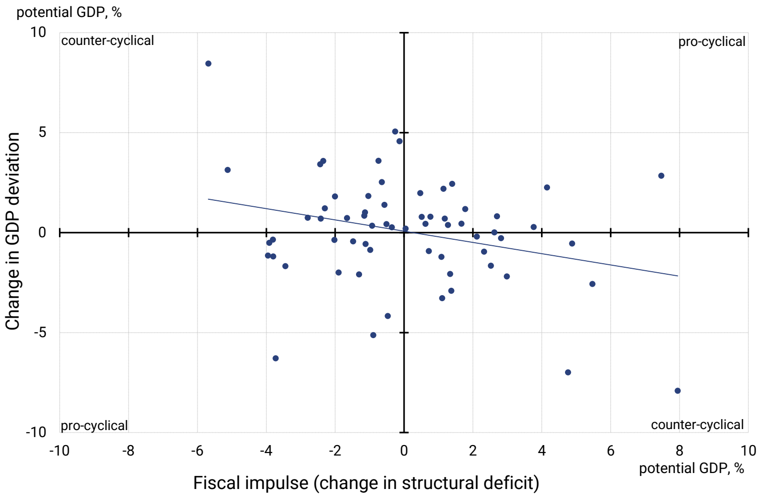
where,

R – total budget revenue;
G – total budget expenditure;
$Y*$ – potential GDP;
Y – actual GDP;
$\varepsilon_{R,Y}$, $\varepsilon_{G,Y}$ – elasticity of budget revenue and expenditure.

The structural deficit generates information on important issues in the budgetary-fiscal policy analysis:

- Measurement of discretionary changes in budgetary-fiscal policy, as changes in the structural deficit reflect budgetary-fiscal policy decisions;
- Determining the orientation of budgetary-fiscal policy. The change in the structural deficit reflects the impact of discretionary budgetary-fiscal policy on the economy. For example, the increase in the structural deficit leads to an expansive budgetary-fiscal policy and the reduction of the structural deficit implies a restrictive budgetary-fiscal policy;
- The analysis of the dynamics of the structural deficit in correlation with the position of the economy towards the economic cycle allows the assessment of the extent to which budgetary-fiscal policy acts as a stabiliser or, on the contrary, contributes to the intensification of imbalances. To this end, the fiscal impulse (change in the structural deficit) is analysed in line with the GDP gap. Therefore, in order to act as a stabiliser, if there is a positive change in the GDP gap (expansion), budgetary-fiscal policy must be restrictive, and when there is a negative change in the GDP gap (recession) – budgetary-fiscal policy must be expansive. This situation describes a counter-cyclical budgetary-fiscal policy stance. If a pro-cyclical budgetary-fiscal policy is promoted, it contributes to the intensification of economic imbalances.

Chart 1: Fiscal impulse and cyclical position of the economy of the Republic of Moldova



Source: NBM

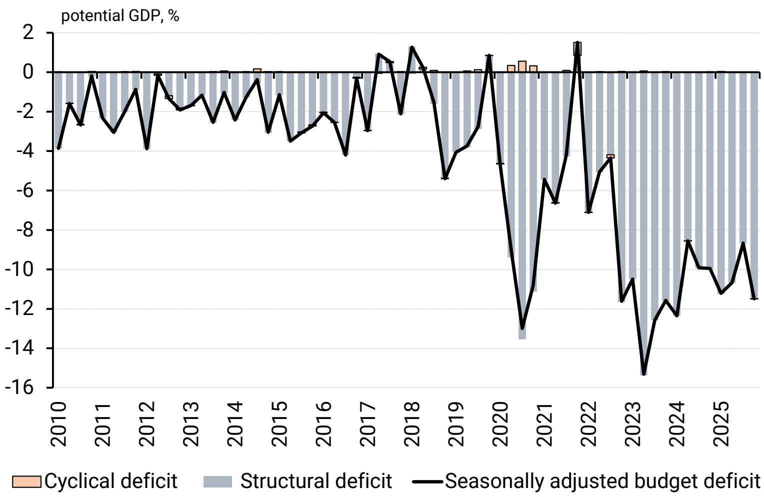
Chart 1 shows the behaviour of discretionary budgetary-fiscal policy towards changing macroeconomic conditions in the Republic of Moldova, quarterly, in the period 2010-2025. In general, in these years, budgetary-fiscal policy has been counter-cyclical, and the trend describes an overall positive situation. At the same time, it should be noted that according to empirical evidence, the incidence of pro-cyclical budgetary-fiscal policies is higher in developing countries, while in developed countries acyclic and counter-cyclical budgetary-fiscal policies predominate.

In the Republic of Moldova, the size of the structural deficit is determined by:

- narrow tax base due to tax evasion, high informal economy, exemptions and facilitations;
- rigid and permanent expenditure such as pensions and social benefits, public sector wages, subsidies and compensations;
- demographic pressures such as labour migration, population ageing;
- pro-cyclical budgetary-fiscal measures, higher spending and lack of fiscal consolidation in times of economic recovery.

In 2022-2025, the Republic of Moldova's budget deficit was partly cyclical due to external imbalances, the energy crisis, high inflation, but still mainly structural. A large and persistent structural deficit indicates that permanent public expenditure exceeds structural tax revenues. The budgetary imbalance does not disappear automatically with the relaunch of the economy, budgetary-fiscal reforms are needed, not just for economic growth. Importantly, expenditure financed by the structural deficit has lower fiscal multipliers (fiscal multipliers show how much the deficit stimulates economic activity) over the medium term, which means that the effect on GDP is temporary because it finances consumption but not investment. In the long run, the high structural deficit may reduce fiscal space and increase financing costs. Thus, it increases public debt and, as a consequence, increases dependence on external financing and vulnerability to future shocks. Respectively, broadening the tax base, reducing the shadow economy, prioritising capital expenditures, reforms in the fiscal sector, but also in the pension and social benefits system are the directions for reducing the structural deficit.

Chart 2: Structural, cyclical and seasonally adjusted deficit of the Republic of Moldova



Source: NBM

From a monetary policy perspective, the structural deficit and the fiscal impulse, respectively, have a direct influence on inflation dynamics. A widening structural deficit and an expansionary fiscal impulse amplify aggregate demand, which may generate inflationary pressures, especially as the economy operates close to its potential. In this context, the National Bank of Moldova is forced to adopt a more restrictive position by raising interest rates or reducing liquidity in the banking system.

At the same time, the high structural deficit affects economic agents' expectations on public debt sustainability and macroeconomic stability, which may lead to higher risk premiums, depreciation of the national currency and intensification of inflationary pressures. Under these circumstances, monetary policy requires restrictive conduct to anchor inflation expectations and safeguard price stability. On the other hand, a restrictive fiscal impulse eases price pressures, providing room for easing monetary conditions and stimulating economic activity without the risk of destabilising inflation.

Therefore, the estimation of the structural deficit and the fiscal impulse is a very important issue in the macroeconomic analysis and the fiscal position, has direct implications for the monetary policy stance and plays a complementary role in achieving the macroeconomic stability objectives. At the same time, the interaction between fiscal and monetary policy is a fundamental element that determines their effectiveness. A non-complementary approach in which budgetary-fiscal policy is expansionary at the same time as restrictive monetary policy may lead to worse-than-expected outcomes and monetary policy needs to offset these macroeconomic imbalances with higher adjustment costs. Conversely, in the case of a coherent policy mix characterised by a structural deficit and a prudent fiscal impulse, budgetary-fiscal policy contributes to the achievement of the stability objectives pursued by monetary policy, facilitates the balanced evolution of the economy and reduces the need for aggressive monetary policy adjustments, helping to strengthen the credibility of the macroeconomic framework.