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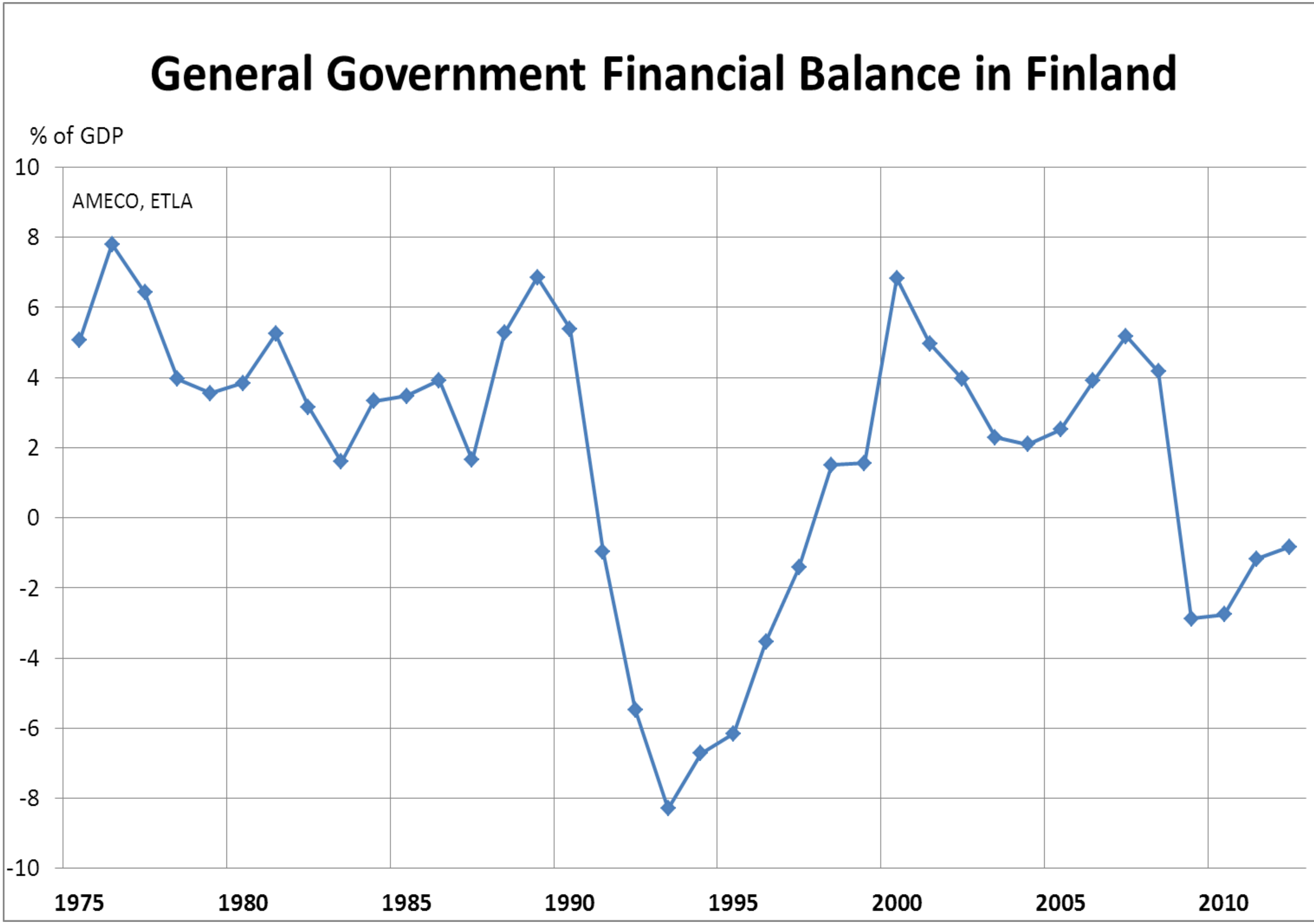
FISCAL POLICY: the role of rules

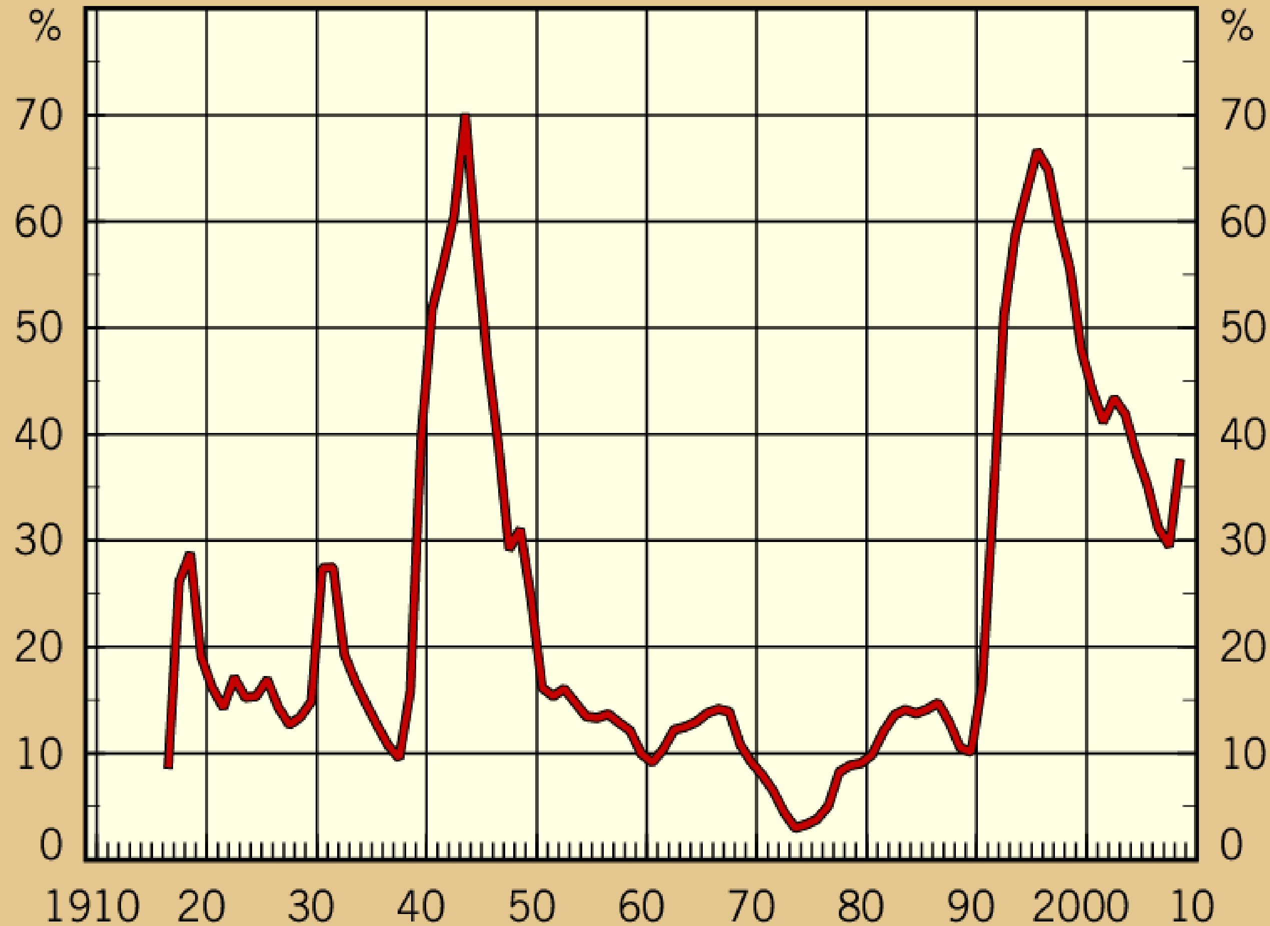
- is there a deficit bias in Finland?
- fiscal policy decision making: the options
- the case for (and against) fiscal policy rules
- fiscal sustainability and uncertainty
- a comment on the fiscal objectives/rules of the new government
- a comment on pension policy in Finland
- a comment on EMU and fiscal policy rules

Why expect a deficit/debt bias?

- demographics & democracy
- myopia & weak information
- lobbying & the common pool problem
- asymmetric stabilization policy
- political strategy


General Government Financial Balance in Finland
% of GDP
AMECO, ETLA
10
8
6
4
2
0
-2
-4
-6
-8
-10
1975
1980
1985
1990
1995
2000
2005
2010

Central government debt 1917-2009, % of GDP



Sources: Statistics Finland, State Treasury.

ETLA SIXTEN/valtion_velka_eng

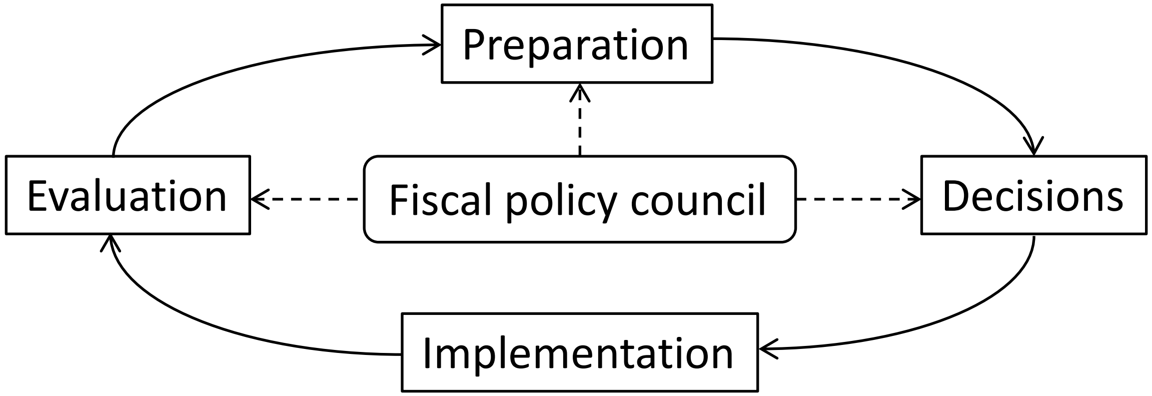
Public finances in Finland have generally been strong

- institutions are mostly OK
- political polarization is modest
- a strong role has been played by bureaucrats and the balanced budget doctrine
- real or perceived borrowing constraints on markets
- favourable circumstances (increasing labour supply, low wages, low tax rates etc)

but the outlook for the future is less benign

- the balanced budget doctrine is out, borrowing is easy, labour supply declining, wage and tax levels high…

THE POLICY MAKING PROCESS



- *Discretion*: freedom of choice of policy response (in the light of current events)
- *Rules*: politically imposed constraints on policy choices (assignment, procedures, transparency, ceilings/triggers…)
- *Delegation*: outsourcing of some aspects of the decision making process to experts (like fiscal policy councils)
    - soft version of FPC: inputs to evaluation (Swe) or preparation (US)
    - hard version of FPC: some decision making authority
    - a way to reconcile rules with discretion

The case for fiscal policy rules (geared to sustainability)

- some protection against time inconsistency, myopia and other sources of deficit bias
- should reduce fiscal policy uncertainty and risk of ending up in unsustainable debt positions
- may help counteract moral hazard
- rules may be politically more feasible ex ante (because of the insurance element) than action in difficulties ex post (when redistribution dominates)

The case against rules

- rules are futile or demoralizing if easily avoided or manipulated (and if there are no credible sanctions)
- benefits of new information are lost if there is no room for discretion
- exceptions are unavoidable and intelligent escape clauses difficult to formulate
- some rules are soft (guidelines) others hard (like numerical ceilings written into the constitution)
- the degree of strictness needs consideration as there is a need to reconcile the requirements of simplicity and flexibility

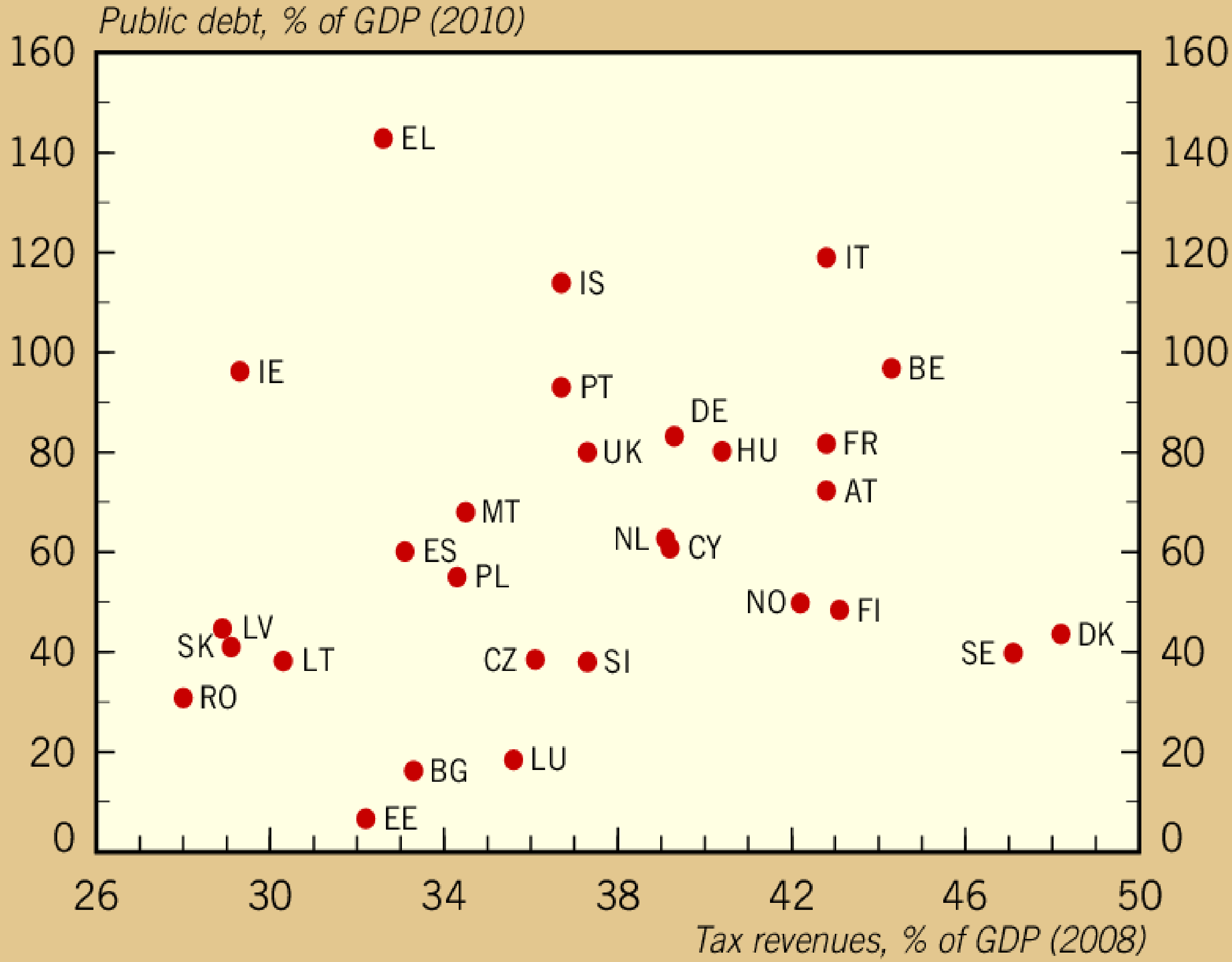
What objectives rules (for overall fiscal policy)?

- Long-term fiscal sustainability as overarching objective/constraint + sufficient buffers (+ considerations of social efficiency and intergenerational equity)
- specification of medium term structural balance consistent with appropriate convergence towards sustainability
- definition of multiannual fiscal framework in terms of expenditure ceilings and tax parameters consistent with the targeted structural balance
- see the Swedish FPC for best practice
- NB: policy rules and councils are complementary, not substitutes (transparency key)
- NB the relations between fiscal policy requirements and policy towards aging (retirement age, prefunding, health and old age care)

Uncertainty & fiscal policy rules

- assessments of fiscal sustainability are highly uncertain and prone to big revisions
- the uncertainty could/should be a focus of analysis
- policy rules may help reduce the range of uncertainty (Lassila, Valkonen, Alho)

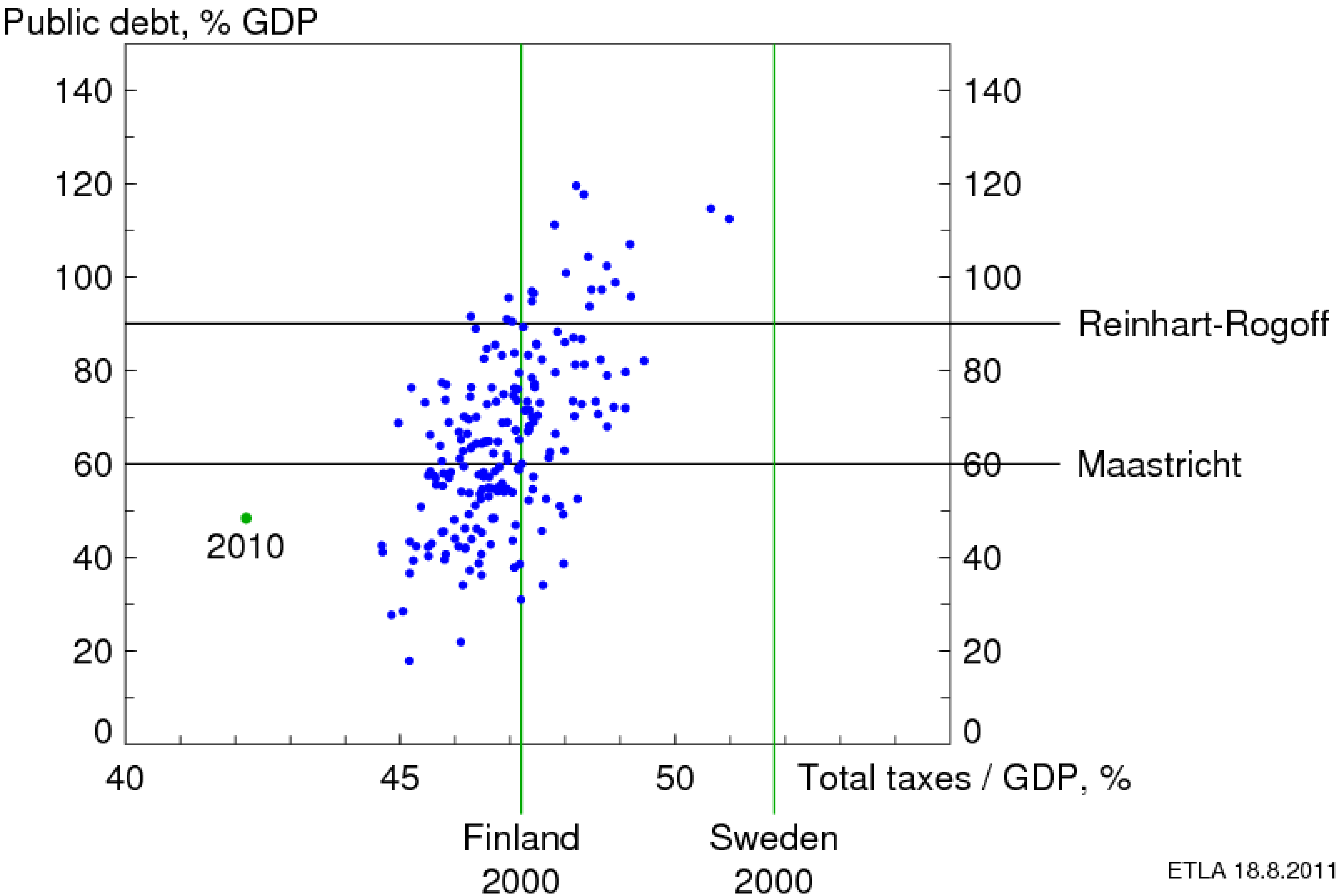
Public debt and tax revenues, % of GDP



Source: Eurostat.

Kohti_parempaa_verotusta/jla_extra_eng

Public debt and taxes in the 2060's in Finland: baseline 1)



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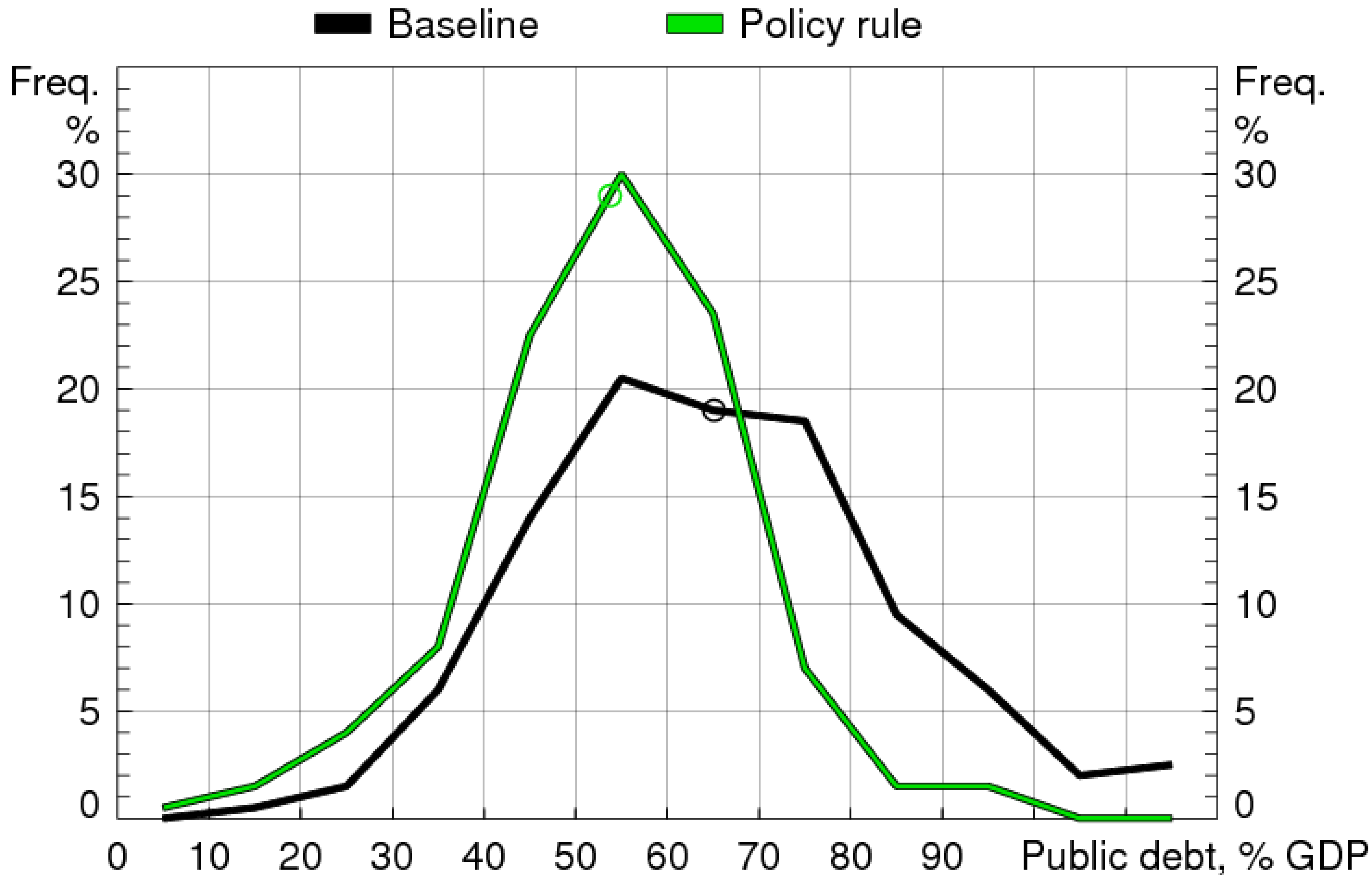
1) Baseline: State tax rates constant, pension contributions and municipal taxes adapt to expenditures

Public debt in the 2060s



Baseline: State tax rates constant, pension contributions and municipal taxes adapt to expenditures
Policy rule: VAT rate conditional on sustainability gap and forecasted public debt/GDP-ratio

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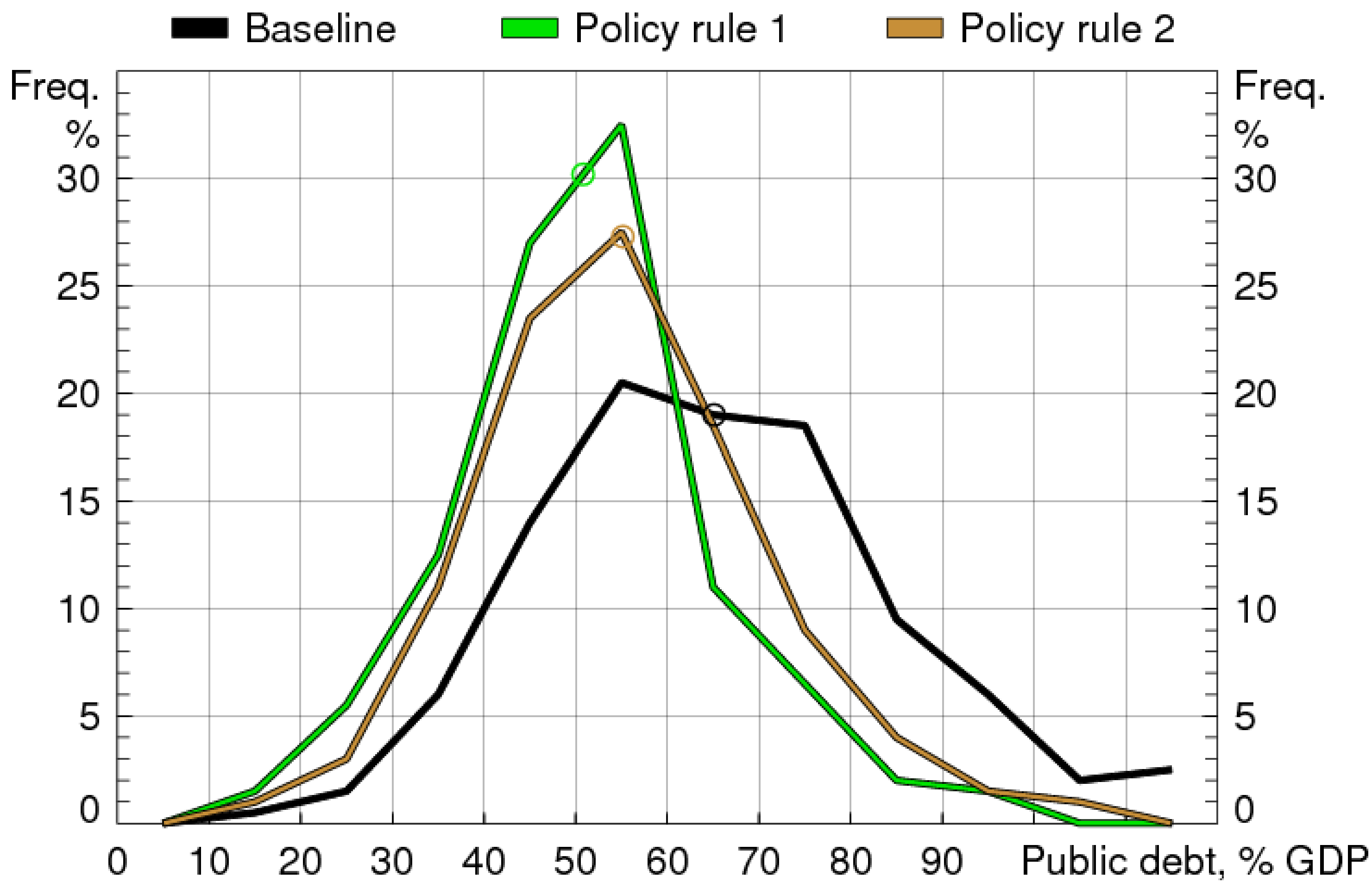
Public debt in the 2060s



Baseline: State tax rates constant, pension contributions and municipal taxes adapt to expenditures

Policy rule 1: VAT conditional on 10 year forecast of public debt /GDP ratio

Policy rule 2: VAT conditional on actual public debt /GDP ratio

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Fiscal policy commitments of the new government

1. central government debt/GDP should start declining before 2015 and central government deficit should go below 1 % of GDP
2. expenditure cuts and tax increases of 2,5 bn up to 2015 (cumulative effect on level, 50/50 split)
3. the government commits itself to additional decisions (though action may be postponed) if action under point 2 is not enough to achieve goal under point 1
4. the government initiates action to curtail the sustainability gap before 2015 based on assessments to be made later

comments:

- action under 2 unlikely to deliver 1 (but the government aspires to “better than forecast growth”); wishful thinking
- the trigger under 3 allows postponing problems to the subsequent government (lacks credibility) or risks becoming procyclical in effect (no cyclical adjustment)
- commitment under 4 is pretty timid

Rules for pension policy (earning-related) in Finland

- present situation:
    1) the life expectancy coefficient reduces monthly pensions in line wit the increase in life expectancy
    2) the contribution rate is adjusted so as to cover entitlements (+ partial funding)
    3) pensions and accrued pension rights are indexed to weighted averages of wages and consumer prices

- problems/suggestions:
    - the second rule is ambiguous and controversial
    - age limits in the pension system should be indexed to life expectancy (cf Denmark)
    - there should be a trigger for some sort of (quasiautomatic) adjustment of the contribution rate and/or of the accrual rate or pensions (e.g. the index compensation), e.g. Sweden and notably Canada
    - the (existing) pension group could be formalized (explicit mandate) and its composition and working methods modified

EMU & fiscal policy rules

- the SGP has failed repeatedly, but policy makers may learn
- feedback from financial markets are likely to enhance future fiscal discipline
- but neither policy coordination nor market can be relied upon too much (reactions too timid or too late)
- the no bail out rule is key: there should in the EU or euro area be a crisis resolution mechanism for banks and sovereigns
- this mechanism needs to be underpinned by both rules (such as a trigger for default/restructuring) and institutions with some supranational authority to decide (the ESM or some sort of EMF, but no "fiscal union" is needed)

Fiscal policy rules in Finland: concluding comments

- Is there a problem in the sense of a deficit bias? Perhaps
- Rules play a significant role in Finland as well but are in certain cases ill designed (and not well monitored)
- The fiscal policy commitments of the government are not well anchored in an overarching objective and are vulnerable to the cycle
- Fiscal sustainability is not given serious attention
- Uncertainty of the long run fiscal outlook could &should be explicitly considered
- Pension policy is of key importance but in a limbo: clear commitments and additional rules could help (+monitoring)
- EMU needs an operational and credible no bail out rule rather than further rewriting of the SGP or an Euro + Pact
- Will a Fiscal Policy Council be set up? Unlikely