Spending rules bring stability to fiscal policy in Finland

Helvi Kinnunen, Economist, Monetary Policy and Research

During the electoral period currently drawing to a close, the government spending rules have played a key role in Finland's fiscal policy. Spending limits have, admittedly, been used to regulate fiscal policy since the early 1990s, but they have not previously steered budget policy as clearly as they do now.[1] The spending limits became more important in the budget process when the spending rules were reformed at the start of the present government's term of office in 2003. Expenditure has, additionally, been held within the limits, even though the boundaries set for expenditure covered by the limits have been rather tight. Thus, economic policymakers have evidently considered the spending limits and the levels they have been set at as well-founded. The credibility of the spending rules has, therefore, clearly improved.

There are, however, a number of factors associated with the spending limit agreement that in reality make expenditure policy more relaxed than would appear based solely on the formal spending limits. One potentially relaxing factor is that the limits are defined at constant prices. This means that government expenditure's share of GDP value will typically grow even when expenditure is held within the spending limits. This is because public services production prices tend to rise faster than prices in general. It is also possible the spending limits could 'leak', since the spending rules do not cover all public expenditure. Consequently, savings in central government can simply mean increased expenditure in other areas of general government expenditure. Although central government governs some parts of local government expenditure, altogether only around half of combined central and local government primary expenditure is funded by central government. We could well ask, therefore, whether the success in holding expenditure within the spending limits is due to the limits themselves not being particularly tight relative to the performance of the economy at any given moment.

The Finnish system of spending limits is considered below from the perspectives outlined above. But we shall first assess the system in the light of economics literature and compare it with the practices current in other EU member states.

Expenditure rules reduce the deficit bias caused by the political process

Expenditure rules, and fiscal policy rules in general, are necessary because some features in political decision-making tend to create pressures for excessive increases in expenditure. In fact, economics literature talks of a deficit bias caused by the political process.[2]

One possible factor contributing to the deficit bias is the electoral cycle. As the elections approach, political decision-makers could have an incentive to increase expenditure (or cut taxes). This would give a short-term boost in support for the ruling coalition,

[1] On adherence to spending limits see Brunila and Kinnunen (2002) and Ministry of Finance (2003).

[2] See European Commission (2006).

assuming the electorate cannot see far enough ahead to understand the costs accruing later as a result of the increased expenditure.

Another factor contributing to the deficit bias could be party-political calculations on the part of the government. If a change in government seems probable, it could be advantageous to the governing party to increase the deficit prior to the elections. This would leave the incoming government to bear the costs of its predecessor's irresponsible policies.

A third factor that is considered to contribute to the deficit bias is the common pool problem familiar to economic theory. When the representatives of different political groups and interest groups, eg the representatives of different ministries, negotiate over the use of public resources, they all seek to maximise their own appropriations, with none taking on board the concept of common budget financing.

Because the political process has this tendency to produce excessive growth in public expenditure, it is necessary to find means that can more efficiently hold expenditure within the limits set by the available resources. In practice, this is done either by delegating decision-making to the finance minister or by making a political agreement on expenditure caps. It has been observed that countries with two-party systems, where one party at a time is in government, have generally adopted delegation. In contrast, political agreements are used in countries where governments are formed by multiparty coalitions.[3] Of the EU countries, the expenditure rules applied by eg the Netherlands, Ireland, Belgium and Slovakia are based on a political agreement. In other countries, eg France, Germany and Italy, control of expenditure has been delegated to the finance minister. In Germany, fiscal policy is also monitored by an independent council of experts. The Swedish system incorporates aspects of both approaches.

Finland's spending limits are by their nature a political agreement. In the government programme, the governing parties agree in advance the overall spending framework for central government expenditure and the limits for each administrative branch for the entire electoral period of four years. The precise allocations are reviewed annually in the government discussion on spending limits, at which the government sets revised limits for central government expenditure to guide the various administrative branches in formulating their proposals for the next year's budget.

Negotiations with the ministries over spending limits and the government discussion on spending limits are conducted in the spring, which in recent years has meant in practice that the key budget decisions have also been decided at this time. Thus, the formal government budget session has receded in importance in the annual budget process. In principle, therefore, Finland's spending rules serve to reduce the above-mentioned risks of

[3] See European Commission (2005).

excessive expenditure growth deriving from the political process. The allocation of central government financial resources to the various ministries in the form of capped appropriations prevents the emergence of a deficit bias caused by the efforts of different administrative branches to maximise their own appropriations.

The spending rules in principle also make it easier for the budget process to be informed by the long-term economic outlook. In practice, longer-term economic pressures and prospects are reflected not only in determining the overall level of expenditure, but also via the multiannual operating and financial plans of the different administrative branches. These plans, which cover periods of four years, include general operational guidelines and focus points and the most important targets for the development of social effectiveness and operational performance. They also include calculations for the level of appropriations already decided upon in each administrative branch, the relevant ministry's proposal for future expenditures and estimates of expenditures excluded from the spending limits and of the revenues of the administrative branch.

Finland's spending rules are an efficient but non-transparent tool

The spending rules applied in Finland are one example of fiscal policy rules.[4] The literature proposes a variety of optimality conditions for the form of such rules. In setting expenditure caps, it is essential to base them on a sufficiently realistic estimate of future trends in the economy's financial resources. One potential problem is that the government's own estimate could be misleading for political reasons. If the aim is to achieve an objective estimate of future financial resources, the job can be entrusted to an outside party.

Other criteria of optimal spending rules that have been mentioned include unambiguousness and transparency. Outsiders should be able to monitor compliance with the limits. This highlights governments' accountability for their expenditure policy. One requirement of optimal spending rules is broadness of scope. They should ideally cover the entire public sector, making them harder to evade. It has also been suggested that cyclically dependent expenditure items should be separated from discretionary expenditure.

In practice, spending rules differ greatly from one country to another.[5] For example, in the EU, where most member states apply some sort of spending rule, there are differences in terms of whether the rule is defined numerically, qualitatively or a combination of the two. The extent to which spending rules cover the various sectors of general government finances also varies. In the majority of cases they are set so as to cover just central government finances, ie expenditure items under direct political control. Another distinction can be drawn between spending rules written into law

[4] See eg Kopits, G and Symansky, S (1998).

[5] European Commission (2006).

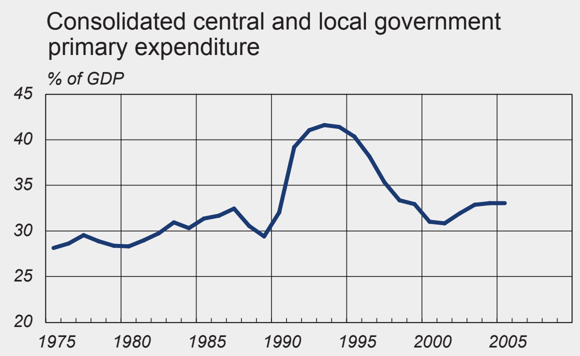
and those based on a political agreement. Moreover, rules may be based on the government's own forecast or on an assessment by an independent party. The different types of rule are linked with the specific practices in different countries, and there is considerable variation between countries in the role of spending rules in fiscal policy.

Finland's spending limits cover approximately three quarters of the appropriations for the annual expenditures included in the Budget. Finland's spending limit agreement is specifically designed to cover only those expenditure items that come under fiscal policy decision-making. This has been achieved by the exclusion of items that fluctuate automatically according to the economic cycle, such as expenditure on housing allowance and unemployment allowance and current transfers to the Social Insurance Institution. The effects of discretionary changes in these categories of expenditure are, however, included in the spending limits. The emphasis on the discretionary element reinforces accountability, but it also makes the system less transparent. In practice, it is very difficult for anyone outside the Ministry of Finance to assess whether spending has actually been held within the limits.

The spending limits also do not include interest payments on central government debt or expenditure to compensate for the effects on other tax recipients of changes in the tax basis. Also not included are expenditure against income from the European Union, expenditure against income from pools profits and transfer of profits by the Finnish Slot Machine Association (RAY) and financial investment expenditure.

Contrary to the earlier spending ceiling framework, supplementary budgets have now also been included within the spending limits. With this in mind, the spending limits each year include an undistributed reserve to cover unforeseen expenditure. Income from sale of shares has been allocated to special expenditure, with part of it to be directed to infrastructure investments and to fund research and development. A supplementary agreement has been attached to the spending rules whereby the central government deficit as measured by National Accounts concepts cannot be allowed to exceed 2¾% of GDP even when the economy is sluggish.

Chart 1.



Source: Statistics Finland.

The problem with the spending limits is their narrow scope and failure to compress cost pressures

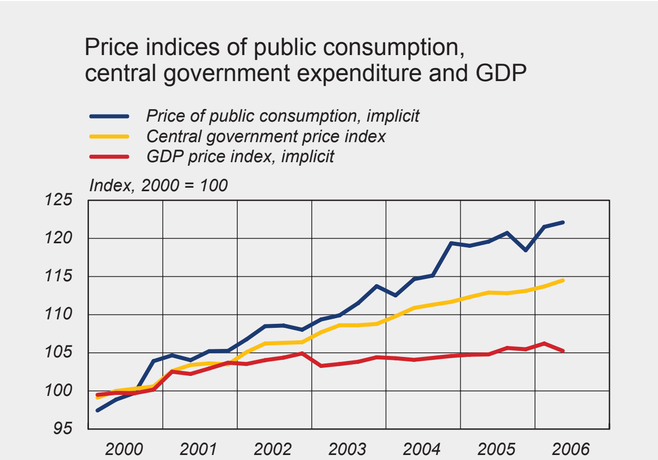
From the perspective of the manageability of public expenditure, the biggest problem with Finland's spending rules is their scope. The wide-ranging autonomy of local government in Finland means that a considerable proportion of public expenditure lies outside the scope of centralised political decision-making. Hence the spending limits are not a particularly effective tool for regulating the economy's overall tax burden or the size of public (ie general government) finances.

If the size of public finances is measured on the basis of combined central and local government primary expenditure (ie their combined expenditure excluding interest payments and government transfers and grants to local authorities), even the successful central government expenditure policy of recent years has not meant a contraction in the size of public finances relative to the economy as a whole (Chart 1). Instead, it would seem that the GDP share of combined central and local government expenditure has in recent years continued the gradual upward trajectory that began in 2002.

The strict control on expenditure in the spending rules is in part merely apparent also because the spending limits are defined at constant prices. Rising wages and other costs involved in the production of public services tend to increase the expenditure burden relative to the development of the financial base even when there is no increase at all in expenditure measured at constant prices. This has been particularly true in Finland in recent years. It has been largely overlooked that the upward trend in central government expenditure prices has been considerably faster than average price rises across the economy as a whole. For example, in 2003–2005 the overall price index for central government rose by a full 6%, while the GDP price index rose by less than 1%. This explains why, despite the Government's tight spending policy, total central government expenditure coming under the spending limits has not declined relative to GDP. In fact, without the tight spending policy, the faster price rises in central government would have led to a significant increase in the relative size of central government. Moreover, in the absence of strict controls on volume expenditure growth, central government finances would no longer be structurally in balance.

The importance of relative prices to growth in the size of public finances is clearly visible if we compare the price trend in public consumption as a whole with the development of the GDP price component (Chart 2). The price of public consumption has risen much

Chart 2.



Sources: Statistics Finland and Bank of Finland.

faster than GDP prices. The growth in the ratio has been fed both by the considerable contribution of wages in the price of public consumption and by the weak productivity trend in general government. According to calculations by Statistics Finland[6], productivity in both central and local government has been steadily declining since the late 1990s. The trend in relative prices has, therefore, increased the public sector's share of the economy and at the same time contributed to the continued high average tax ratio.

Outlook for spending rules

Credible and binding spending rules are in principle an effective tool for keeping public expenditure under control. They can help to lengthen the planning span of fiscal policy and, by reducing politicians' room for manoeuvre in budget policy, they also reduce the risks of volatility in spending policy. This means a reduction in the efficiency losses caused by changes in tax policy. Setting spending limits on a rolling basis for several years ahead, as is done at present in Finland, would also make it possible to take systematic account of long-term objectives and immediately foreseeable structural changes. Although the limits do not bind the next government, the process nevertheless serves to enhance the sustainability of public finances, provided expenditure pressures have been properly assessed. Under current practices, however, the long-term spending limits are essentially just technical calculations. Accordingly, increasing costs from demographic ageing have not been reflected in short-term spending policy. In principle, the spending rules could provide an opportunity to assess the impacts of these factors.

Finland's spending rules have in different contexts – eg in relation to the EU's fiscal policy coordination procedure – been used as an example of well-functioning fiscal policy rules. They have brought stability to the Finnish economy, and hence a competitive edge relative to other countries. The key issue for fiscal policy is the credibility of the rules. When public expenditure growth is under control, this also reduces concern over sudden adjustments in fiscal policy, making it easier for economic agents to make long-term commitments. In particular, the stability of public finances is important to the direction of corporate investment.

An important challenge for the future in spending limits is how to achieve a better forecast of growth in the GDP share of expenditure caused by changes in relative prices. The projects currently under way to improve cost-efficiency in the public finances are important. In fact, the containment of cost pressures is essential if growing expenditure needs are to be met. Control of expenditure cannot, however, rely on this alone. It is clear that the costs of public service production will continue to rise in the future. The GDP share of central and local government expenditure could continue to grow even if expenditure policy measured at constant prices remains strict.

[6] Statistics Finland (2006) and Kinnunen (2005).

Sources:

Brunila, A and Kinnunen, H, 'Spending limits and fiscal discipline in euro area countries', Bank of Finland Bulletin 1/2002.

European Commission (2005), Directorate-General for Economic and Financial Affairs 'Public Finances in EMU', European Economy, No 3/2005.

European Commission (2006), Directorate-General for Economic and Financial Affairs 'Public Finances in EMU', European Economy No 3/2006.

Kinnunen, H (2005), 'Public services productivity, the labour market and public finances in Finland', Bank of Finland Bulletin 1/2005.

Kopits, G and Symansky, S (1998), 'Fiscal Policy Rules', IMF Occasional Paper 162.

Ministry of Finance (2003), Finanssipolitiikan sääntöjen ja kehysmenettelyn kehittäminen Suomessa. [Development of fiscal policy rules and spending rules in Finland'], Working group report, 7 February 2003.

Statistics Finland (2005), Jalava J (ed.), Tuottavuuskatsaus 2004 [Productivity review 2004], Statistics Finland.