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Fiscal policy targeting under imperfect information

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ABSTRACT

Systematic deficit biases and the sovereign debt crisis have increased interest in fiscal rules and institutions, in particular the setting of intermediate fiscal policy targets. Theoretical arguments point to targeting of the structural budget balance, but it is difficult in practice because this variable is riddled with measurement problems and noise. This paper first briefly documents the noise in measures of the structural budget balance, and then proceeds to analyse how this inherent information problem affects budget targeting. A strict targeting of the structural budget balance leads to excessive policy responses to transitory influences, and thus causes excessive policy activism in contrast to the underlying "smoothing" aim motivating fiscal policy targets. This points to a fundamental weakness of the recently implemented fiscal compact for EU countries requiring member states to target the structural budget balance on an annual basis.

1. Introduction

Public finances are in most OECD countries under severe pressure due to failures to consolidate public finances and to undertake appropriate reforms to address approaching demographic changes. The financial crisis has further worsened the situation and brought the problems to the fore. In a recent assessment by IMF (2011), it is found that structural budget balances in advanced economies need to be improved by on average about 8% of GDP over a decade for the debt level to reach 60% of GDP in 2030.

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In the theoretical literature there are a number of arguments supporting non-balanced budgets including tax smoothing, stabilization policy/risk diversification and intergenerational distribution (see e.g. Elmendorf and Mankiw, 1998). However, the current situation can hardly be reconciled with any of these explanations, and there is broad consensus that the present problems mainly reflect political inefficiencies or biases.

This has reinforced the interest in rules and institutions for fiscal policy. With a lag this discussion is similar to the earlier discussion in relation to monetary policy. For monetary policy there has been a significant shift towards independent and rule-based policy making.[1] Although there has been proposals to develop similar independent institutions for fiscal policy (see e.g. Wyplosz, 2002 and Calmfors, 2003), the consensus is that this is not feasible without interfering too much in the policy decision process and the autonomy of democratically elected politicians. Instead the focus has been on the development of fiscal policy targets and rules with the purpose of increasing the political costs of opportunism and shortism in economic policy making. These costs can be further increased by assigning independent institutions (watch dogs) a role in monitoring and commenting upon the extent to which actual policies have followed the fiscal targets and rules (see Calmfors and Wren-Lewis, 2011).

The main role of rules is to strengthen political accountability; that is, to ensure that policy decisions are in accordance with stated objectives and intentions. A broad definition of accountability has that

> Accountability ensures that actions and decisions taken by public officials are subject to oversight so as to guarantee that government initiatives meet their stated objectives and respond to the needs of the community they are meant to benefit, thereby contributing to better governance (World Bank, 2006).

And in a more narrow definition

> A relation between an actor and a forum, in which the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgement, and the actor may face consequences (Bovens, 2006).

Clear and well-defined rules can serve to strengthen accountability. Rules are defined in terms of intermediate targets and the latter should be well defined, easy to monitor and under reasonable control by the policy maker. If so deviant or opportunistic behaviour is revealed, and policy control mechanisms can be enforced.

Few intermediate targets for fiscal policy satisfy the abovementioned requirements. There seems to be two overriding commonly shared requirements. First, automatic stabilizers should be allowed room to operate. This is the rule-based part of fiscal policy and it is widely accepted to be stabilizing. Secondly, the fiscal targets should not preclude political prioritization, but they should ensure that systematic imbalances do not arise between revenues and expenditures for the public sector. In short they should contain deficit biases and ensure that the intertemporal budget constraint is respected, but leave room for political prioritization on the size and structure of the public sector.

The most obvious candidates for intermediate targets are the debt level and the budget balance (as also seen in e.g. the Stability and Growth Pact). However, both of these have their shortcomings. The debt level can vary substantially in the short run due to changes in prices of financial assets. The budget balance captures how activities in a given period affect the debt level, and this variable is therefore closer related to policy decisions. However, it is also significantly affected by the cyclical position of the economy, which is beyond the control of the policy maker. Moreover, it is desirable that the budget varies with the cycle so as to perform the automatic stabilizing role. A variable closer related to policy is the cyclically adjusted or structural budget balance.[2] Theoretically it makes sense to make this variable an intermediate target since it captures the underlying structure of public finances which matters for

[1] There is a vast theoretical and empirical literature on monetary policy rules and targeting (see e.g. Svensson, 2011 for a recent overview). Monetary policy targeting builds on an announced inflation target, implementation with focus on inflation forecasts (stabilizing expectations) and a high degree of accountability/transparency. The institutional framework is an independent central bank with a mandate for price stability, and which thus can be held accountable for its policy decisions relative to the mandate.

[2] In principle this is equivalent to targeting the debt net of short-term variations in asset prices.