

Does the structural budget balance guide fiscal policy pro-cyclically?

Evidence from the Finnish Great Depression

Tero Kuusi, ETLA

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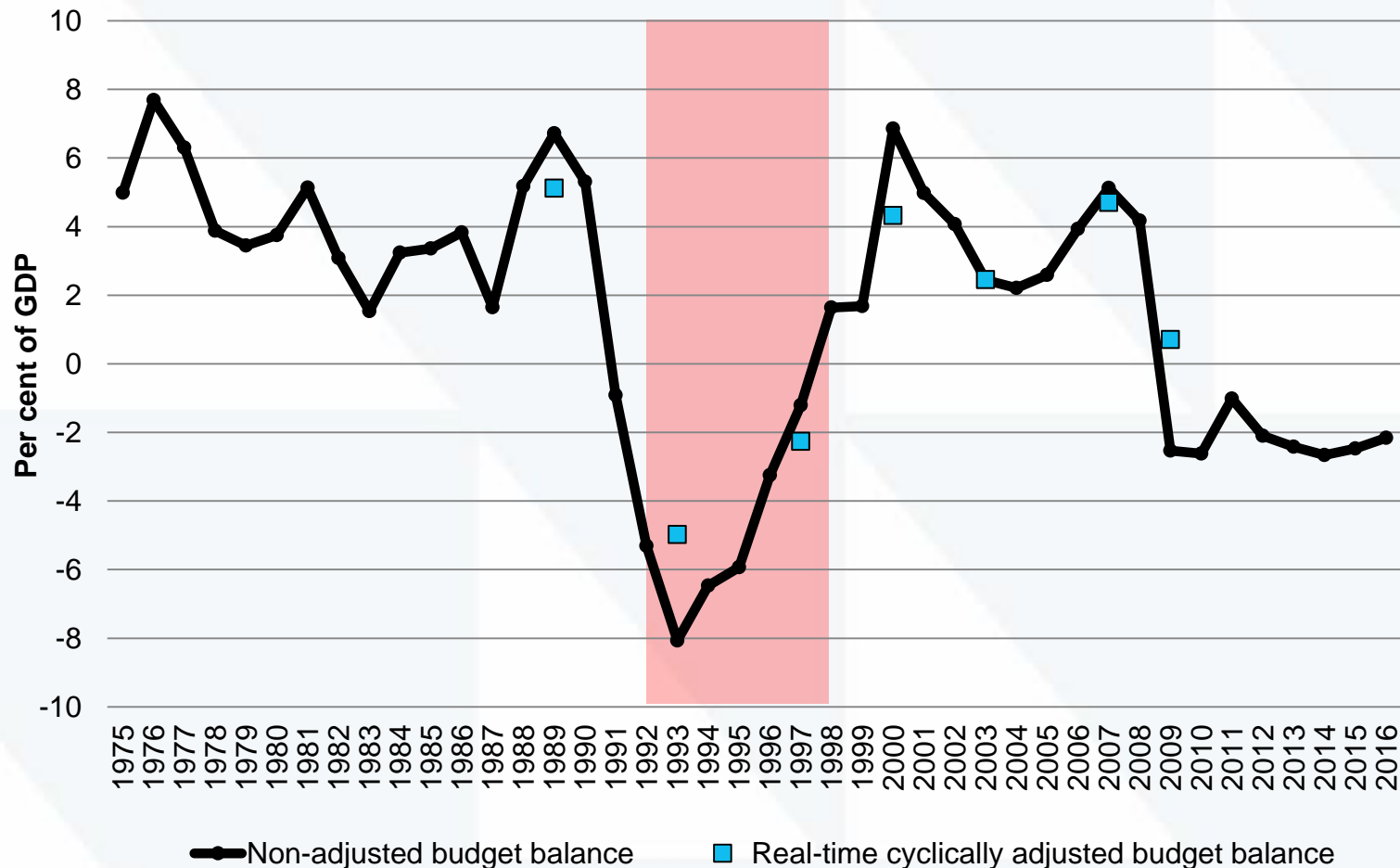
Introduction

- Firststrun addresses the EU's current fiscal policy design. One of the main fiscal policy indicators is the structural budget balance (SB).
 - SB measures the cyclically-adjusted general government balance net of one-off expenditure and revenue items.
- EU uses several alternatives, which all involve uncertainties and different assumptions.

The current analysis

- **Research question:** How fiscal policy based on the SB alternatives would have worked in practice in the historical context?
 - Case Finland 1984-2014. Special focus on the Finnish Great Depression (FGD) of the 1990s.
- **Analysis of the methodological alternatives:**
 - "Top-down": The SB based on the output gap and the elasticity of revenue and cost items
 - "Bottom-up": Expenditure growth net of discretionary revenue measures (actual decisions) compared to medium-term potential GDP growth.

The “top-down” SB guides fiscal policy pro-cyclically – alternatives are needed



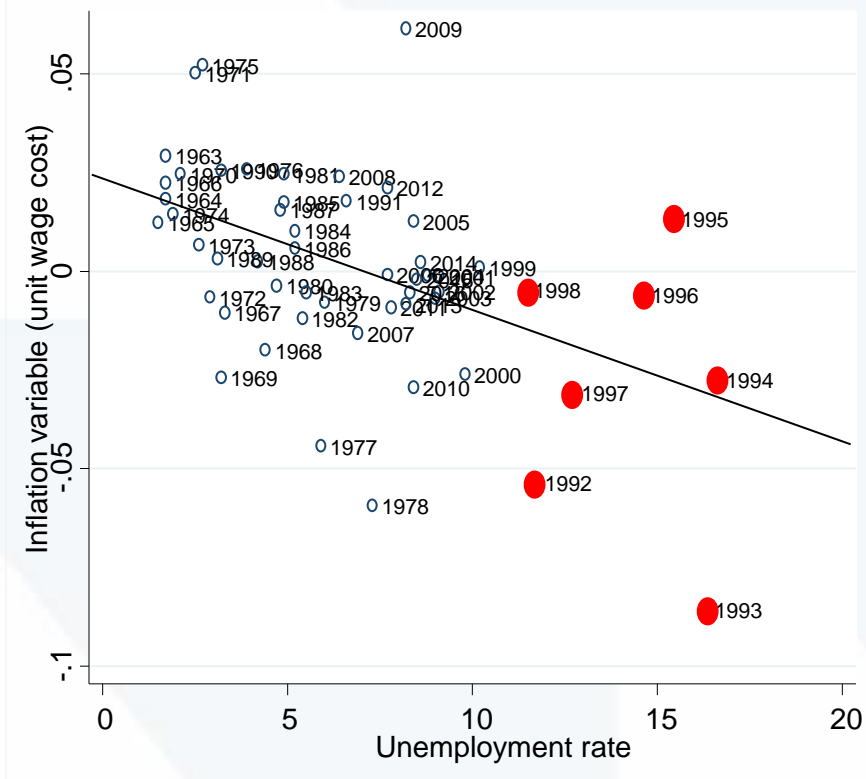
Methodology

- "Top-down": Commission's production function based output gap methodology
 - Commission 2/2014 forecast's data and algorithms.
 - Evaluation in **real-time** basis without using information on the development of the economy in subsequent years.
- "Bottom-up": Discretionary fiscal effort (the expenditure rule and the Bottom up –assessment of effective actions)
 - A new historical dataset of discretionary revenue measures and other required variables 1975-.

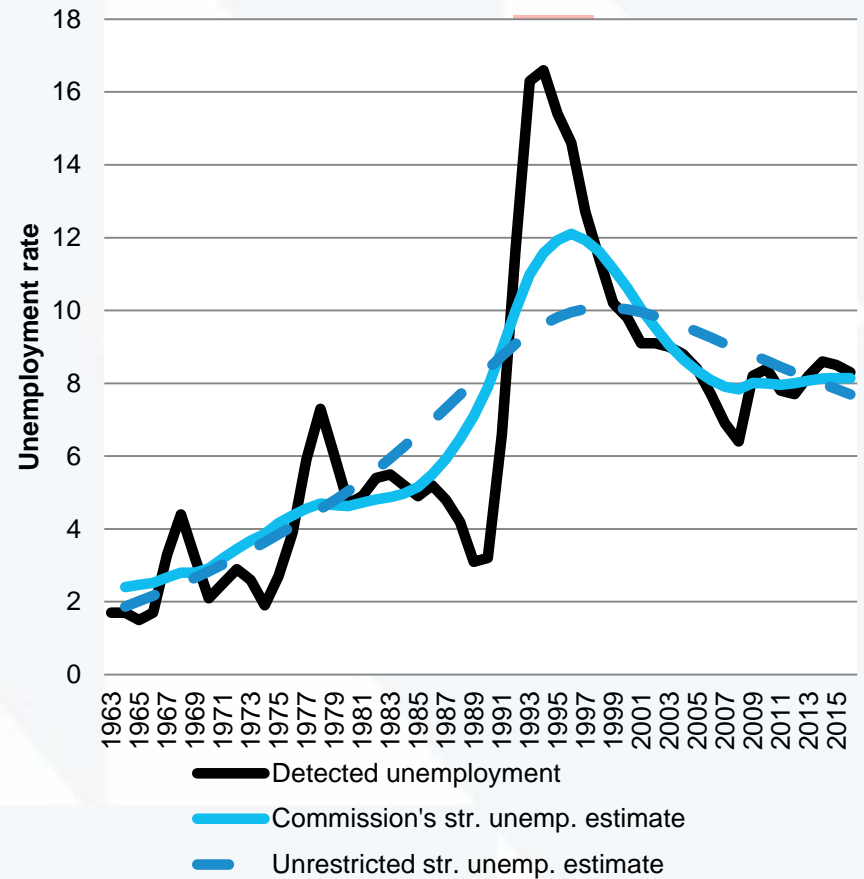
Selected issues

Measuring the structural unemployment

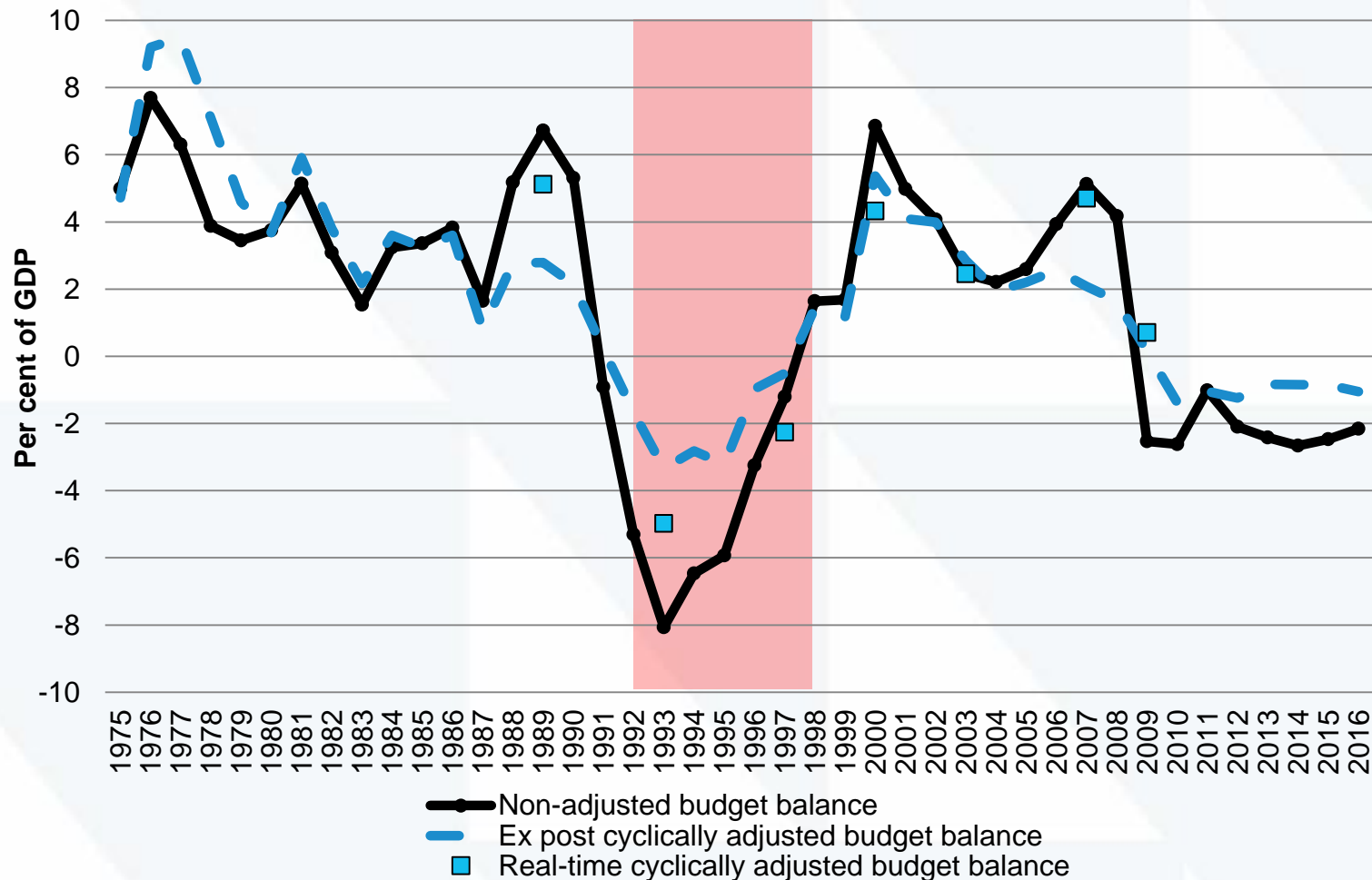
Inflation is a poor indicator of cyclical unemployment during the FGD, and its use results in ...



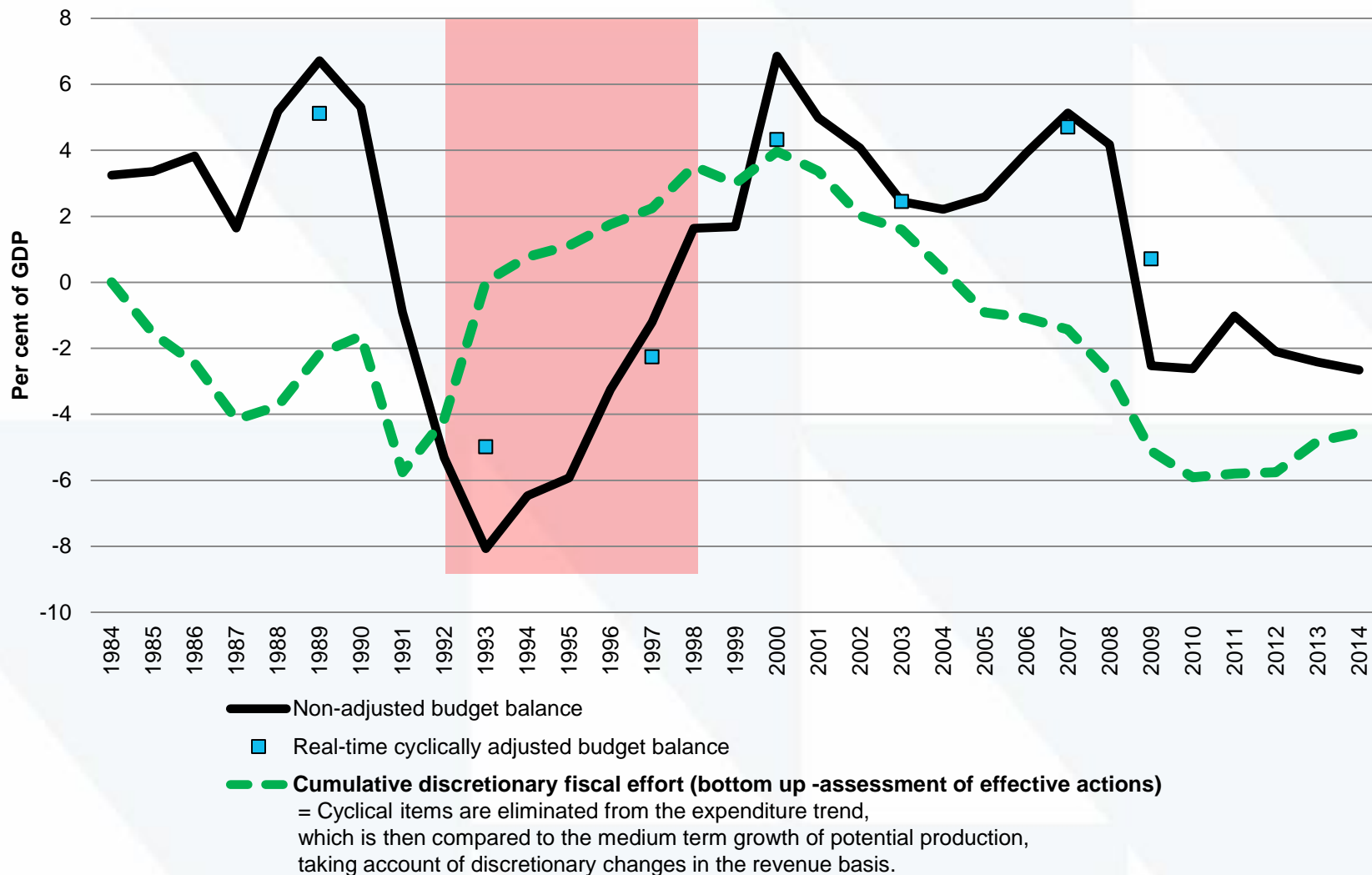
high estimates of the structural unemployment that are amplified by parameter restrictions



Pro-cyclicality of the “top-down” SB becomes pronounced in *real time*



The "bottom-up" estimates provide less pro-cyclical guidance



Main lessons

- The “top-down” structural balance may guide fiscal policy pro-cyclically
- The “bottom-up” estimates of the SB are less dependent on the cycle
 - For Finland the methods yield conflicting policy implications especially for the 1990s crisis, but not currently.
 - Due to the methodological problems, it appears that parallel indicators are needed, even though their use maintains the current complexity of the rules and increases the margin for their interpretation.