

Chapter 3

Strengthening the fiscal framework

Strengthening the fiscal framework would provide the means for both restraining the growth of public expenditures and helping automatic stabilisers work more efficiently. After reviewing current conditions in Iceland and discussing the pros and cons of fiscal policy activism, the chapter explains how better fiscal rules could improve the efficiency of public spending as well as lead to greater stability over the cycle. The final section lays the argument for extending fiscal rules to local governments.

A sound fiscal position

Fiscal consolidation in the 1990s restored broad budget balance, and strong growth in recent years has led to sizeable budget surpluses. Consequently, the net public debt of the general government has declined from almost 40% of GDP in 1995 to 8% in 2006. Furthermore, although Iceland's generational accounts were slightly deteriorating in the years up to 2004 (the latest available estimate), intertemporal public liabilities are deemed to be low by international standards. This owes mostly to the operation of occupational pension funds for private sector workers that have been mandatory for more than 30 years, and to similar arrangements in the public sector. All in all, long-term sustainability of public finances is not a cause of major concern relative to other OECD countries. This does not mean, however, that there is ample room for increasing public expenditures: as noted in Chapter 1, the government faces considerable contingent liabilities since it guarantees the debt of certain companies and institutions, and it would therefore be prudent to keep sufficient budgetary buffers. As well, the volatility of the macroeconomy, especially in a very small open economy such as Iceland, implies that fiscal trends can reverse rapidly. Overall, a cautious fiscal policy is called for by this chapter.

What is the role for discretionary fiscal policy?

A central question for fiscal policy is whether it should play an active role in countercyclical stabilisation. The consensus view among economists is that monetary policy is the preferred instrument of macroeconomic stabilisation. In the words of John Taylor (Taylor, 2000), for instance: "Monetary policy has a comparative advantage over fiscal policy in achieving countercyclical goals." In this view, fiscal policy should contribute to demand management through automatic stabilisers while discretionary countercyclical measures should be avoided. Hence, fiscal settings should be determined by medium-term considerations, such as boosting national savings. There are some exceptions to this, which can arguably include recent conditions in Iceland. This does not imply, however, that the standard prescriptions do not generally apply in Iceland, and that a new demand management framework is needed.

Fiscal policy is subject to long lags

A first reason for according monetary policy the responsibility for macroeconomic stabilisation is its quicker responsiveness. The lag from the receipt of economic news to a central bank's decision as to how to respond is short. In Iceland, the Central Bank meets every two months. By international standards this is not that unusual, though monthly meetings are perhaps more common. In any case, meeting frequency does not preclude almost immediate reaction to fast-breaking news.

In contrast, fiscal decisions take much longer. That is partly because fiscal decisions are more complicated, with multiple taxes and spending programmes to choose from, partly because they have controversial distributional implications, and partly because

fiscal decisions involve large numbers of decision makers with different objectives. Any change in a government budget appropriately invites discussion and disagreement about priorities. In Iceland, most fiscal measures are jointly decided once a year in the annual budget. Exceptional measures can be decided more quickly, outside the regular budget process. But normally, joint (and hence less frequent) decisions are preferable in order to compare competing priorities. In other small OECD countries, decision-making lags appear to be similar; in larger countries, the lags appear to be even longer. In addition, there is a further lag between the decision and its implementation, especially for investment projects, which varies depending on how much planning is necessary. In large part for this reason, supporters of fiscal activism often prefer that it be implemented through variations in taxes and transfers.

Effectiveness

In Iceland, as in other OECD economies, fiscal policy is ordinarily less powerful than monetary policy. Specifically, a typical variation in government spending or taxes will have a smaller effect on output, and a much smaller effect on inflation, than a typical change in interest rates. (See Box 3.1 for a presentation of short-run effects of fiscal policy in a standard macro-econometric model of the Icelandic economy.) One limitation of this argument is that it is not clear that “typical” variations are actually optimal – though they presumably have some basis in preferences and costs. Perhaps, fiscal settings should be more variable. If they were, they would have significant macroeconomic effects. Another qualification is that in some conditions, monetary policy may be constrained (such as in the well-known liquidity trap example); then, fiscal multipliers are much larger.

Accountability

A final argument for relying on monetary policy instead of discretionary fiscal policy is that this clarifies responsibility for macroeconomic management and promotes accountability. If both fiscal and monetary policy are responsible for demand management, then identifying and correcting failures in policy is difficult and public discussions become confused. The recent situation in Iceland is an example. Over the past few years, the Central Bank repeatedly raised its policy rate while the Treasury ran large fiscal surpluses. It was often said of each arm of policy that it “has already done a lot” and that the responsibility for further action lay with the other arm. Arguably, the failure of monetary policy to approach its target was obscured and excused by the perception that fiscal policy was failing to be appropriately “supportive”. Rather than calling for higher interest rates, some commentators preferred to blame fiscal inaction. This distraction made the political climate very difficult for the monetary authority to respond fully.

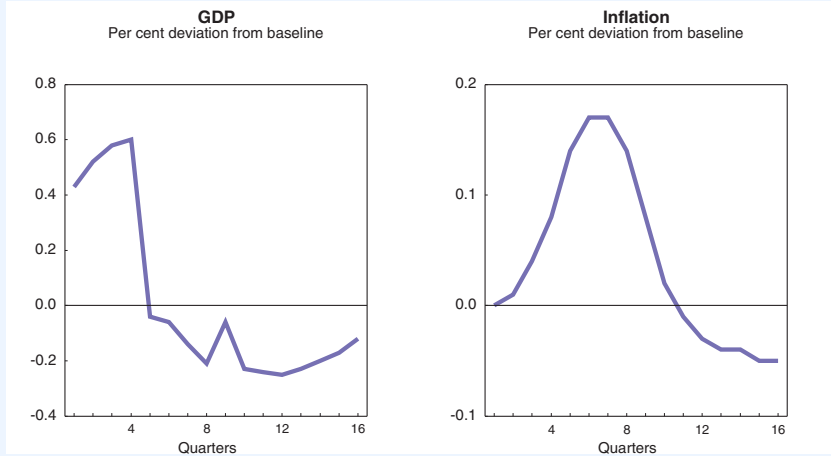
Summary: normally, fiscal activism should be avoided

These objections do not apply to automatic stabilisers. The tendency of government receipts to rise and transfer payments to drop when activity increases tends to dampen booms automatically and instantaneously. Automatic stabilisers boost activity faster than discretionary macro policy during downturns and reduce the need for large variations in policy instruments. And not being subject to review, they do not involve a blurring of responsibility. Indeed, allowing them to run their course contributes to stabilising the economy.

Box 3.1. Estimated short-term effects of fiscal policy

Figures 3.1 and 3.2 show the effect of changes in fiscal settings on output and inflation, as estimated by the Central Bank of Iceland's quarterly macroeconomic model (QMM), which incorporates a Taylor-rule type monetary policy reaction function (Danielsson *et al.* 2006). Figure 3.1 shows the effects of an increase in government spending by 1% of GDP sustained for 4 quarters. GDP increases simultaneously by about three-fifths of the shock, then returns to near the baseline when the shock is removed. The increase in government spending is partly offset by a large increase in imports. Figure 3.2 shows the effect of a reduction in taxes by the same amount, also sustained for 4 quarters. (This is equivalent to a bringing-forward of tax cuts that would have otherwise occurred a year later.) This has a smaller initial impact on GDP than the spending shock because households save some of the tax cut. But as those savings are spent, the effect persists. In both cases initial impacts on inflation are small, if not trivial. These estimates are approximately symmetric: effects are the same size, but opposite in sign, for a spending reduction or postponement of tax cuts.

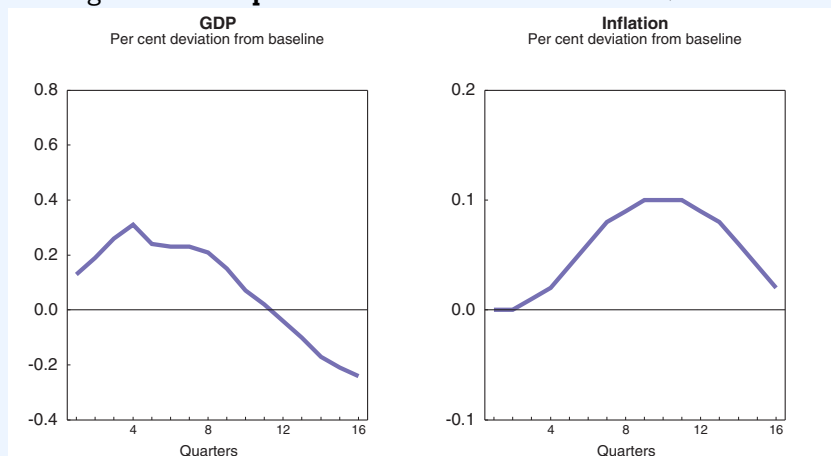
Figure 3.1. **Response to increase in government spending of 1% of GDP**




StatLink  <http://dx.doi.org/10.1787/276642818264>

Source: Central Bank of Iceland (previously unpublished).

Figure 3.2. **Response to reduction in taxes of 1% of GDP**



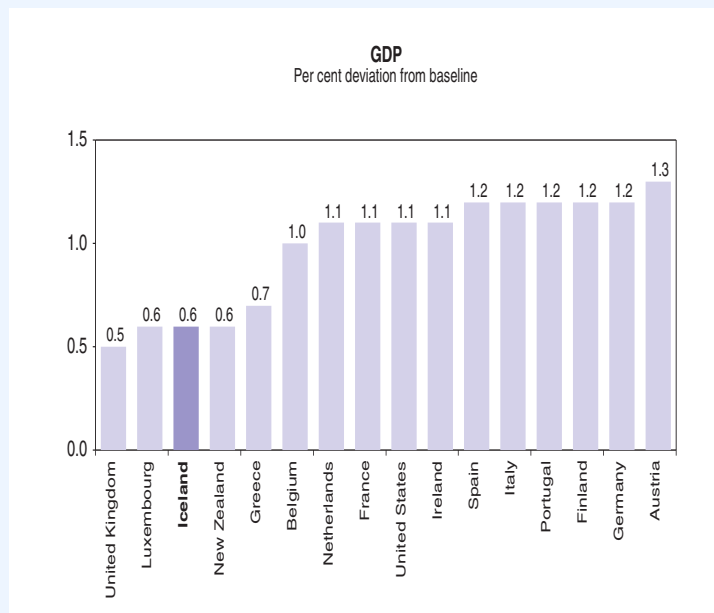
StatLink  <http://dx.doi.org/10.1787/276655442687>

Source: Central Bank of Iceland (previously unpublished).

Box 3.1. Estimated short-term effects of fiscal policy (cont.)

The QMM estimates are similar to those found using macroeconomic models in other countries and would widely be regarded as mainstream. For example, Hemming *et al.* (2002) in a survey of studies report that “most expenditure [GDP] multipliers are in the range 0.6 to 1.4 and most tax multipliers in the range 0.3 to 0.8.”* The estimates for Iceland lie toward the lower end of the international range, which may reflect the country’s small size and hence large short-run marginal propensity to import. Figure 3.3 presents estimates for responses to an increase in spending for various countries. Estimated output multipliers for Iceland are about the same as for other small countries such as Greece, Luxembourg and New Zealand. The estimated inflation multiplier for Iceland is near the middle of other estimates, most of which are tiny. In short, the overall effectiveness of fiscal policy in Iceland is similar to that in other countries, once allowance is made for size.

Figure 3.3. **Response after 4 quarters to increase in government spending of 1% of GDP**



StatLink  <http://dx.doi.org/10.1787/276657154703>

Source: This table is largely based on material compiled by the Central Bank of Iceland. For euro area countries, Fagan and Morgan (2005); for New Zealand, Dunstan *et al.* (2007); for the United Kingdom (the UK Treasury model) Church *et al.* (2000); for the United States (the Federal Reserve’s FRB/US model), Reifschneider *et al.* (1999). Where multiple estimates are presented, that shown assumes monetary policy follows a Taylor rule.

One can get some sense of how important the above multipliers are by considering typical changes in policy settings. One measure of this is the standard deviation of annual changes over the ten years to 2006. Column 2 of Table 3.1 shows standard deviations of changes in government spending and taxes (both measured as a share of GDP), and for comparison, the standard deviations of interest rates. Reading across the top row, a typical annual change in government spending, worth 1.5% of GDP, given a multiplier of 0.6, would boost GDP by 0.9% or about half a typical deviation in the output gap. A standard-deviation change in taxes would change output by about one-fifth a standard deviation change in the output gap. A typical deviation in interest rates would change output by

Box 3.1. Estimated short-term effects of fiscal policy (cont.)

almost one standard deviation change in the output gap. In other words, to offset a typical variation in the output gap would require a relatively ordinary variation in interest rates, a moderately large change in spending or an almost unprecedented change in taxes.

Table 3.1. The effect on GDP of typical policy changes

	Standard deviations (1997-2006)	4-quarter GDP multiplier	GDP Effect
Change in government current expenditure /GDP	1.5 ¹	0.6	0.9
Change in government current receipts /GDP	1.3 ¹	0.3	0.4
Interest rates (Level, short-term, nominal)	2.4 ²	0.7	1.6

1. Per cent of GDP.

2. Percentage points.

Source: OECD database.

Summing up, the QMM estimates confirm that there is no systematic exception for Iceland. As in other OECD economies, fiscal policy is typically less powerful as a stabilisation tools than monetary policy.

* It might be noted that these estimates are far below estimates of generation ago – in the 1970s, multipliers were often thought to be around 3 or 4 (Solow, 2004). It might also be noted that differing empirical approaches tend to give somewhat varying results. For example, recent narrative-based research (Romer and Romer, 2007) finds that tax changes undertaken for counter cyclical reasons have much bigger effects than the above estimates.

It has been argued that fiscal elasticities in Iceland are too small for automatic stabilisers to have a noticeable effect. Indeed, a recent OECD analysis finds that the elasticity of the (flat) income tax relative to the output gap is below unity and that expenditures are nearly stable over the cycle but also that the high corporate tax elasticity is an important offsetting factor (Girouard and André, 2005). Thus, when all factors are considered (see Table 3.2), the cyclical responsiveness of fiscal balances to the economic cycle is estimated a bit below of the OECD average, but is by no means negligible. An alternative study by the Ministry of Finance estimates that the personal income tax elasticity with respect to the growth of the tax base (not the output gap) is on average slightly above unity (Ministry of Finance, 2007). In any case, all the available evidence provides support for reinforcing the effectiveness of automatic stabilisers, especially on the expenditure side, not for fiscal activism.

Table 3.2. Elasticities with respect to the output gap¹

	Corporate tax	Personal tax	Indirect tax	Social security contributions	Current expenditure	Total balance
Iceland	2.08	0.86	1.00	0.60	-0.02	0.37
OECD	1.50	1.26	1.00	0.71	-0.10	0.44
Denmark	1.65	0.96	1.00	0.72	-0.21	0.59
Euro area	1.43	1.48	1.00	0.74	-0.11	0.48
United States	1.53	1.30	1.00	0.64	-0.09	0.34
Korea	1.52	1.40	1.00	0.51	-0.04	0.22

1. The last column is the semi-elasticity which measures the change of the budget balance, as a per cent of GDP, for a 1% change in GDP. It is based on 2003 weights. Aggregate country zone averages are unweighted.

Source: Girouard and André, 2005.

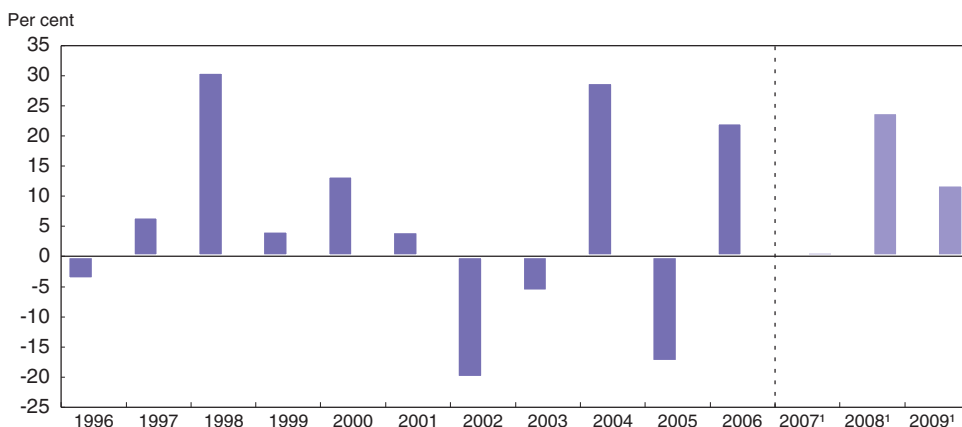
Fiscal activism could potentially help stabilize the economy over the cycle; however, it often turns out to be counterproductive in practice. A few episodes in the recent Icelandic experience well illustrate how difficult it is to too timely implement fiscal policy measures, and stand firm to cyclical and political pressures.


First, the 2007 tax cuts, a sensible structural reform reducing fiscal pressure and thus boosting the efficiency of the economy, turned out to be poorly timed, effectively undoing the work of the automatic stabilisers on the revenue side. According to the multipliers presented in Box 3.1, the tax cuts, which the Central Bank of Iceland estimates to have already cost the government about 2.5% of GDP, should have already boosted output by almost 1 percent and (underlying) inflation by 0.2 percentage point. In fact, the government had planned the timing of the measures to coincide with a downturn in the cycle, which shows not only how difficult it is to timely implement fiscal policy measures but also provides support for phasing in gradually future tax cuts. Furthermore, it should be noted that some of the tax cuts took place mainly with a reduction of the value-added tax, and sales taxes not only are less distortionary than other taxes but also discourage consumption, and therefore, in the case of Iceland, could help stabilising the economy.

A second and related issue is that public expenditures have not been sufficiently countercyclical, as should be assured by the workings of fiscal multipliers. As was pointed earlier (see Table 3.2), public expenditures tend to be fairly constant over the cycle. Much of this is due to the fact that public wage consumption has been procyclical, as it seems that both central and local government find hard to resist demand for higher pays for public employees during booms (Annett, 2007). In 2007, the combination of higher public wages and lower taxes, as shown in Chapter 1 (see Figure 1.7), led the fiscal stance to turn loose at a very inopportune time.

Finally, public expenditures appear to have been excessively volatile in recent years. An enlightening statistic is the standard deviation of the annual growth rate of public investment, which has measured nearly 18% over the past ten years (Figure 3.4). And this pattern is expected to continue over the projection period. In recent years, the volatility of investments by local governments has been a particular source of instability, while

Figure 3.4. **Annual growth of public investment**



StatLink  <http://dx.doi.org/10.1787/276675723206>

1. OECD projections.

Source: OECD Economic Outlook 82 database.

fluctuations of investments by the central government have been in large part the result of short-run stabilization policies. In any case, going forward, a more gradual implementation of public projects could enhance the contribution of public expenditures to macroeconomic stability.

Overall, as long recognized by the Ministry of Finance, these considerations suggest that fiscal policy settings should normally be decided without direct reference to the state of the business cycle. This is not because discretionary fiscal policy is harmful or impossible. It is simply because monetary policy can generally do the job a little better. It can respond more rapidly and more freely, and it has stronger effects on both output and inflation. Furthermore, decision-making is simplified and accountability is strengthened by assigning the task of demand management to monetary policy.

... though there are some legitimate counterarguments

As often is the case in economics, there are valid reasons to sustain the opposite case. First, exchange rate considerations provide a sound argument for fiscal activism, especially for very small open economies. Partly reflecting large interest rate differentials, the Icelandic króna is estimated to be considerably overvalued (Tchaidze, 2007). The appreciation has seriously squeezed the trade-exposed sectors of the economy, while benefiting consumers through lower import prices. Perception of hardship in the exposed sector, coupled with its uneven distribution, has been a source of strong criticism of the Central Bank. In such circumstances, exchange rate concerns do limit monetary policy and enhance the case for discretionary fiscal policy. The situation parallels the zero nominal interest rate lower bound – though the constraint is distributional and political rather than structural. In any case, fiscal tightening can reduce demand pressures when monetary policy is immobilised. Indeed, when interest rates are held constant, fiscal multipliers become larger. Furthermore, to the extent that fiscal measures can reduce pressures on the exchange rate, they can even out the burden of restraint, which seems advisable for both distributional and political reasons. However, while some coordination between monetary and fiscal policy would clearly be desirable, it would be difficult to achieve given the long lags and political constraints that characterise fiscal policy decisions

Another important caveat to the case against fiscal activism comes from the fact that Iceland's recent boom has been unusual in several respects. It has been driven by a combination of greater access to foreign capital and policy-facilitated developments in the housing and aluminium sectors, and, above all, it has been protracted and expected. The economy has been overheating since 2004, and current forecasts call for the unemployment rate to remain low and for inflation to be in excess of its target through 2008. This is relevant in that it invalidates one of the main arguments against discretionary fiscal policy – the long decision lags. While these lags make smoothing business-cycle fluctuations unadvisable, they do not preclude action to smooth imbalances extending over several years.

While exchange rate considerations and the predictability and the length of the expansion indicate that some discretionary fiscal measures would have been desirable over the past few years, they do not provide a strong enough case for fiscal activism. Above all, discretionary fiscal policy is often influenced by political and other constraints and, as discussed earlier and in Chapter 2, monetary policy, even in Iceland, should be the preferred tool to manage aggregate demand over the business cycle. All in all, Iceland's institutional framework, in which fiscal settings are based on medium-term objectives and monetary policy is responsible for short-term stabilisation, appears to be sensible. Against

this backdrop, the next section will present a set of recommendations to strengthen the rules that guide fiscal policy decisions, with the aim of improving the effectiveness of the automatic stabilisers and of curbing the tendency for higher public spending.

The fiscal framework

The fiscal framework has undergone substantial changes since the 1990s, with a goal of enhancing the control and effectiveness of public spending. In 1992, a top-down “frame-budgeting” approach was introduced in order to enhance the policymaking role of the government and to increase overall fiscal discipline. This annual process begins with the government agreeing on a total expenditure level. After a special cabinet committee, led by the Prime Minister, sets expenditure frames (ceilings) for each ministry early on in the budget formulation phase. Each minister is then responsible for allocating available funds to agencies and projects under the department’s auspices, in accordance with the limits set by the frame. The budget is finally presented to Parliament for amendments and approval.

In 2003, the “frame budgeting” approach was supplemented by the adoption of spending rules (Ministry of Finance, 2003). For the central government, a ceiling to real public consumption was set at 2%, and one for real transfers at 2.5%. Furthermore, the personal income tax rate was set to be varied less frequently, with the aim of keeping the budget in balance or preferably a small surplus, while the associated tax credit has been regularly adjusted to offset the fiscal drag of inflation. In addition, the government began to present medium-term plans, setting 4-year revenue and expenditure projections and frames for expenditure growth in real terms.

As argued in previous *Surveys*, this framework has not prevented guidelines for central government’s real expenditure growth from being missed. Table 3.3 shows that real public consumption by the central government has almost always been (even if so slightly) above the 2% ceiling, a tendency which is expected to persist over the near term. It should be noted that the definition of central government is also ambiguous, as it is not clear if it refers to Treasury alone and there seem to be differences between the Ministry of Finance and Statistics Iceland. For real transfer payments, it is even more problematic to verify compliance as there are no readily available statistics. However, the Secretariat estimates that, based on nominal figures from the 2008 budget and on public consumption deflator projections from the Ministry of Finance, Treasury real transfer payments should have grown 4.9% in 2007 and are expected to rise 4.4% in 2008, both well above the 2.5% ceiling. In short, fiscal rules are frequently not met but infringements are obscured by sub-optimal reporting standards. In part deviations from target can be accounted for by one-off shocks

Table 3.3. **Real public consumption, 2004-2009**

	Annual per cent change					
	2004	2005	2006	2007 ¹	2008 ¹	2009 ¹
Central government ²	2.1	2.6	2.8	2.6	2.2	2.6
Central government ³	1.4	3.0	2.4
Local governments	0.0	5.2	6.3	3.2	2.8	2.5
Total public sector	2.2	3.5	3.9	2.8	2.4	2.5

1. Ministry of Finance forecasts.

2. The Ministry of Finance definition of central government includes both the Treasury and the social security sector.

3. The Statistics Iceland definition of central government only includes the Treasury.

Source: Ministry of Finance and Statistic Iceland.

to defence spending related to the closure of the US military base, however the National Audit Office has repeatedly observed that a significant number of ministries and public agencies have far outspent their budget year after year. In 2006, it found that two-thirds out of around 300 budgetary items were outside the 4% deviation allowed for in the regulations concerning budget implementation, a practice that clearly undermines stated government objectives. In addition, these medium-term plans seem to have been in practice more a forecasting exercise than a means of budgetary restraint. With no mechanism in place to ensure that targets are met, each annual budget presents an update of the previous medium-term plan starting from a higher expenditure level. In fact, it should be noted that the budget surpluses posted by the central governments in recent years cannot be attributed to an effective control on expenditures; rather, they are mainly the result of surprisingly buoyant tax receipts associated with stronger-than-expected GDP growth, as shown in Table 3.4.

Table 3.4. **General government fiscal situation**¹
Per cent of GDP

	2001	2002	2003	2004	2005	2006	2007 ²
Revenues	41.9	41.7	42.8	44.1	47.2	48.2	47.4
Expenditures	42.6	44.3	45.6	44.0	42.3	41.8	43.1
Financial balance	-0.7	-2.6	-2.8	0.0	4.9	6.3	4.2
Structural balance ³	-1.6	-3.0	-3.1	-1.4	2.6	4.4	3.2
Structural primary balance ³	-1.0	-2.6	-2.5	-1.1	2.2	3.6	2.5
Net debt ⁴	24.1	23.3	23.2	22.0	9.8	7.3	..
Gross debt ⁴	43.9	43.3	40.6	35.4	25.5	28.9	..
<i>Memorandum items:</i> ⁴							
Central government							
Revenues	31.1	30.8	31.8	33.0	35.4	35.5	..
Expenditures	31.6	32.1	33.6	32.0	31.0	30.1	..
Financial balance	-0.5	-1.3	-1.8	1.0	4.5	5.3	..
Local government							..
Revenues	11.6	11.7	11.9	12.0	12.7	13.7	..
Expenditures	12.2	13.0	12.7	12.8	12.6	13.4	..
Financial balance	-0.6	-1.3	-0.8	-0.8	0.1	0.3	..

1. National accounts basis.

2. OECD projections.

3. Per cent of potential GDP.

4. Ministry of Finance.

Source: OECD Economic Outlook 82; Ministry of Finance.

Even more so than the central government, local governments (that is, the municipalities) have let their spending increase together with revenues. Over the 2003-2006 period, expenditures by municipalities have grown at an average pace of 8% in real terms, three times the rate recorded at the central government level. As municipalities account for one-third of total public-sector spending, their finances have a noticeable impact on the overall fiscal stance. For instance, the strongly procyclical (and ill-timed) surge in public investment between 2005 and 2006 was largely due to the fact that local government investment rose by 50% in real terms.

Thus, in spite of the record budget surplus and the substantial debt reduction, there seems to be ample room to strengthen the existing fiscal framework. Well-designed rules constraining the discretionary power of budget policymakers (both at the central and the

local level) can offer the means for avoiding excessive public expenditures and ensuring long-term sustainability, and can also enhance the effectiveness of automatic stabilisers.

The international experience

Over the past decade and a half, a large number of countries have introduced fiscal rules. Rules have focused on spending, deficits or revenues, and a wide cross-country heterogeneity is documented in Table 3.5. Recent econometric analysis of twenty-four

Table 3.5. **Main fiscal rules currently applied in OECD countries**

Date and name		Characteristics of the set of rules			
		Budget target	Expenditure target	Rule to deal with windfall revenues	Golden rule
Australia	Charter of Budget Honesty (1998)	Yes	No	No	No
Austria	Stability and Growth Pact (1997)	Yes	No	No	No
	Domestic Stability Pact (2000)				
Belgium	Stability and Growth Pact (1997)	Yes	No	Yes	No
	National budget rule (2000)				
Canada	Debt repayment plan (1998)	Yes	No	Yes	No
Czech republic	Stability and Growth Pact (2004)	Yes	Yes	No	No
	Law on budgetary rules (2004)				
Denmark	Medium term fiscal strategy (1998)	Yes	Yes	No	No
Finland	Stability and Growth Pact (1997)	Yes	Yes	No	No
	Spending limits (1991, revised in 1995 and 1999)				
France	Stability and Growth Pact (1997)	Yes	Yes	Since 2006	No
	Central government expenditure ceiling (1998)				
Germany	Stability and Growth Pact (1997)	Yes	Yes	No	Yes
	Domestic Stability Pact (2002)				
Greece	Stability and Growth Pact (1997)	Yes	No	No	No
Hungary	Stability and Growth Pact (2004)	Yes	No	No	No
Iceland	Frame budgeting (1992)	No	Yes	No	No
	with real expenditure ceilings (2003)	No	Yes	No	No
Ireland	Stability and Growth Pact (1997)	Yes	No	No	No
Italy	Stability and Growth Pact (1997)	Yes	Yes	No	No
	Nominal ceiling on expenditure growth (2002)				
Japan	Cabinet decision on the Medium term fiscal perspective (2002)	Yes	Yes	No	No
Luxembourg	Stability and Growth Pact (1997)	Yes	No	No	No
	Coalition agreement on expenditure ceiling (1999, 2004)				
Mexico	Budget and fiscal responsibility law (2006)	Yes	No	Yes	No
Netherlands	Stability and Growth Pact (1997)	Yes	Yes	Yes	No
	Coalition agreement on multiyear expenditure targets (1994, revised in 2003)				
New Zealand	Fiscal responsibility act (1994)	Yes	Yes	No	No
Norway	Fiscal Stability guidelines (2001)	Yes	No	Yes	No
Poland	Stability and Growth Pact (2004)	Yes	No	No	No
	Act on Public Finance (1999)				
Portugal	Stability and Growth Pact (1997)	Yes	No	No	No
Slovak Republic	Stability and Growth Pact (2004)	Yes	No	No	No
Spain	Stability and Growth Pact (1997)	Yes	No	No	No
	Fiscal Stability Law (2001, revised in 2006)				
Sweden	Fiscal budget act (1996, revised in 1999)	Yes	Yes	No	No
Switzerland	Debt containment rule (2001, but in force since 2003)	Yes	Yes	Yes	No
United Kingdom	Code for fiscal stability (1998)	Yes	No	No	Yes

Source: OECD (2007, Table 4.2); Ministry of Finance.

OECD countries (including Iceland) since 1978 indicates that a combination of expenditures and deficit rules has had favourable effects on fiscal consolidation outcomes (OECD, 2007).

The international experience provides further interesting lessons for Iceland. In several countries, the fiscal framework has been successfully reinforced by establishing a strong reporting system and mechanisms that increase the political costs of breaching the rules. Efficiency was also improved by adopting an approach based on prudent macroeconomic forecast and on independent analyses of the fiscal and economic effects of the policies to be enacted. Finally, transparency and communication with the public (as in the case of inflation targeting) seem to be crucial features of any successful experience with fiscal rules.

The experience of the Netherlands, where political fragmentation usually gives rise to multi-party coalitions as in Iceland, seems the most fitting. The Dutch fiscal framework is based on four-year expenditure ceilings (Bos, 2007). However, the ceilings are rigid and are separately set for central government spending, social security and healthcare. Furthermore, an independent agency provides not only prudent forecasts of the Dutch economy but also detailed analyses of the economic effects of the policy measures proposed by the various parties to use before elections, during coalition formation, and to underpin the annual budget process. It should also be noted that while expenditures ceilings are set in real terms, they are indexed to the deflator of “national” expenditures (which therefore excludes import and export prices), and that automatic stabilisers are allowed to operate on the revenue side. Finally, there is an official advisory group which provides annual recommendations to ensure that budgetary rules and principles evolve with best practices and changing circumstances.

Last but not least, in many countries fiscal rules for the central government are often complemented by a wide variety of rules at subnational levels. In particular, several EU countries have set up domestic stability pacts to align domestic fiscal rules for local governments with their Maastricht commitments.

Improving the central government budgeting framework

International comparison reveals that fiscal framework in Iceland is sensible, but such comparisons also provide further motivation and practical suggestions to strengthen it. As noted earlier, the main problem with the existing “frame budgeting” is that the frames are seldom respected, resulting in continued expenditure slippage. There are two main reasons: these ceilings are effectively set every year and the base of expenditures is allowed to drift up. Best practice calls for multi-year spending targets and overall fiscal objectives to be clearly laid out and incorporated into coalition agreements. This is at variance with current practice where coalition agreements contain only vague references to fiscal policy. Compliance to the rules should be verified regularly, and results should be made available to the public. There should be political costs for failing these objectives, and rewards for achieving them. Greater political ownership would also deter altering the frames during the legislative process and having to resort to supplementary budgets in the implementation phase. In addition, multi-year frames should be set for each ministry. These ceilings should be binding in order preclude expenditure base drift, so that if a ministry overspends one year, it will have less resources the subsequent years. Finally, in order to deal with unexpected events, contingency rules could be included *ex ante* in the budget.

The adoption of nominal spending limits would considerably increase transparency, which is essential for the success of any rule. If the public understand why an action is being taken, that greatly increases the likelihood of the associated rule being successful and sustained. Switching to nominal ceilings would also increase the government's ownership of the goal of controlling inflation. In contrast, the government has repeatedly been accommodating wage increases which are at variance with the inflation-targeting framework adopted in 2001. Ideally for this purpose, once inflation has stabilised, the nominal ceilings could be set based on the Central Bank's inflation goal. As a minimum, if the government were to decide to stick to real ceilings, it should follow the Dutch example and inflate expenditures based on an index that excludes import and export prices, therefore abandoning the GDP deflator. This would ensure that exchange rate fluctuations do not alter the value of public expenditures, with the possible risk of provoking the development of dangerous inflation spirals.

Greater emphasis on a medium-term horizon would also allow developing better plans for reducing fiscal pressures. In 2007, tax cuts provided a considerable stimulus to an economy which was already overheating, and should have been postponed or offset by additional spending restraint. On the other hand, it is not obvious that it is worth deviating from the existing principle that tax credit should be indexed to nominal income. In any case, if budget surpluses were to persist, the government should avoid further cuts to sales taxes, which lower households' incentive to save, and instead reduce income taxes, with positive supply effects. For this reason, any harmonisation among the different value-added tax rates should aim at being revenue neutral.

Switching to a nominal multi-year budgeting plan would not only strengthen the medium-term orientation of expenditure policy and budget discipline but would also enhance the contribution of fiscal policy to macroeconomic stabilization. Less expenditure slippage and well-timed tax cuts would greatly improve the efficacy of automatic stabilisers on the revenue side. In addition, once inflation has stabilised, nominal ceilings based on Central Bank inflation expectations would likely result in a more countercyclical public spending.

Another issue of contention is the timing of public investment, as it appears to have been exceedingly volatile in the recent past. Public investment should be based on careful cost-benefit analysis, including environmental impacts. Ordinarily, if benefits exceed costs, investment should be undertaken even though in some cases, timing will determine benefits and costs and thus it may be worthwhile to wait. This is not to say that public investment should be used for countercyclical stabilisation purposes, as the time required for the cost-benefit analysis and the long implementation lags make it an odd instrument to offset short-term fluctuations. In fact, the Icelandic experience seems a primer of what not to do: delaying worthwhile public investment just to add it to the list the following year does not contribute to economy stability, and creates confusion about the merits of each single project. In a boom, it is preferable to allow marginal private projects to be crowded out by increasing interest rates rather than seek to fine-tune worthwhile public projects.

Finally, while the advantages of spending rules over deficit rules are clear (Anderson and Minarik, 2006), it appears that the best practice calls for a combination of the two (OECD, 2007). In this light, it would be beneficial if the current practice of aiming at keeping the budget in balance or preferably a small surplus would be supplemented by a clearly-stated and transparent medium-term balanced-budget requirement. In fact, as the

experiences over the past ten years of other OECD countries illustrate (such as Australia, Canada, Finland, New Zealand and Sweden), nothing should prevent Iceland from running persistent budget surpluses. This would be particularly opportune given the considerable external imbalances, the large amounts of contingent liabilities and the economic volatility, among other considerations.

The case for subnational fiscal rules

The specific structure and increasing responsibilities of local governments both have consequences on overall spending outcomes. Local authorities are still in the middle of a merging process that began more than fifty years ago. There are now 79 municipalities as compared with 171 in 1994 and 229 in 1950, when the pace of mergers accelerated. Nonetheless, large differences in size have persisted: Reykjavik counts for over one-third of Iceland's population, while over one-half of the municipalities have less than 1 000 inhabitants.

This amalgamation process has facilitated the transfer of responsibilities from the central government to the municipalities, thus improving the allocative efficiency of public spending by matching public services to local preferences. Local governments are now responsible for providing primary and secondary education (up to the age of sixteen), social services (including those for the elderly and housing for low-income earners, but excluding employment services) and some infrastructure (such as harbours and environmental matters). To finance these activities, municipalities have some limited taxation powers on income and real estate property, which provide approximately 70% of their income. Nearly 20% of local revenues come from charge fees for services that municipalities provide, and over which they have considerable discretion. Direct payments from the central government, mostly through the Equalisation Fund, account the remainder (less than 10%). Municipalities can also raise loans to meet capital expenditure without authorisation from the central government.

Local revenues have surged from 11.6% of GDP in 2001 to 14.3% in 2006 (see Table 3.4), and municipalities have shown even less restraint than the central government in spending these windfall resources. The pick-up in expenditures can be partly attributed to strong population growth which in turn has led to an increasing demand for local public services (especially schooling and housing-related investment). It appears nonetheless that municipalities have systematic difficulties in containing costs, as it is harder for them to resist claims for more public services and higher pay for employees.

As expenditures by local governments account for about a third of the overall level, national spending objectives cannot be achieved without effective co-operation between the central government and the municipalities. For instance, both in 2004 and in 2006, a run-up in investment at the local government level partly offset the central government's efforts to restrain public spending. Furthermore, as noted earlier, the municipalities are responsible for the provision of politically-sensitive services (such as education), which further increases the central government's stake in the conduct of local fiscal policy. Finally, it should also be noted that in Iceland oversight of local governments from financial markets and tax competition among local authorities can only play very limited roles to foster best practice, given the size of the country and most municipalities. In sum, there seems to be ample scope for improving the budgeting process at the local level and to institutionalise the co-operation across levels of government.

In the first half of 2007, the Ministry of Finance began negotiations with the municipalities to address these issues. In exchange for debt relief and increased transfers, the Ministry has proposed the introduction of ceilings on real expenditure growth and the level of debt as well as a balance budget requirement over the business cycle. Unfortunately, little progress has been made so far, but the case for extending fiscal rules to municipalities is sound.

First of all, the revenues of Iceland's municipalities are highly elastic with respect to the cycle since the local income tax is the main source of revenues and the Equalisation Fund is financed through a fixed percentage (now 1.4%) of the taxation income of the central government. To offset the negative consequences of the combination of the cyclical variability of local finances with a tendency to spend-it-all, expenditure ceilings can be used in order to both smooth and curb the spending of municipalities. Limiting the discretionary power of budget policymakers should not only improve long-term fiscal sustainability and short-term stability, but also help to restrain the size of the public's sector and thus raise aggregate efficiency (Sutherland *et al.*, 2005). In addition to the Ministry of Finance's proposal, in order to reduce the cyclicity of local revenues, the share of property taxes (which tend to be relatively stable over the cycle) could be increased, and the Equalisation Fund's transfers could be linked to cyclical conditions (or projections as in the case of Denmark).

The central government plan also calls for borrowing constraints and a balanced budget requirement. It should be noted that the two are based on similar grounds, in that they essentially set objectives for the flow and the stock of debt in order to ensure long-term sustainability (Sutherland *et al.*, 2005). The case for their adoption is also clear given that municipalities are likely (and rightly) perceived by lenders as borrowers as having their finances implicitly guaranteed by the central government. In practice, however, this is a minor issue in Iceland in view of the sound fiscal position of local authorities: the combined net financial liabilities of municipalities stood at 4% of GDP in 2006, having come down from almost 10% in 2000.

An important obstacle to the effective introduction of local fiscal rules is the minuscule size of many municipalities, which prevents the adoption of innovation in public management since their implementation costs become excessive relative to the resulting savings. It is therefore crucial to accelerate the amalgamation process, or at least combine the budgeting process of the smallest local authorities. Notwithstanding this concern, the proposed local fiscal rules could provide the means for achieving the efficiency gains of local autonomy as well as ensuring that national spending objectives are met. Rules should be designed to take into account changes in population and costs resulting from new central government legislation. Furthermore, credible enforcement mechanisms should be set in place. Also for this reason, as for the central government, ceilings should be set in nominal rather than real terms and for a specific multi-year period rather than over an undefined business cycle.

Concluding remarks

In summary, although public debt has been brought down and the long-term position of public finances is sound, the conduct of fiscal policy in Iceland could be improved. Recent budget surpluses are more than accounted for by a surge in revenues, and some fiscal slippage has led to a renewed increase of public expenditures relative to GDP. In contrast, other OECD countries used windfalls in government's revenues to set-up rainy

day funds. As well, there seems to be room to take off some pressure from monetary policy for short-term stabilisation. It should be stressed that the latter is not an argument in favour of fiscal activism but for stronger automatic stabilisers, especially on the expenditure side. While discretionary fiscal policy is not harmful or impossible, monetary policy should remain the preferred instrument for managing aggregate demand mainly because it can respond more rapidly and more freely from political constraints. As detailed in Box 3.2, the medium-term orientation of expenditure policy of both central and local governments should be reinforced by introducing multi-year budget goals with binding spending limits. The resulting framework should help restrain overruns of budget spending and enhance the effectiveness of automatic stabilisers.

Box 3.2. Recommendations regarding fiscal policy

- The “frame-budgeting” approach could be improved to curb spending overruns and increase the contribution of fiscal policy to macroeconomic stabilisation. Binding multi-year spending ceilings should be set for each ministry to preclude expenditure base drift.
- Greater transparency and clearer communication to the public would also increase the enforceability of existing fiscal rules. For example, coalition agreements should include precise references to the medium-term fiscal objectives (such as budget surpluses), so as to provide a term of reference against which to measure the performance of the new government. As well, reporting standards of compliance to rules need to be improved.
- Once inflation has stabilised, the adoption of nominal ceilings consistent with Central Bank’s inflation target would result in a more countercyclical fiscal policy and would also enhance transparency and increase the government ownership of the goal of controlling inflation. If the existing real ceilings are maintained, inflate public expenditures using an index that excludes import and export prices in order to ensure that exchange rate fluctuations do not give rise to inflation spirals.
- Automatic stabilisers should be allowed to run their course. Future tax cuts should be phased in gradually and be part of a medium-term strategy to increase the efficiency of the economy. In addition, both central and local governments should restrain public sector wage growth during expansions.
- Public investment is not well suited as policy instrument for demand management and should be solely based on careful and independent cost-benefit analysis. To the extent possible, projects should be implemented smoothly in order to contribute to macroeconomic stabilisation.
- The planned implementation of fiscal rules for municipalities could help ensure the achievement of national spending objectives. Nominal ceilings should be set for a specific multi-year period, rather than over an undefined business cycle. Reduce the cyclicity of local revenues in order to offset a secular tendency to spend-it-all by municipalities.
- An acceleration of the amalgamation process would help the implementation of subnational fiscal rules, as the small size of many municipalities prevents the adoption of innovation in public management as implementation costs are deemed excessive.

Bibliography

- Anderson, B. and J. Minarik (2006), "Design Choices for Fiscal Policy Rules", *OECD Journal on Budgeting*, Vol. 5, No. 4, September.
- Annett, A. (2007), "Toward a Robust Fiscal Framework for Iceland: Motivation and Practical Suggestions", *IMF Working Papers*, No. 07/235.
- Bos, F. (2007), "The Dutch fiscal framework; history, current practice and the role of the CPB", *CPB Documents*, No. 150, CPB Netherlands Bureau for Economic Policy Analysis.
- Church, Mitchell, Sault and Wallis (2000), "Comparative properties of models of the UK economy", *National Institute Economic Review*, No. 161.
- Daniélsson, A., L. Eliasson, M. Gudmundsson, B. Hauksson, R. Jónsdóttir, T. Ólafsson and T. Pétursson (2006), "QMM A Quarterly Macroeconomic Model of the Icelandic Economy", *OECD Economics Department Working Paper*, No. 32, Department of Economics, Central Bank of Iceland.
- Dunstan, A., D. Hargreaves and O. Karagedikli (2007), "The Impact of Fiscal Policy on the Business Cycle", *Reserve Bank of New Zealand Bulletin*, Vol. 70, No. 1.
- Fagan, G., and J. Morgan (ed.) (2005), *Econometric Models of the Euro-area Central Banks*, Edward Elgar Publishing.
- Girouard, N. and C. André (2005), "Measuring Cyclically-adjusted Budget Balances for OECD Countries", *OECD Economics Department Working Papers*, No. 434.
- Hemming, R., K. Michael and M. Selma, (2002) "The Effectiveness of Fiscal Policy in Stimulating Economic Activity: A Review of the Literature", *IMF Working Paper*, No. 02/208.
- OECD (2007), "Fiscal Consolidation: Lessons from past Experience", Chapter 4 in *Economic Outlook*, No. 81, Paris.
- Ministry of Finance (2003), "2004 – Fiscal budget information", Reykjavik, October.
- Ministry of Finance (2007), "The elasticity of the personal income tax", *The Icelandic Economy – Spring 2007*, Reykjavik, October, pp. 49-52.
- Reifschneider, D., R. Tetlow and J. Williams (1999), "Aggregate Disturbances, Monetary Policy and the Macroeconomy: the FRB/US Perspective", *Federal Reserve Bulletin*, January, pp. 1-19.
- Romer, C. and D. Romer (2007), "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks", *NBER Working Paper*, No. 13264.
- Solow, R. (2005), "Rethinking Fiscal Policy", *Oxford Review of Economic Policy*, Vol. 21, No. 4, pp. 509-514.
- Sutherland, D., R. Price and I. Joumard (2005), "Fiscal Rules for Sub-central Governments: Design and Impact", *OECD Economics Department Working Papers*, No. 465.
- Taylor, J. (2000), "Reassessing Discretionary Fiscal Policy", *Journal of Economic Perspectives*, No. 14, pp. 21-36.
- Tchaidze, R. (2007), "Estimating Iceland's Real Equilibrium Exchange Rate", *IMF Working Papers*, No. 07/276.

Table of contents

Executive summary	8
Assessment and recommendations	11
Chapter 1. Challenges facing the Icelandic economy	19
Longer-term economic performance	20
The economic situation	22
Near-term prospects and risks	26
Immediate policy requirements	30
Longer-term challenges	32
Annex 1.A1. Progress in structural reform	38
Chapter 2. Towards a more effective monetary policy	41
Implementation and communication of monetary policy	42
Effectiveness: is monetary policy impotent?	47
Fine-tuning the framework	53
Concluding remarks	55
Bibliography	55
Chapter 3. Strengthening the fiscal framework	57
A sound fiscal position	58
What is the role for discretionary fiscal policy?	58
The fiscal framework	65
Bibliography	73
Chapter 4. Improving cost-effectiveness in the health-care sector	75
Overview of the health-care system	76
Outcomes by international comparison	77
Costs and financing	79
Spending efficiency	86
Government policies	92
Concluding remarks	93
Bibliography	95
Boxes	
1.1. What drives private consumption?	23
1.2. How big is the external deficit?	25
1.3. New investment projects	28
1.4. Financial market developments	28
2.1. Recommendations regarding monetary policy	55

3.1.	Estimated short-term effects of fiscal policy	60
3.2.	Recommendations regarding fiscal policy	72
4.1.	National Audit Office recommendations on pharmaceuticals	84
4.2.	Centralisation and efficiency	91
4.3.	Recommendations on health care	94

Tables

1.1.	Balance of payments	26
1.2.	Short-term projections	27
1.3.	Interest rates	30
1.4.	Public investment	32
1.5.	Treasury guarantees	33
1.6.	Agriculture: Producer support estimate	36
3.1.	The effect on GDP of typical policy changes	62
3.2.	Elasticities with respect to the output gap	62
3.3.	Real public consumption, 2004-2009	65
3.4.	General government fiscal situation	66
3.5.	Main fiscal rules currently applied in OECD countries	67
4.1.	General government expenditure on health care	81
4.2.	Projections for public health and long-term care spending	85
4.3.	Potential for hospital cost reductions	90

Figures

1.1.	Aggregate economic indicators	21
1.2.	Indebtedness	22
1.3.	Growth has resumed	23
1.4.	Determinants of private consumption	24
1.5.	Tensions and imbalances persist	25
1.6.	Credit Default Swap (CDS) spreads for major banks	29
1.7.	Monetary and fiscal stance	31
1.8.	Real health expenditure per capita	34
1.9.	Student performance on the science scale and spending per student	35
2.1.	An overheated economy	42
2.2.	Central bank policy interest rate in real terms	43
2.3.	Central bank inflation forecasts	44
2.4.	Medium-term nominal Treasury bond yields	45
2.5.	Yield on indexed HFF bonds	46
2.6.	Breakeven inflation rate	47
2.7.	Response to 1 percentage point temporary increase in interest rate	48
2.8.	Indexed mortgage rates	51
2.9.	The mortgage rate channel of monetary policy	52
3.1.	Response to increase in government spending of 1% of GDP	60
3.2.	Response to reduction in taxes of 1% of GDP	60
3.3.	Response after 4 quarters to increase in government spending of 1% of GDP	61
3.4.	Annual growth of public investment	63
4.1.	Life expectancy at birth	77

4.2. Obesity	78
4.3. Total expenditure on health as a share of GDP	80
4.4. Health expenditure per capita, public and private, 2005.....	80
4.5. Long term care beds	83
4.6. Spending to outcome frontier, 2003.....	87
4.7. Nurses.....	88
4.8. Physicians.....	89

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Iceland were reviewed by the Committee on 29 January 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 11 February 2008.

The Secretariat's draft report was prepared for the Committee by Hannes Suppanz and Andrea de Michelis under the supervision of Patrick Lenain.

The previous Survey of Iceland was issued in August 2006.

This book has...



StatLinks 

**A service that delivers Excel® files
from the printed page!**

Look for the *StatLinks* at the bottom right-hand corner of the tables or graphs in this book. To download the matching Excel® spreadsheet, just type the link into your Internet browser, starting with the <http://dx.doi.org> prefix.

If you're reading the PDF e-book edition, and your PC is connected to the Internet, simply click on the link. You'll find *StatLinks* appearing in more OECD books.

BASIC STATISTICS OF ICELAND

THE LAND

Area (1 000 sq. km)	103	Unproductive area (1 000 sq. km)	82
Productive area (1 000 sq. km)	21	of which:	
of which:		Glaciers	12
Cultivated area	1.1	Other area devoid of vegetation	67
Rough grazings	20		

THE PEOPLE

Population, 31 December 2007	312 872	Occupational distribution, 2007 (per cent)	
Net increase 1997- 2007, annual average, %	1.4	Agriculture	3.8
		Fishing and fish processing	4.7
		Other manufacturing	11.5
		Construction, total	10.1
		Trade	16.3
		Transport and communication	7.1
		Other services	59.6

PARLIAMENT AND GOVERNMENT

Present composition of Parliament	2007
Independence Party	25
The Alliance Party	18
Progressive Party	7
The Left-Green Movement	9
The Liberal Party	4
Last general election: 12th May 2007	

PRODUCTION AND CAPITAL FORMATION

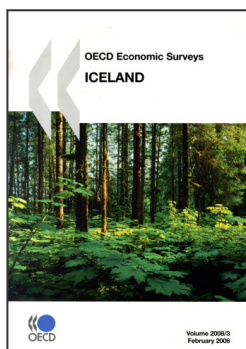
Gross domestic product in 2006		Gross fixed capital formation in 2006	
ISK million	1 162 930	ISK million	387 992
Per head, US dollars	54 764	Per cent of GDP	33.4

FOREIGN TRADE

Exports of goods and services in 2006, % of GDP	32.2	Imports of goods and services in 2006, % of GDP	38.4
Main exports in 2006 (% of merchandise exports)		Imports in 2006, by use (% of merchandise imports)	
Fish products	51.2	Consumer goods	20.2
Aluminium	23.5	Capital goods and transport equipment	46.2
Other manufacturing products	14.8	Industrial supplies	25.1
Agricultural products	1.8	Fuels and lubricants	8.4
Miscellaneous	8.7		

THE CURRENCY

Monetary unit: Króna		Currency units per USD, average of daily figures:	
		Year 2007	64.1
		December 2007	62.4



From:
OECD Economic Surveys: Iceland 2008

Access the complete publication at:
https://doi.org/10.1787/eco_surveys-isl-2008-en

Please cite this chapter as:

OECD (2008), "Strengthening the fiscal framework", in *OECD Economic Surveys: Iceland 2008*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-isl-2008-5-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.