The new guideline for spending petroleum revenue - A problem for stabilisation policy?

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"The structural, non-oil budget deficit shall approximately correspond to the expected real return on the Government Petroleum Fund at the beginning of the fiscal year. The expected real rate of return on the Petroleum Fund is estimated at 4 per cent. The spending rule for oil revenues refers to a situation with normal capacity utilisation in the economy. If the economy is at risk of overheating, fiscal policy restraint should be considered, while in a cyclical downturn a somewhat higher use of petroleum revenues may be required."

Ministry of Finance, English summary of National Budget 2002
http://www.statsbudsjettet.dep.no/Engelsk_nb/kap1.html

This citation summarises the new guidelines that the Storting approved this summer. I have been asked about whether there is a conflict between these guidelines and stabilisation policy (or demand management as it is called in the programme). From the quote above this appears to be an unnecessary question. The government has hedged by explicitly permitting deviations in response to cyclical imbalances. However, I shall still take the opportunity to make some remarks about the connection between the new guidelines and stabilisation policy.

An expansionary trend

After the niceties that have to do with cyclical variations have been shredded off, the guideline says that the non-oil budget deficit each year should equal four per cent of the capital in the petroleum fund. The government's net cash flow from petroleum production will be accumulated in the fund. This means that the real amount that can be spent grows from year to year by four per cent times the cash flow from petroleum production. Thus, for a long time into the future we should expect fiscal policy to have an underlying expansionary trend.

There is nothing wrong with this. Economists have a reputation for always warning about fiscal expansions. Since there are no limits to the calls for increased government expenditures and reduced taxes, we are usually forced into this sad role. However, contrary to what some want us to believe, everybody agrees that "the people of Norway" should benefit from the oil revenues. There then has to be a period when more money is actually spent.

Some may fear that a continuing fiscal expansion will lead to continuous overheating of the economy. Even in the absence of other disturbances, this is hardly the case. In theory, what happens is that the expansion quickly leads to an increase in labour costs in Norway relative to in other countries. This takes place through a combination of wage
increases and currency appreciation. The mix is determined mainly by monetary policy. Reduced cost competitiveness means that production of internationally tradeable goods is shifted from Norway to abroad. This is a slow and gradual process. However, after a while production will shift abroad at a speed that matches the fiscal expansion. The boom will end. It is likely to be followed by a recession when the full effects of the increased cost level are felt. Wage costs will overshoot their long run equilibrium level during the boom. They are not likely to come down again without a period of high unemployment first.

Hence, in theory, the phasing in of oil revenues means an initial overheating followed by a period of relatively high unemployment later. This is not an argument against the new guidelines. If we want to taste the roast, we cannot avoid the heat. Rather the new norm was designed to reduce the heat. It means a slow and gradual phasing in of the oil revenues. More gradualism means less overheating, less overshooting in labour costs and less unemployment later.

However, phasing in oil revenues is not a process that starts with the new guidelines. We have been doing this at varying speeds since the mid 1970s. Labour costs in Norway are already high. The recent appreciation of the Norwegian krone, especially relative to the Swedish krone, has compounded the problem. Thus, almost daily there are news about job cuts and relocations in the traded goods industries. The party may already be over.

Comparing cost levels is a difficult art. At a time of international recession there are job cuts everywhere. Still I would not bet on the proposition that our relative wage costs do not already exceed the long run equilibrium.

More generally, stabilisation policy is not about preventing structural change. Stabilisation policy is about avoiding abrupt changes in fiscal policy, about avoiding to create "shocks" that are difficult for the economy to absorb. The new guidelines try to take care of this. Stabilisation policy is also about responding in a rational way to disturbances that originate in the private sector or abroad, and to that I now turn.

**Stabilisation relative to a long term plan**

The terms "expansionary" and "contractionary" are relative. The yearly National Budgets have taught us to focus whether the budget is expansionary or contractionary relative to last year. In a discussion of how fiscal policy should be conducted, it is equally important to focus whether fiscal policy is expansionary or contractionary relative to the long run plan for fiscal policy. The 2002 budget is expansionary relative to the 2001 budget, but neutral relative to the long-term plan that is defined by the new guidelines. At least this is the case if we take the government figures at face value.

Before the government can conduct a sensible stabilisation policy, it must have an idea of where fiscal policy should be heading in the long run. Stabilisation policy is best seen as deviations from this plan. This is also the view implicit in the new guidelines when they refer to the state of the business cycles. Non-oil deficits should be above the norm in recessions, below the norm in booms.
However, the new guidelines may be a bit simplistic at this point. Ideally the policy response should depend on what caused the boom or the recession in the first place. There is fairly general agreement that as a minimum the government should allow the automatic stabilisers to work (that is it should smooth the paths of tax rates and of government consumption). That is taken care of by focusing on the structural deficit. The citation at the beginning indicates an intention to do more than that. Or does it? Active labour market programmes are an integral part of our system for unemployment relief. However, calculations of the structural deficit make no correction for the cyclicity of these expenditures. There are similar problems related to the transfers to local government. Hence, what appears as fiscal activism, may be classified as automatic stabilisation with an alternative definition of the structural deficit. If this is all that is intended, it is difficult to disagree.

If one wants to go further, the debate starts in earnest. If private investment in buildings or construction is in a slump, it may seem a good idea to seize the opportunity for more government investment. If there has been a negative shock to private consumption demand, it may even be a good idea to lower taxes temporarily, although most macroeconomists may disagree on that. However, there are reasons to warn against fiscal activism as a response to all kinds of perceived disequilibria. If labour costs are too high relative to abroad, some slack in the labour market may be needed to bring labour costs down. If labour costs need to increase in order to create more room for non-traded goods industries, some initial "overheating" of the labour market may be needed to make this happen. We do not know with much precision what equilibrium relative wage costs or equilibrium employment are. It is necessary to allow the market forces some "working space" in order that they can guide the economy towards equilibrium. (In the market forces I include the organisations in the labour market). Attempts at complete stabilisation run against two serious risks: We may stabilise around the wrong level, and we may stop necessary structural adjustments.

Translated to the current situation in Norway, even if we observe some job losses, we should not jump to the conclusion that fiscal policy should be expansionary relative to the long-term plan. Many job losses are in the traded goods industries and unrelated to domestic demand. The arguments for some element of fiscal activism may be strengthened if we see some decline in construction activity or further increases in the savings rate. So far the arguments are not compelling.

In my view the new guidelines give sufficient room for stabilisation policy. The worry is rather that the stabilisation clause will be used to justify expansionary policies when they are not warranted.

The guidelines as a source of disturbances

Since our profession is to worry, it is appropriate to continue with another worry. May the new guidelines, in spite of the good intentions, themselves be a source of disturbances? Apparently this can happen if there is a large change from one year to the next in the value of the petroleum fund, either due to capital gains or losses in the fund, or because oil revenues are extraordinarily high. Not unexpectedly, this worry has struck the Ministry
of Finance too. Hence, in their white paper to parliament they take care to spell out that in such cases the change in expenditure will be phased in gradually. That seems perfectly sensible. Rapid spending increases or reductions usually involve a lot of waste, because it takes much longer to move real resources than to move money. This is one reason to focus not just the deviation from the long run plan, but also the change from last year.

However, we should not underestimate the political force that the main rule of the new guidelines will have. In a year where we have had luck with the oil price or with the investments of the petroleum fund, it will not be easy for the Minister of Finance to convince the public that large increases in expenditure must wait. At least, though, the new rules give people some immediate satisfaction. Politically this may be easier to sell than the strategy that was followed last year.

A particular problem is related to the fact that the petroleum fund is invested abroad and with a view to maximising the international purchasing power of the fund in the long run. The new guideline applies to the value of the fund at the beginning of every year and measured in Norwegian kroner. Politically it may then be more convenient with an investment strategy that focuses the short run return measured in domestic purchasing power. This would reduce the risk of fiscal policy itself being the cause of demand shocks. However, each year’s expenditure is going to be only four per cent of the petroleum fund. It would be a pity if this lead to a major reduction in the fund’s investment horizon.

The new guidelines have not changed the rules governing the petroleum fund. This means that in the end it is still the actual oil-inclusive surplus on the government budget that is added to the fund (or the corresponding deficit that is subtracted). In a boom the actual surplus will exceed the structural surplus. This means that the fund increases more rapidly than the long-term trend. According to the main rule of the new guidelines, the non-oil structural deficit should then increase the next year. The opposite happens after a year of recession. Since booms and recessions have a tendency to persist for more than one year, this introduces a small pro-cyclical element in fiscal policy. Again the guidelines are flexible enough that this can be avoided. However, the political force of the main rule may still be strong, when this can be used to argue for higher expenditures.

**No simple rule lasts forever**

If the new guidelines are followed, and if the actual real return is on average equal to the expected four per cent per year, the guidelines ensure that we can continue to increase the non-oil deficit until the last drop of oil has been extracted. This seems like a cautious way of spending the petroleum wealth. However, that neglects the other big long-term challenge for fiscal policy, namely the ageing of the population and the maturing of the national pension scheme. Really we had needed an operational norm for government savings that took account of both challenges. The new norm answers only one of them explicitly, although both were discussed thoroughly in the background material. The opinion of the government must have been that, everything considered, the new rule yielded a reasonable answer to both challenges. This opinion was taken even though
projections indicated that in order to accommodate the ageing of the population, the new guidelines will require either severe cuts in public services or large tax increases 15-20 years from now.

When the initial conditions and expectations that are the basis of the long-term projections change, it is not obvious that the new rule still will provide a good answer to both challenges. Recently proceeds from the sale of government property (shares in SDØE and Statoil) have been added to the petroleum fund. This is one such change in the initial conditions. Money is spent at a greater pace than was the original intention, and the future problems connected to the ageing of the population increase. There are bound to be many more changes in initial conditions and expectations, for instance changes in the pension system. Hence, we can be quite certain that the new rule will not forever be considered as compatible with a good long-term plan. The longer the rule is adhered to without revision, the larger the fiscal shock may be when it is finally revised.

If, as proposed by many, part of the national pension scheme is going to be funded, that will require a complete rethinking of the guidelines.

**Conclusion**

As hinted at in the introduction, the main conclusion is that the new guidelines are flexible enough to permit any sensible stabilisation policy. They pose some dangers though. The stabilisation clause can be misused as an excuse for raising expenditures above the norm also when this is not part of a good stabilisation policy. The main rule may override the stabilisation clause when this yields the highest spending level. The main rule has a built-in mechanism that should help to bring expenditures back on track. However, as initial conditions and expectations about the future change, the main rule itself may come under increasing pressure. If it breaks down, there is always the risk of a major fiscal shock. A breakdown is a serious threat to economic stability. The rule itself is not.