Enhancing Fiscal Credibility: a Role for Independent Fiscal Institutions?

Xavier Debrun,
Deputy Chief, Fiscal Policy and Surveillance,
Fiscal Affairs Department, International Monetary Fund

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Overview of the Presentation

- The Crisis and its Fiscal Footprint
- The Challenge: Restoring/Maintaining Sustainability
- Can Fiscal Independent Fiscal Institutions Help?
  - Principles,
  - Evidence.
- Policy Implications
The Crisis and its Fiscal Footprint

- Public debt soared on top of historically high levels.

Advanced Economies, 1880-2013 (Percent of GDP)
Many countries have either a stock issue or a flow issue, and some a combination of both.
Advanced Economies: Illustrative Adjustment Needs, 60 percent of GDP by 2030

Fiscal Adjustment Needs
(Percent of GDP)

- Required adjustment between 2013 and 2020
- Change in the CAPB, 2010-13
23 Advanced Economies: Historical Evidence on Primary Balances

Maximum Improvement in Primary Balances, 1950-2011
The Credibility Challenge

- Countries with strong fiscal rules enjoy lower yields → institutional constraints seem to convey information on future policies.
- Euro area yields.

10-year benchmark yields (Percent; unweighted average)
The Credibility Challenge

• Rules = instrument of choice to signal future policies.

• But some countries do well without rules…

• … and in others, they fail to deliver.
Can Fiscal Councils also Help?

- Recent surge in the number of countries establishing non-partisan ("independent") agencies aimed at promoting sound fiscal policies (i.e. sustainable, countercyclical), especially in Europe and since the crisis.

![Graph showing the increase in fiscal councils from 1960 to 2013.](image)

Source: IMF Fiscal council dataset.

- Part of a broader trend to improve institutions governing the budget.
- So far: little systematic evidence on functions and effectiveness covering the universe of fiscal councils.
IMF Policy Paper

- Clarify the concept of FC,

- Provide a consistent dataset summarizing key features of existing FCs among the Fund’s membership,

- **Provide evidence** aimed at identifying the likely determinants of effectiveness,

- Provide a common understanding of what FCs can potentially achieve and under what conditions → ultimately: facilitate mapping of specific sources of fiscal biases into features of FCs remit and tasks.
Challenges

• **Policy challenge:**
  – Significant heterogeneity in the population of FCs → delicate balance between formulating a general policy line and allowing for country-specificity.

• **Methodological challenge:**
  – Small sample and often very short experience → Conventional statistical techniques can unveil conditional correlations at best.
  – Perennial issue: endogeneity of institutions.
  – Importance of case studies for a “forensic” examination of causality.
Definition

- A fiscal council is a permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government’s fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances, short-medium-term macroeconomic stability, and other official objectives.
Definition

• In addition, a fiscal council can perform one or several of the following functions:
  – (i) contribute to the use of unbiased macroeconomic and budgetary **forecasts** in budget preparation (through forecasting or proposing prudent levels for key parameters),
  – (ii) identify sensible fiscal policy options, and possibly, formulating **recommendations**, and
  – (iii) facilitate the implementation of **fiscal policy rules**.
  – (iv) cost new or planned policy initiatives.
Broad Institutional Models

• **Stand-alone institutions.**
  – Closest counterparts to central banks. Often part of comprehensive Fiscal Responsibility Laws.

• **Under the executive or legislative branch of political system.**
  – Operational independence is essential → reputation of professionalism and non-partisanship.

• **Paired with other independent institutions**
  – Audit office, central bank, statistical agency. But risk of confusion.
Common Denominator: Watchdog

- All FCs provide assessments and contribute to the public debate → “Beware the dog!”
  - Notice the leash = no delegation of policy instruments.
The Economics of Fiscal Councils

• **Transmission channels to policy:**
  – Overall: raise transparency \(\rightarrow\) higher reputational/electoral rewards of sound policies, higher cost for fooling the public.
  – Better align voters and elected policymakers incentives \(\rightarrow\) reduce **informational asymmetries** (educate and inform).
  – Close technical loopholes in the fiscal framework (forecast, costing, implementation of CABs,…);

• **What distinguishes FCs from other watchdogs?**
  – Specific mandate from government \(\rightarrow\) **accountability/ownership.**
  – Requirement to benchmark assessments against stated objectives of government.
The Effectiveness of Fiscal Councils

• **Evidence-based assessment**
  – Lessons: elements of a common denominator to effective Fiscal Councils → helps inform good practice.

• **Mix of methodologies**
  – Correlation with outcomes (balance, cyclicality),
  – Forecasts’ quality,
  – Measure of media impact,
  – Selected case studies:
    • Focus on diverse track record and age.
The Effectiveness of Fiscal Councils

- Countries with FCs appear to behave differently → stronger primary balances after conditioning for: persistence, public debt, output gap, national fiscal rules, and fixed-effects.

Marginal impact of FC with a given characteristic on average primary balances (estimated, dynamic LSDVC panel model, 1990-2011)

Source: IMF staff estimates.
Note: light-colored bars indicate that the estimated marginal impact of the binary variable is not statistically different from zero.
The Effectiveness of Fiscal Councils

- Countries with fiscal councils have more accurate forecasts.

Source: IMF staff estimates.
The Effectiveness of Fiscal Councils

- Countries with fiscal councils have less optimistic forecasts.

![Graph: Mean forecast error: FCs that provide or assess forecasts](chart1)

![Graph: Mean forecast error: FCs with high media impact](chart2)

Source: IMF staff estimates.
Complementary Case Studies

• 7 Case Studies - Belgium, Canada, Hungary, Korea, the Netherlands, Sweden, and the United States.

• Selection Criteria:
  – length of existence,
  – spectrum of functions performed,
  – diversity of region and context.

• Assess, if and how each FC influences fiscal policy debate.

• Standardized structure, explores both successful and unsuccessful cases.
Key Lessons (1): Design Issues

• **Adjust design to country-specific contexts**
  – United States’ CBO a model for Korea, Canada, and Hungary FCs
  – Successful adaptation in Korea to lesser extent in Hungary and Canada

• **Strong and clear legal basis for independence is important**

• **Remit reflects sources of the problem:**
  **Impetus for creating FCs both economic and political**
  – Strengthening legislative oversight – Korea, United States, Canada.
  – Improve forecasting – UK.
  – Costing of electoral proposals – Australia.
  – Maintaining sustainable public finances – Sweden.

**Different institutional context**
  – Sweden and Belgium (more than one FC playing a role).

• **Resources commensurate to the FC’s remit are essential:**
  • One size does not fit all.
Number of FTE Staff and Functions
Key Lessons (2): Effectiveness

- **Case studies confirm importance of operational independence:**
  - Activities must be *perceived as non-partisan* (e.g. reputation of technical competence). Successful examples in actively developing non-partisan credentials: US CBO, Dutch CPB, Sweden
  - **Legal guarantees** important for *new* institutions.
  - Independence is also critical for the FC to perform its duties (secured resources, hiring competent staff, determining work agenda within remit, speak with one voice, freedom to access media, control on workload).

- **Clear benchmarks for fiscal policy (e.g. fiscal rules) increase the traction of FCs.**

- **A media strategy and strong media presence to communicate assessment of fiscal policy is vital.**
  - Media presence is essential to raising the alarm when fiscal policy is going off track. For example Dutch CPB in 2003 and 2005.
Media Reports of the Dutch CPB- Effective Media Communication when Fiscal Policy is going off Course
Additional Lessons from Case Studies

- Independent costing of policy proposals and programs contributes to improving the policy debate and transparency.
- Can help to curb governments’ tendency to underplay full costs of policies.
  - The Dutch and Australian FCs costing of electoral platforms discourages unaffordable election commitments.

- **FCs have stronger impact when there is political and public consensus on sound public finances (e.g. Canada and Sweden).**
  - Misaligned preferences can lead to open conflicts and political interference → see case of Belgium.
Caveat: Preference Misalignment Hurts

- Conflicts between FC and government can be damaging (see Belgium: impact of HCF recommendations).

Source: Coene and Langenus (2011)
Further Policy Considerations

• **Pre-requisites/enabling factors**
  – Reasonably good PFM, statistics,
  – But not just for mature democracies with large capacities → most political systems have checks-and-balances and “neutral/technical” inputs to policy processes.

• **Remits and tasks: correspondence between causes and manifestations of policy bias towards excessive deficits.**
  – Broad remit,
  – At a minimum: watchdog,
  – Freedom to set work agenda.
Further Policy Considerations

• **Normative analysis: exception rather than rule, but...**
  – Consensual political culture (value to neutral inputs to the debate),
  – Contentious distributive issues → consensus is required (decentralization, inter-generation [resource-rich],...),
  – No veto right.

• **Countries with fiscal rules:**
  – Role for the council: forecast, technical inputs (CAB estimates), distribution of effort across entities.
Further Policy Considerations

• **Stand-alone institution?**
  – Pro: strong legal basis and budget required,
  – Con: new institutions and credibility?

• **Nesting in existing institution?**
  – Pro: import credibility of reputation of host,
  – Con: confusion of mandates.

• **Communicate with other commentators on fiscal policy.**
  – Peer pressure vs. cacophony,
  – In EU: coordination with EU?
Further Policy Considerations

• **FCs should promote transparency**
  – Explain policies, analyze risks,
  – Promote best practice PFM and statistical governance.

• **FCs should be accountable**
  – Dismissal rules for FC management,
  – Ex-post assessments of performance and quality of work.
Final Thoughts

- **Countries should not set up FCs because they are told so → ownership is key → Not all countries need an FC (or can make one work in their institutional setup).**
  - Risk of countries to reluctantly set up FCs because “Brussels wants it.”
- **FCs can be tailored to country-specific circumstances:**
  - Understand nature of fiscal issues and institutional setup governing the budget.
  - In particular, no evidence that effective FCs belong to one particular class.

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<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Existing Institution</th>
<th>Parliamentary Budget Office</th>
<th>Under the Executive</th>
<th>Stand-alone Institution</th>
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