

Towards More Effective Fiscal Rules: A Role for Fiscal Councils?

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Disclaimer

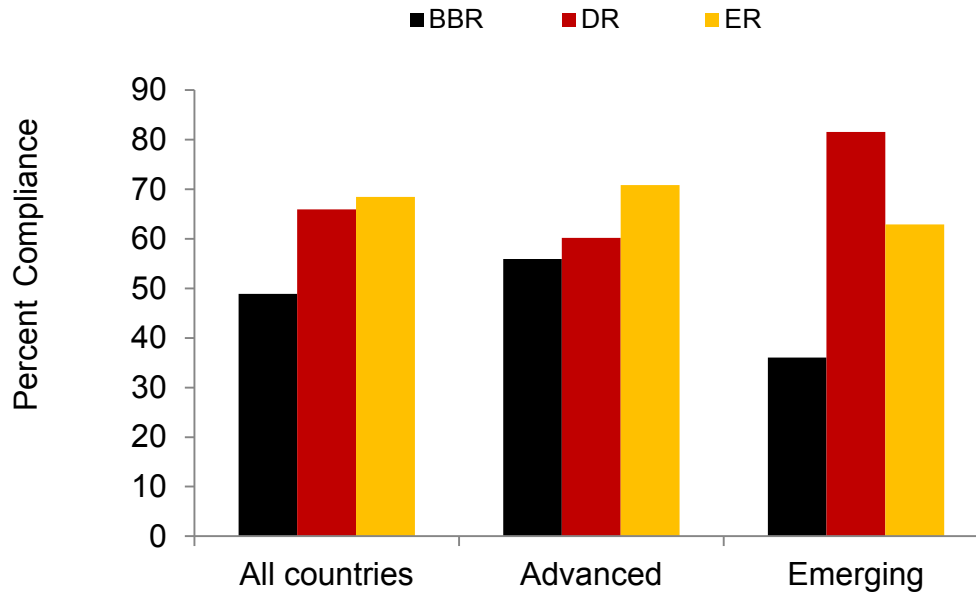
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Contents

- **Issues with fiscal rules:**
 - Enforceability (self-imposed, bad design [wrong credibility-flexibility trade-off], decentralized/federal setting)
 - Compliance (circumvent / lack of transparency,...)
 - side-effects (procyclicality, hidden debt, poor quality adjustment).
- **How Fiscal Councils Can Help?**
 - Monitoring compliance
 - Inputs: forecast, recommendations (e.g. decentralized setting)
- **FC can:**
 - Ex-post: greater incentives for self-compliance
 - Ex-ante: expand universe of effective fiscal rules

Issue with fiscal rules: non-compliance

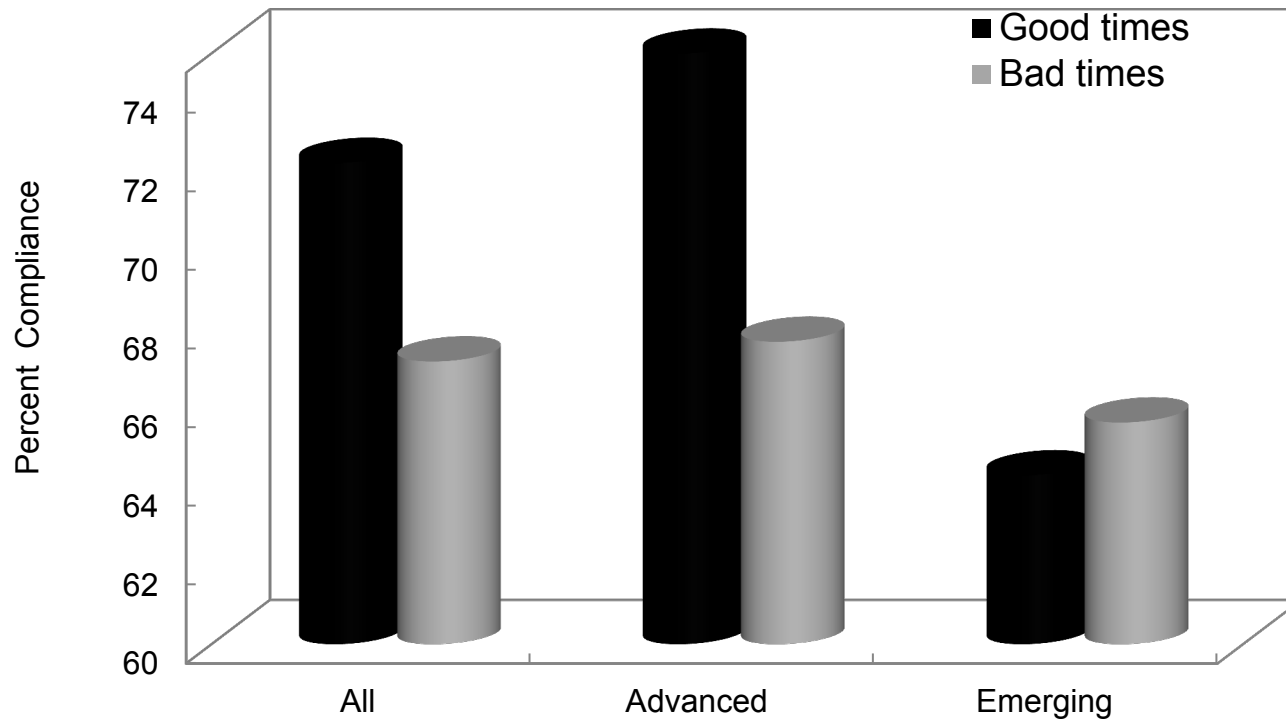
Compliance with Fiscal Rules: 1985-2012



Source: FAD Fiscal Rules Dataset and IMF staff estimates.

Issue with fiscal rules: non-compliance

Compliance during good and bad times (expenditure rules only... spending is the least endogenous budget aggregate)



Source: FAD Fiscal Rules Dataset and IMF staff estimates.



Rules and councils

- **FCs can help implement (better) rules (i):**
 - FC can **prevent common strategies to circumvent rules:**
 - FC can discourage or prevent the use of optimistic **forecasts** that help only ex-ante compliance.
 - FC can alleviate government's incentives to twist estimates of structural balance rules, or avoid expenditure reclassifications associated with golden rules, or provide independent estimate of the impact of certain structural reforms on budgets, growth, and long-term sustainability.
 - FC can limit or prevent abuse of escape clauses.
 - FC can foster coordination between central and subnational entities.
 - By doing so, FC reduces the loopholes associated with “smarter” rules, **expanding the set of feasible rules** ex-ante.



Rules and councils

- **FCs can help implement (better) rules (ii):**
 - FC can play a role in formal enforcement mechanism. (Political enforcement does not work, as SGP showed):
 - If judicial enforcement, FC can provide expert economic opinion to Judiciary.
 - If automatic error correction (e.g. “debt brake”), FC can manage the system (e.g. by deciding when correction is required and at what pace).
 - FC can make the rule more incentive-compatible for well-intended governments. → FC can foster the rule’s status as a sensible benchmark for good policy in the public debate → the rule itself is more credible.
 - Over time, FCs can facilitate sensible amendments to fiscal rules without fearing excessive damage to credibility.
 - Example: FC could be tasked to provide medium-term reviews of fiscal rules and propose amendments.



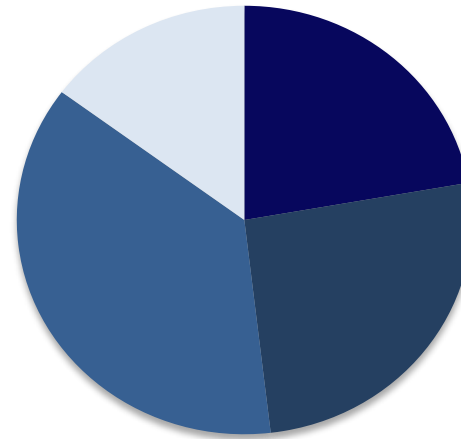
Rules and councils

- **The rule provides a clear and transparent benchmark, facilitating FCs watchdog role:**
 - Monitoring is easier to communicate to the public → stronger media impact → greater effectiveness.
 - Helps the FC sending clearly “positive” (as opposed to normative) messages.
 - Obvious pre-condition: the rule must be sensible (compatible with the FC ultimate objectives).

Stylized facts

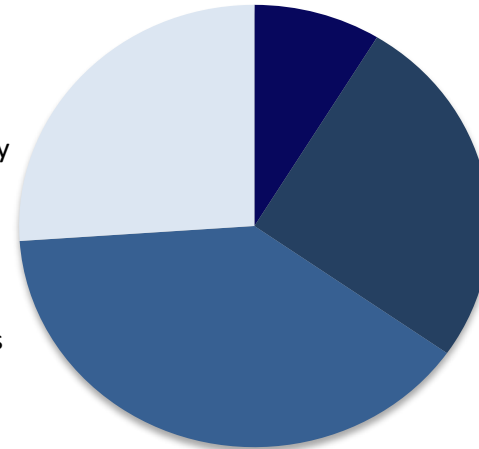
- **Most countries with FCs also have fiscal rules**

- National rule only
- Supranational rules only
- National and Supranational rules
- No rules



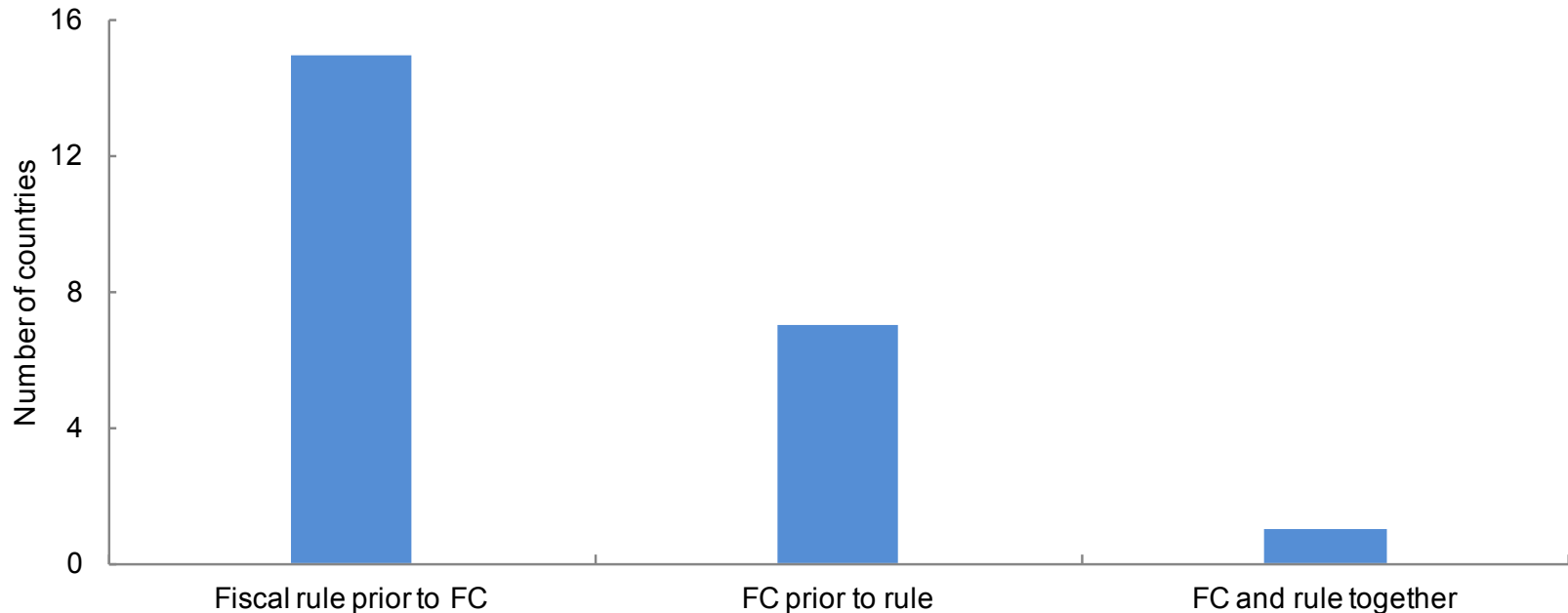
- **Among those, the FC is often mandated to monitor compliance.**

- National rule only
- Supranational rule only
- National and supranational rules
- No monitoring of rules



Rules and councils: sequencing

- **Fiscal councils have often been created after the introduction of a fiscal rule**
 - their mandate can more easily reflect past experience with implementation of fiscal rules, or allow a reform of rules (towards smarter rules) → more recent FCs are tasked to monitor compliance.



Effectiveness: FC and FR work well together

- Fiscal rules are associated with stronger fiscal performance independently of FC existence.

Table 1. Fiscal Council and Fiscal Performance
Bias Corrected LSDV Dynamic Panel Model

Dependent Variable: Primary Balance in percent of GDP								
Primary Balance (t-1)	0.823 (27.86)***	0.823 (27.96)***	0.826 (29.94)***	0.819 (24.29)***	0.824 (28.15)***	0.826 (28.07)***	0.825 (28.44)***	0.824 (28.05)***
Debt (t-1)	0.015 (3.00)***	0.016 (3.34)***	0.016 (3.18)***	0.022 (3.50)***	0.016 (3.24)***	0.016 (3.17)***	0.016 (3.34)***	0.017 (3.39)***
Output Gap (t-1)	-0.096 (2.74)***	-0.094 (2.70)***	-0.097 (2.87)***	-0.095 (2.62)***	-0.099 (2.84)***	-0.095 (2.72)***	-0.092 (2.65)***	-0.093 (2.67)***
Fiscal Rules Index (FRI)	0.280 (2.75)***	0.278 (2.72)***	0.268 (2.67)***	0.276 (2.44)**	0.250 (2.50)**	0.289 (2.84)***	0.292 (2.87)***	0.280 (2.76)***
Fiscal Council	0.496 (1.26)							
Legal indep		0.810 (1.98)**						
Indep. budget			1.096 (1.95)*					
Staff number (High level)				0.174 (1.89)*				
Fiscal rule compliance					1.296 (2.48)**			
Scoring						1.355 (2.44)**		
Forecast Assessment							0.993 (1.97)**	
High media impact								0.844 (2.09)**
Time dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	901	901	901	890	901	901	901	901
Countries	58	58	58	58	58	58	58	58

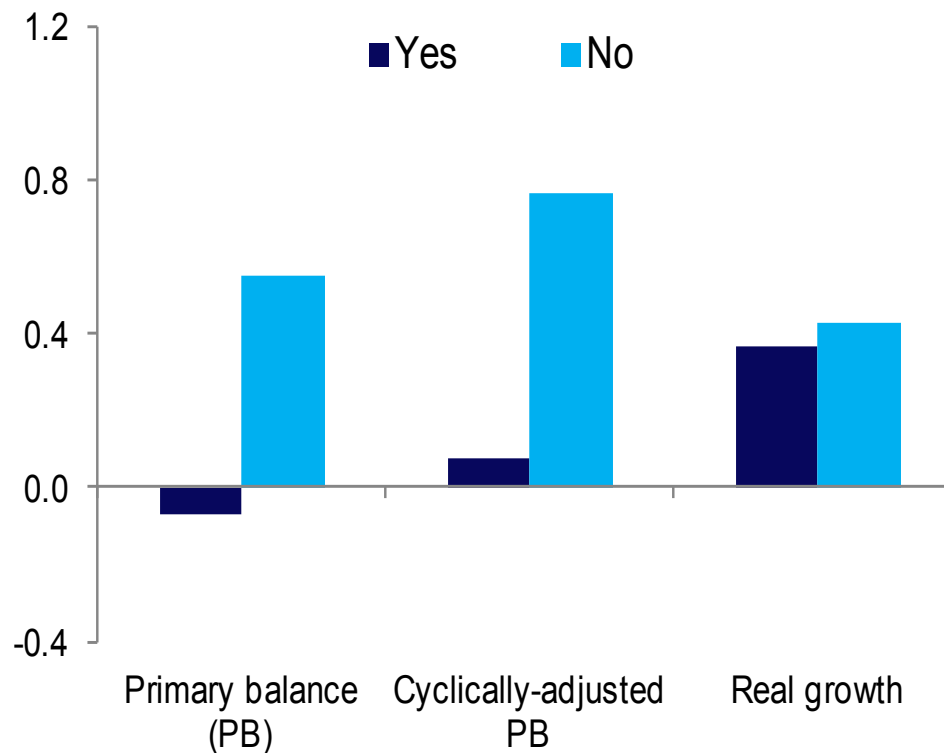
Absolute bootstrapped t-statistics in parentheses.

* significant at 10%; ** significant at 5%; *** significant at 1%.

Effectiveness: FC monitoring and forecasts



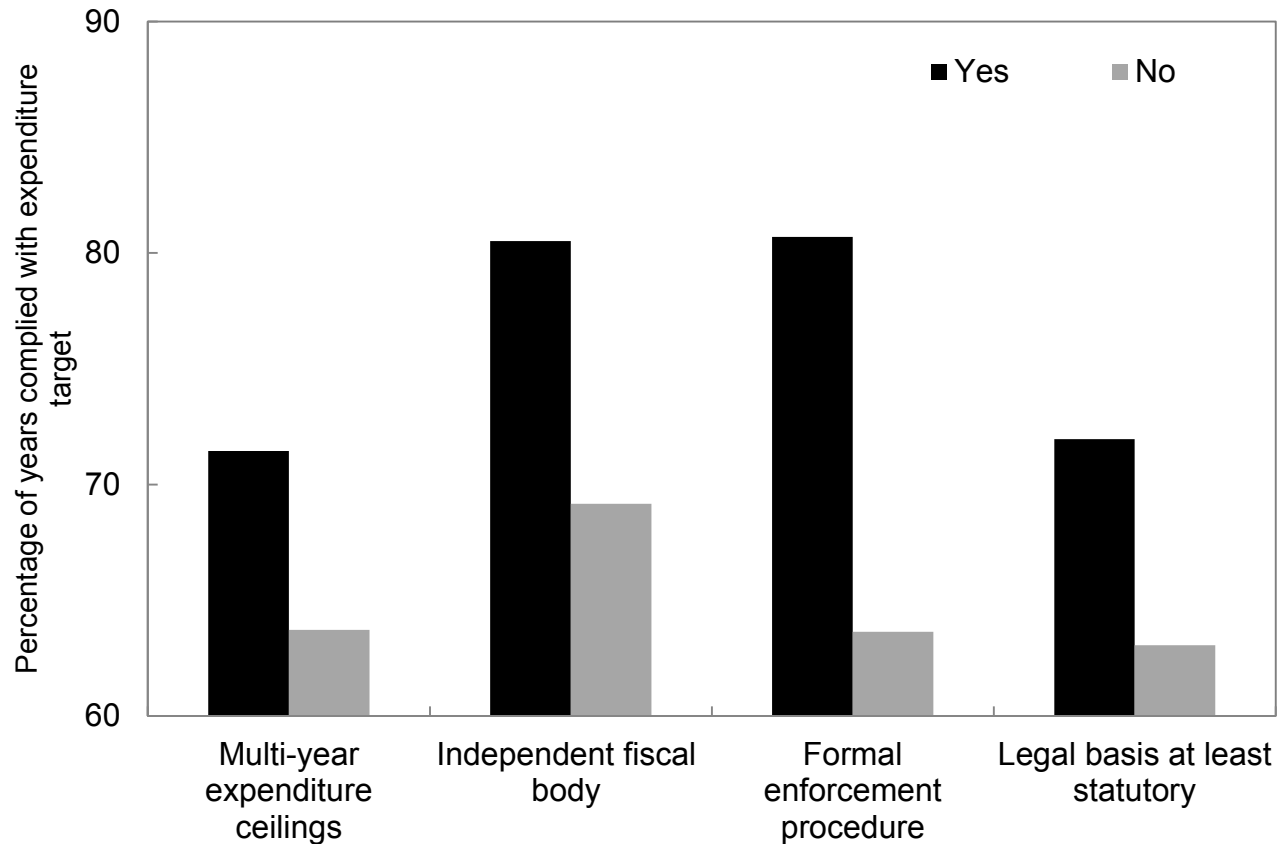
- Countries where FCs monitor FRs exhibit no forecast bias in budgetary balances, despite a positive bias in growth forecast.



Mean forecast error between countries where FC monitors FR compliance and the other countries (with or without FCs)

Compliance is higher with an FC

Expenditure Rules: Design Features and Compliance (expenditure rules)



Source: FAD Fiscal Rules Dataset and IMF staff estimates.



Conclusions

- **The substitutability argument is fundamentally flawed.**
- **Stylized facts suggests a revealed preference for complementing FRs with FCs.**
- **Tentative evidence that this complementarity works.**
- **Important policy lessons.**

Lessons

- **Mandate FC to report publicly on FR compliance (ex-ante and ex-post)**
- **Mandate FC to perform tasks that eliminate potential loopholes often used to circumvent rules:**
 - Role in assessing or (ideally?) producing macroeconomic and budgetary forecasts.
 - Role in providing technical inputs for “smart” rules (cyclical adjustment, definition of one-offs, impact of structural reforms,...).
 - Role in making recommendations on certain aspects of implementation, notably conditions for the activation of escape clauses.
- **Mandate FC to assist in enforcement procedures:**
 - error-corrections, expert role in judicial procedures).
- **Mandate the FC to review rule’s adequacy on a regular basis**
 - Keep the rule consistent with overarching objectives.
 - Enhances flexibility of the rules-based fiscal framework without jeopardizing credibility.