

Fiscal Councils in Emerging Markets

Xavier Debrun,
IMF Fiscal Affairs Department

NIPFP-DEA Conference

**“Next Generation Fiscal Reform Frameworks to Deliver Effective
Counter-Cyclical Policy: Indian and International Experiences”**

Goa, December 12-13, 2014



Disclaimer

The views expressed in this presentation are my own and do not necessarily represent those of the IMF or IMF policy.

Outline

- **Motivation**
- **Fiscal rules**
- **Fiscal councils**
 - Key stylized facts,
 - Impact,
 - **Synergies with fiscal rules.**

Motivation

- Realization that democratic control by elected policymakers may not suffice to yield satisfactory outcomes.
- Alan Blinder (1997) suggests that “politicization” is a problem:
The real source of the current estrangement between Americans and their politicians is, I believe, the feeling that the process of governing has become too political. Americans increasingly believe that their elected officials are playing games rather than solving problems. [...] Most important, **government appears excessively beholden to those with political clout, often at the expense of the public interest.**
- I prefer James Madison’s (1788) warning:
“A dependence on the people is, no doubt, the primary control on the government; but **experience has taught mankind the necessity of auxiliary precautions.**” → we need **institutions** (“precautions”) to provide the right incentives and make democratic controls work well.

Motivation

- Fiscal policy is at the heart of the political process → democratic control over the power of the purse is essential.
- Wars were fought for that... among which the US war of independence → “no taxation without representation.”
- **Introducing Independent Fiscal Institutions (fiscal councils) is not about “depoliticizing fiscal policy.”**

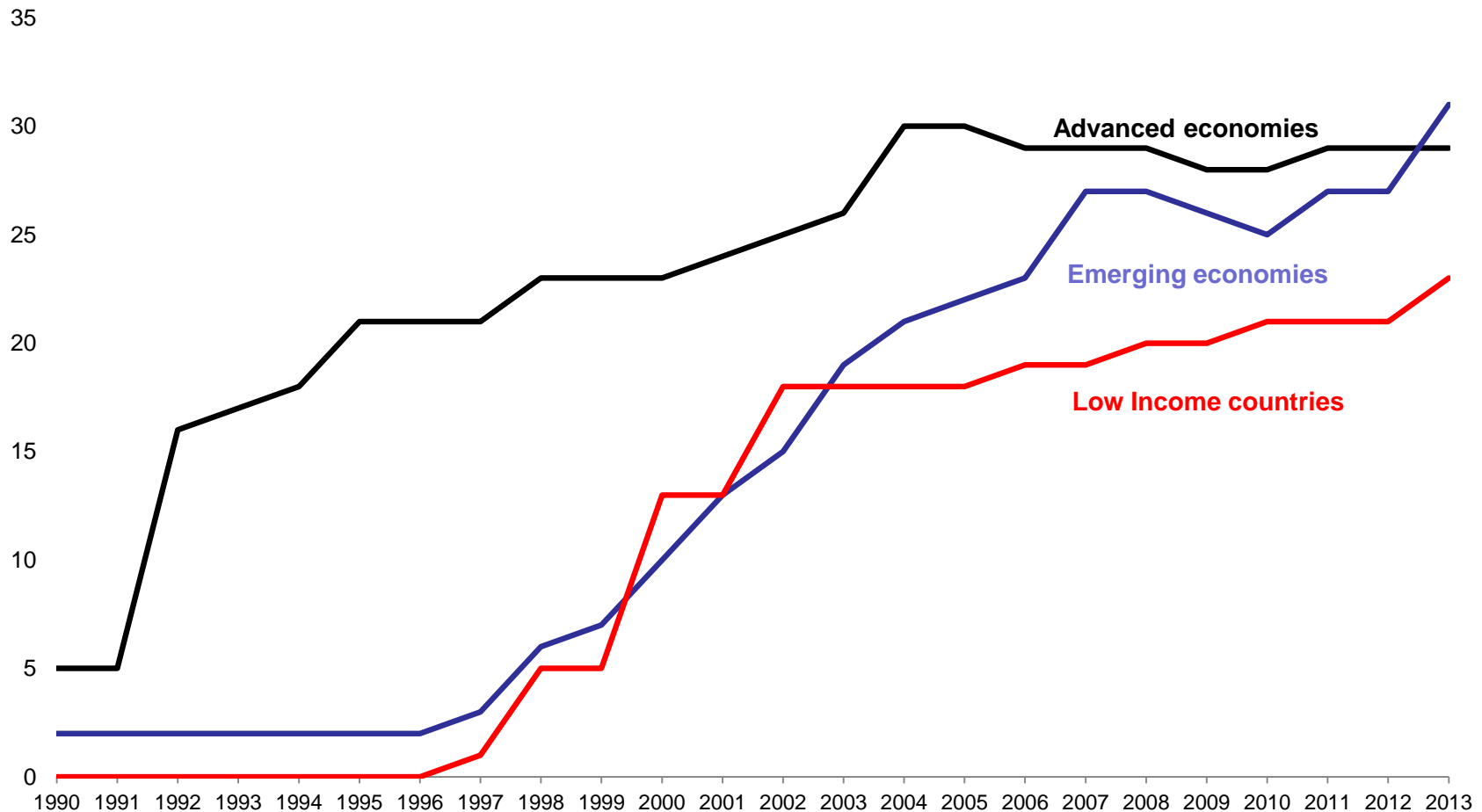


Motivation

- **Economic theory and empirical evidence shows that absent “precautions,” policies are “biased.”**
- **Bias = systematic gap between actual policy outcomes and what is generally considered as desirable.**
- **What “bias” ?**
 - Excessive public debt and deficits,
 - Destabilizing fiscal policy (procyclical) → “voracity”
 - Electoral cycle,
 - Insufficient high-quality spending.

The use of fiscal rules has been growing...

Number of Countries Using Fiscal Rules, 1990-2013

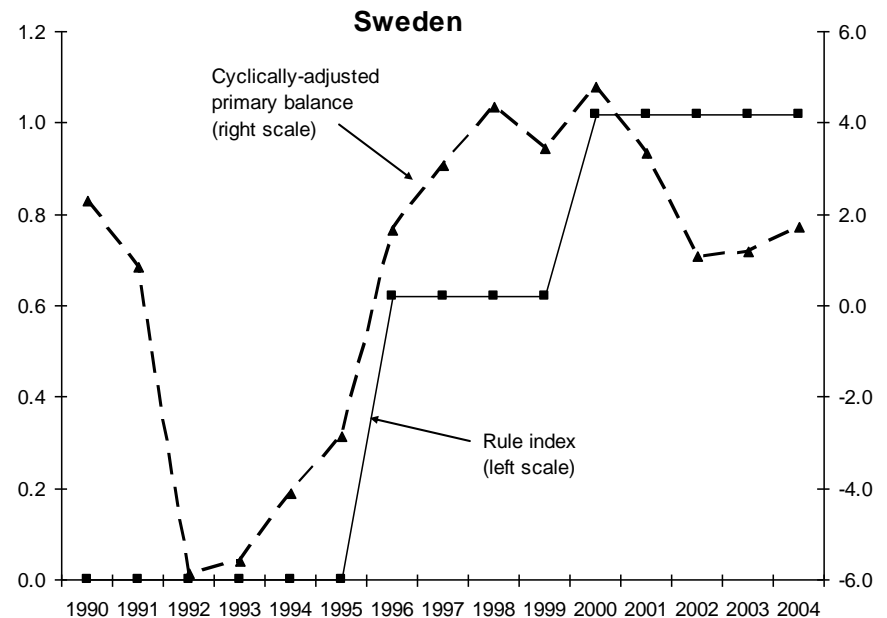
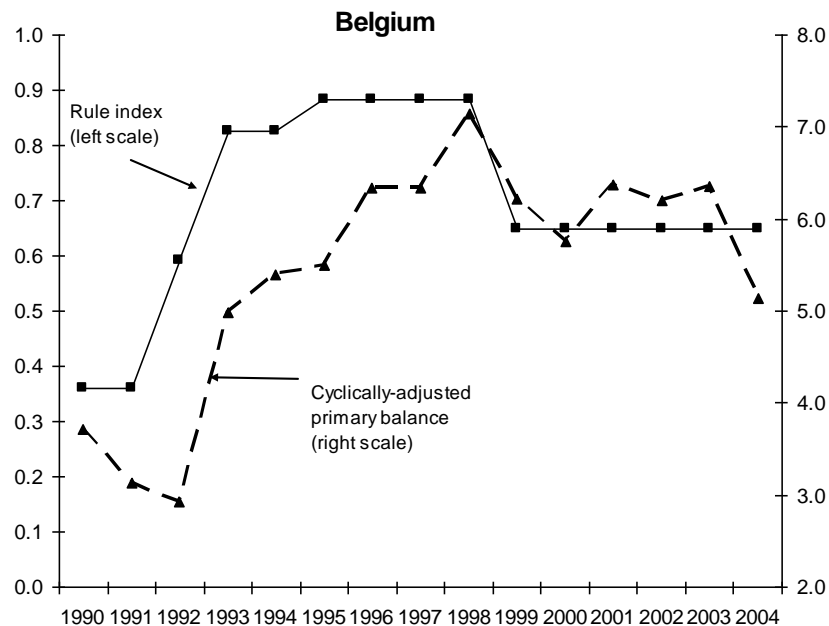


Source: FAD Fiscal Rules database.

Notes: Figure includes both national and supranational fiscal rules.

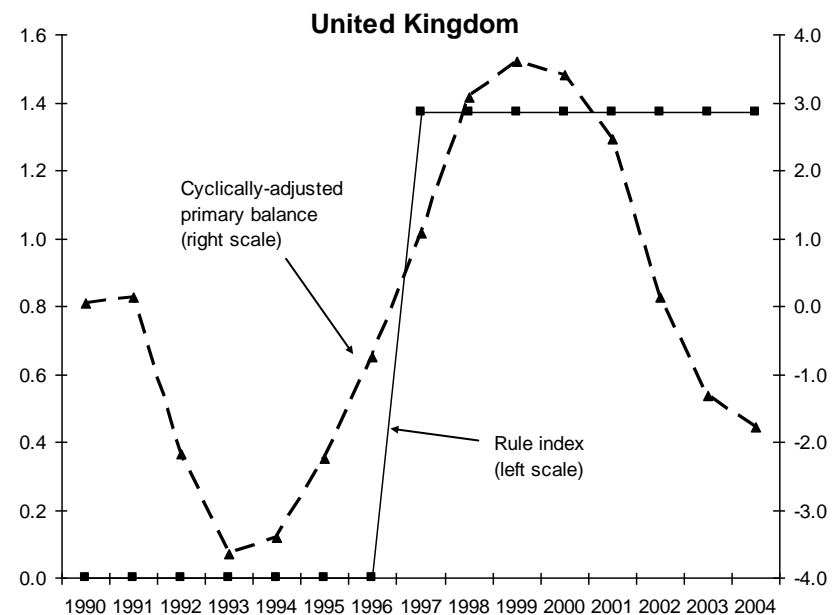
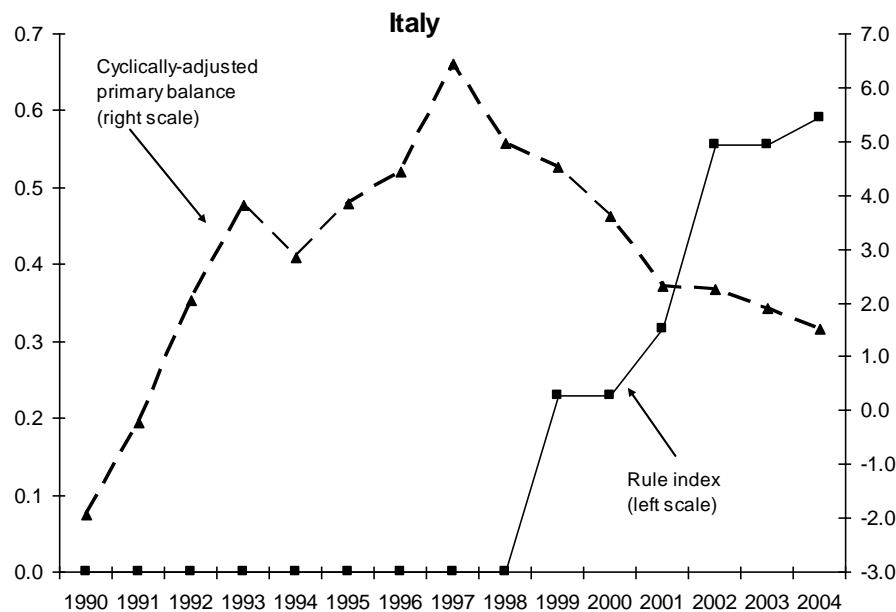
Evidence on rules is rather mixed

- **Cross country:**
 - countries with rules have on average stronger fiscal positions (but causal link?).
- **Examples where rules are associated with better policies.**
 - Illustrations of tying-hands and signaling arguments...



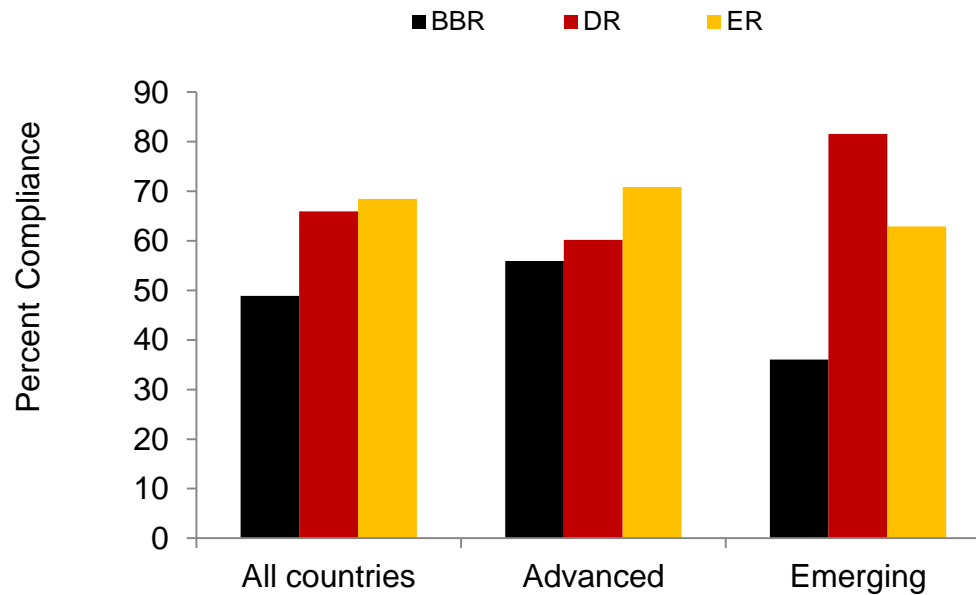
Evidence on rules is rather mixed

- Examples where rules do not seem to matter or are even used as “smokescreen.”



Issue with fiscal rules: non-compliance

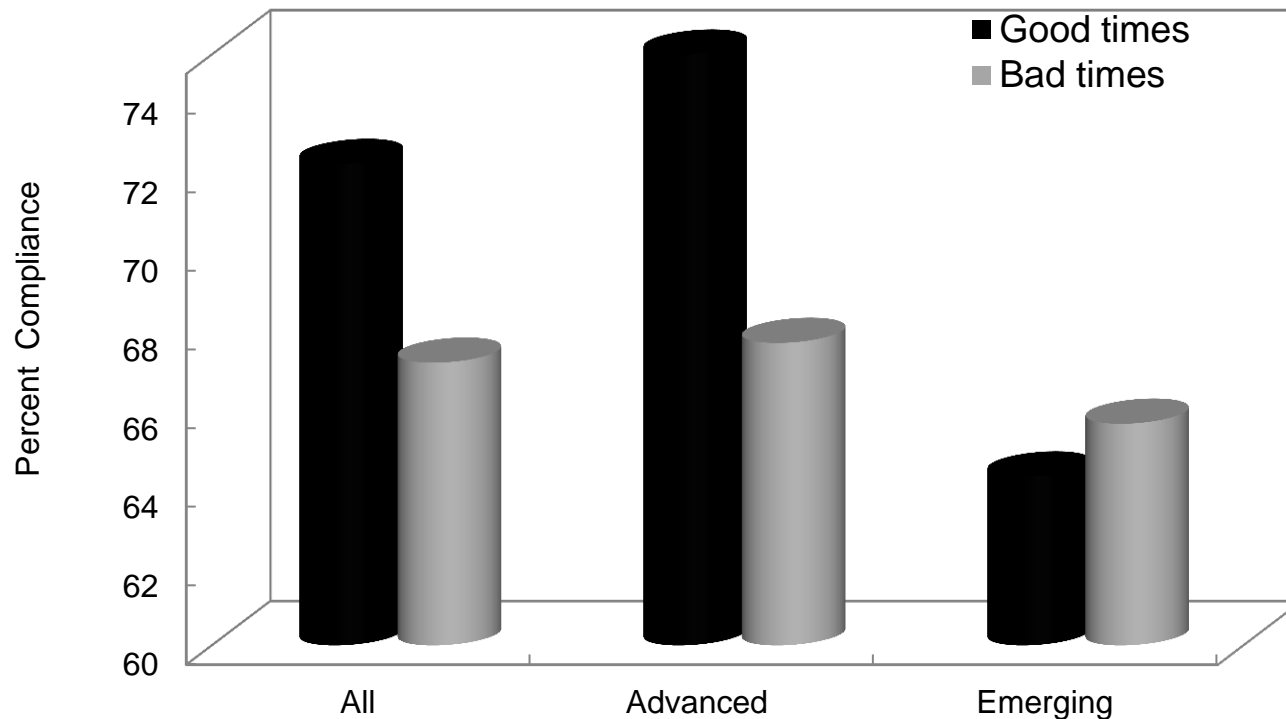
Compliance with Fiscal Rules: 1985-2012



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.

Fiscal Councils to substitute for rules?

- **A substantial literature proposes fiscal councils as substitutes to rules :**
 - **LATAM:** Eichengreen et al. (1999) propose national fiscal councils.
 - **EU:** Proposal to replace “dead rules” with “living bodies” → FC would set binding debt and deficit limits (Fatàs et al., 2003; Wyplosz, 2005)
 - **Common denominator:** They have in mind an independent fiscal authority (central bank analogy).
- **Fallacy about substitutability argument:**
 - Political-economy models show deficit bias entrenched in the fabric of the political system → **CB analogy is logically flawed.**
 - The **soft power** of real-world fiscal councils cannot be expected to fully substitute for the constraining role of rules.
 - THEY MUST WORK TOGETHER.

What is a fiscal council?

- *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.*

What is a fiscal council?

- *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.

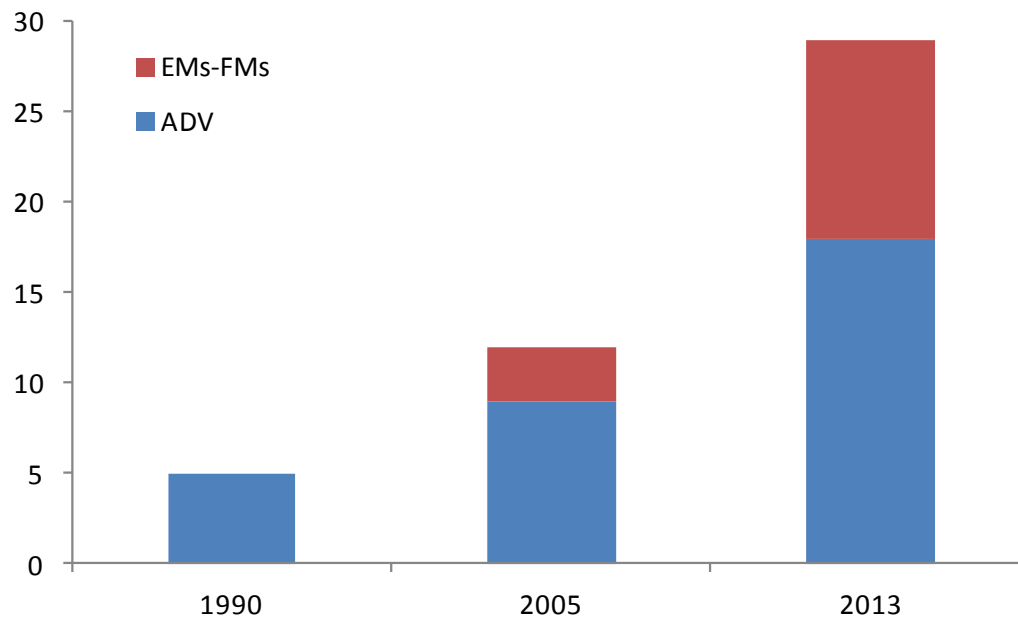


The Economics of Fiscal Councils

- **Transmission channels to policy:**
 - **Raise transparency** → higher reputational/electoral rewards of sound policies, higher cost for fooling the public.
 - Better align voters and elected policymakers incentives → 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 → **accountability/ownership**.
 - Requirement to benchmark assessments against stated objectives of government.

Fiscal Councils: a Growth Industry

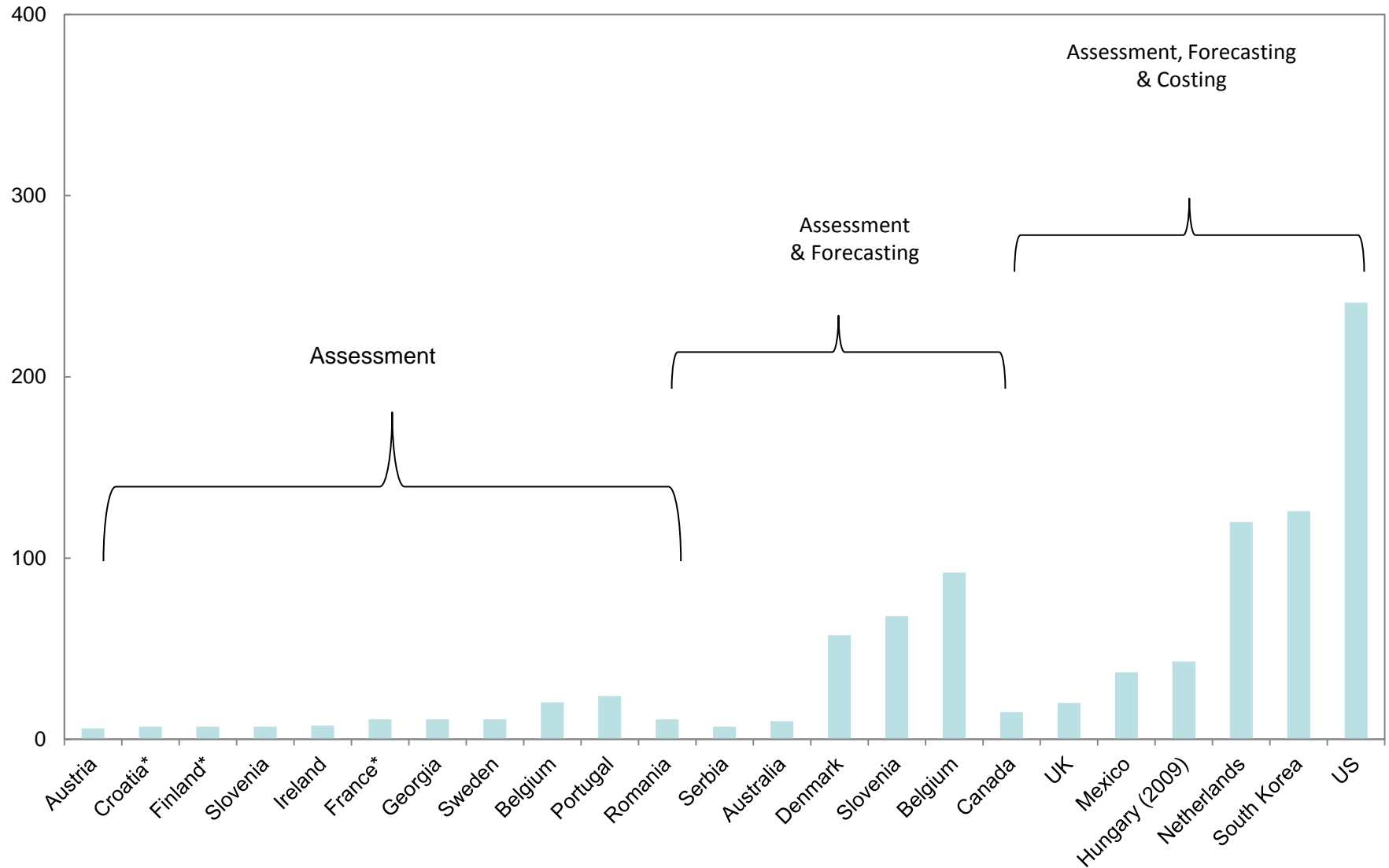
- Recent surge in the number of countries establishing non-partisan (“independent”) agencies aimed at promoting sound fiscal policies (i.e. sustainable, countercyclical)..



Source: IMF Fiscal council dataset.

- So far: little systematic evidence on functions and effectiveness covering the universe of fiscal councils.

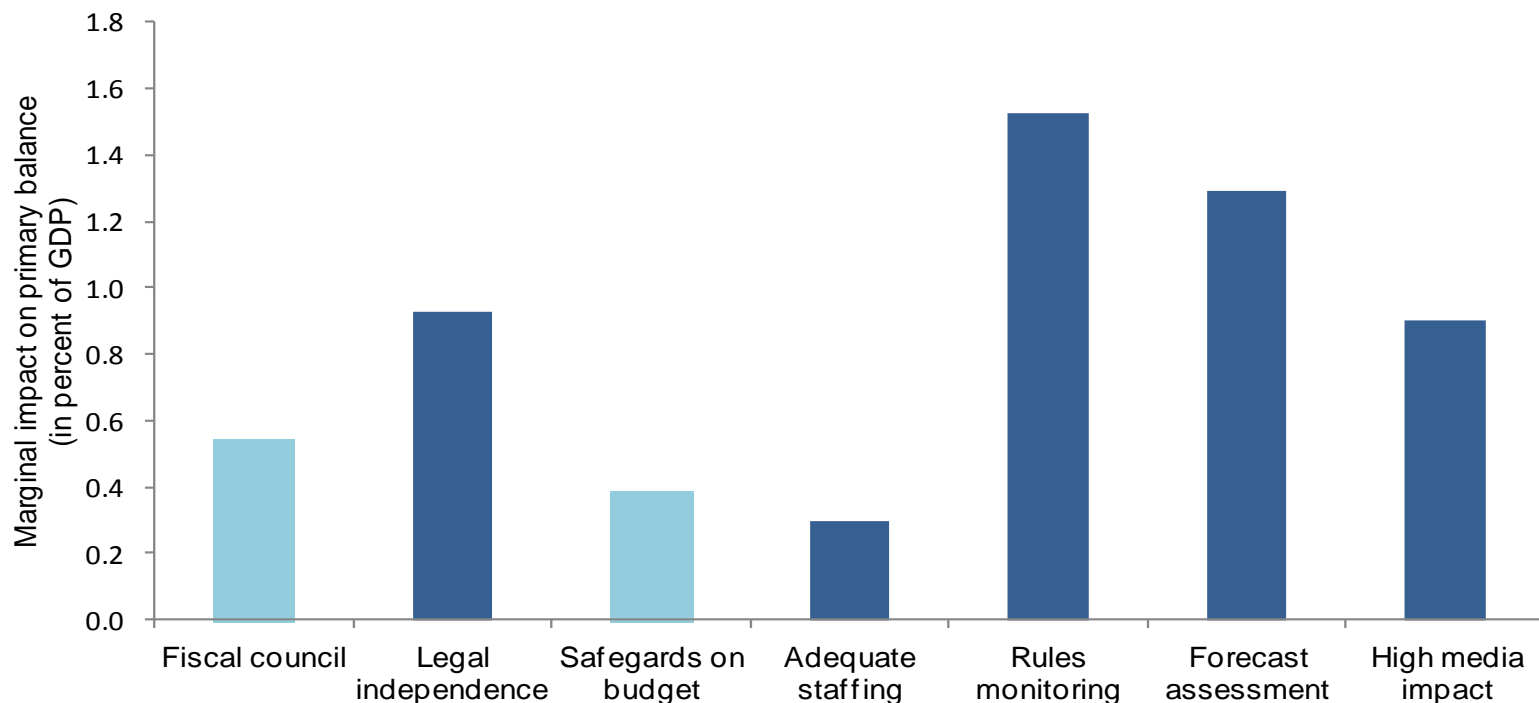
Number of FTE Staff and Functions



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)



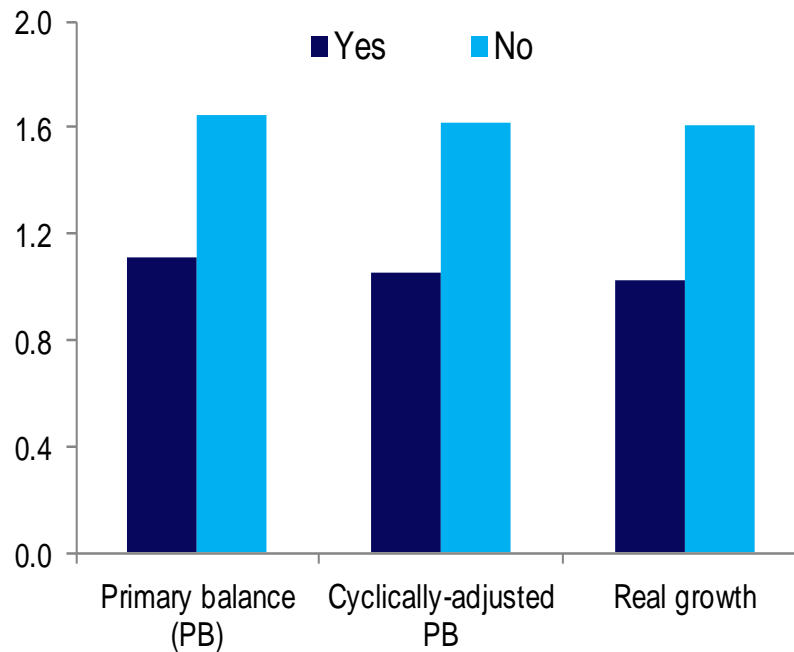
Source: IMF staff estimates.

Note: light-colored bars indicate that the estimated marginal impact of the binary variable is not statistically different from zero.

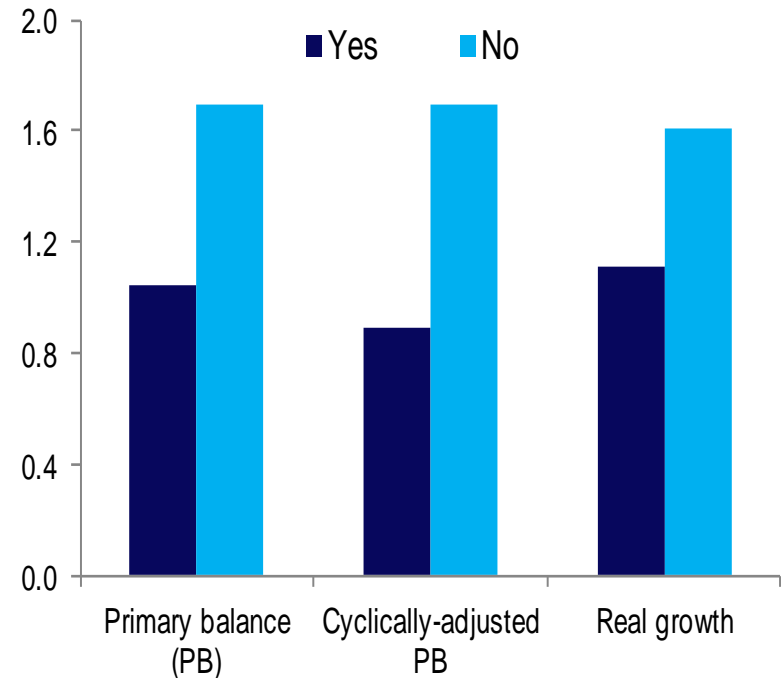
The Effectiveness of Fiscal Councils

- Countries with fiscal councils have more accurate forecasts.

Absolute forecast error: FCs that provide or assess forecasts



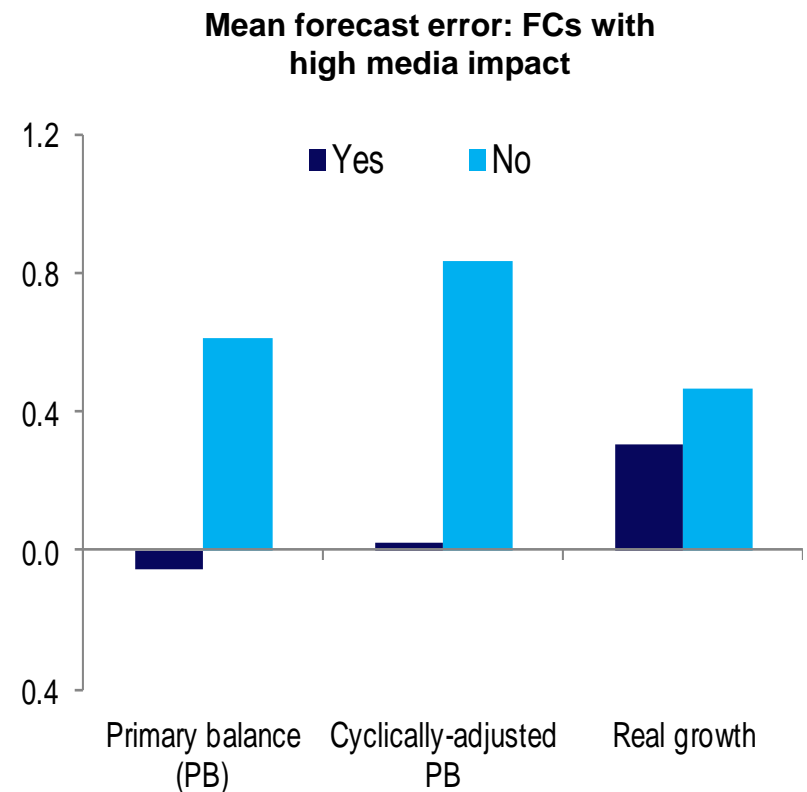
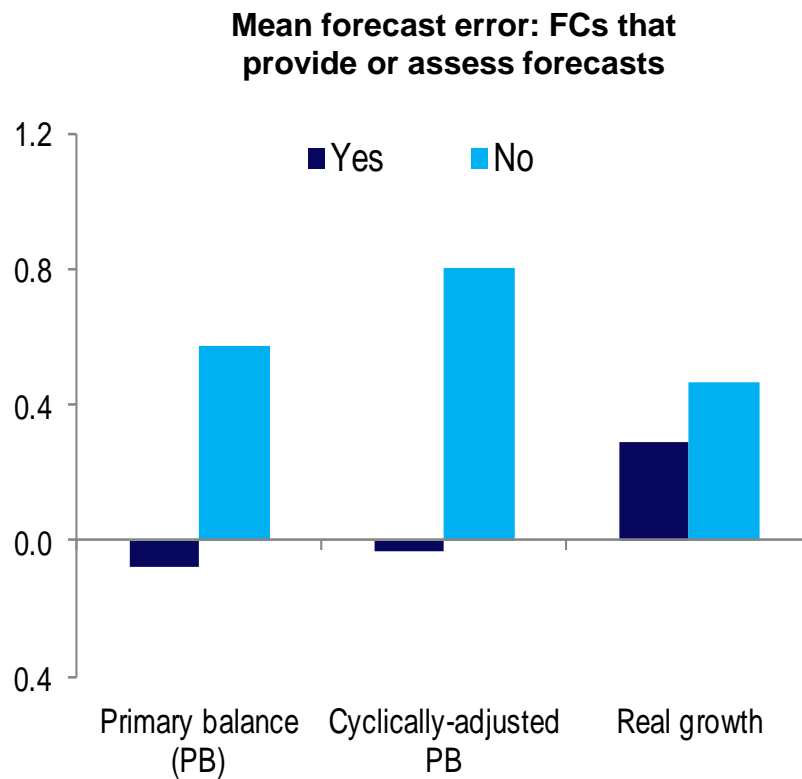
Absolute forecast error: FCs with high media impact



Source: IMF staff estimates.

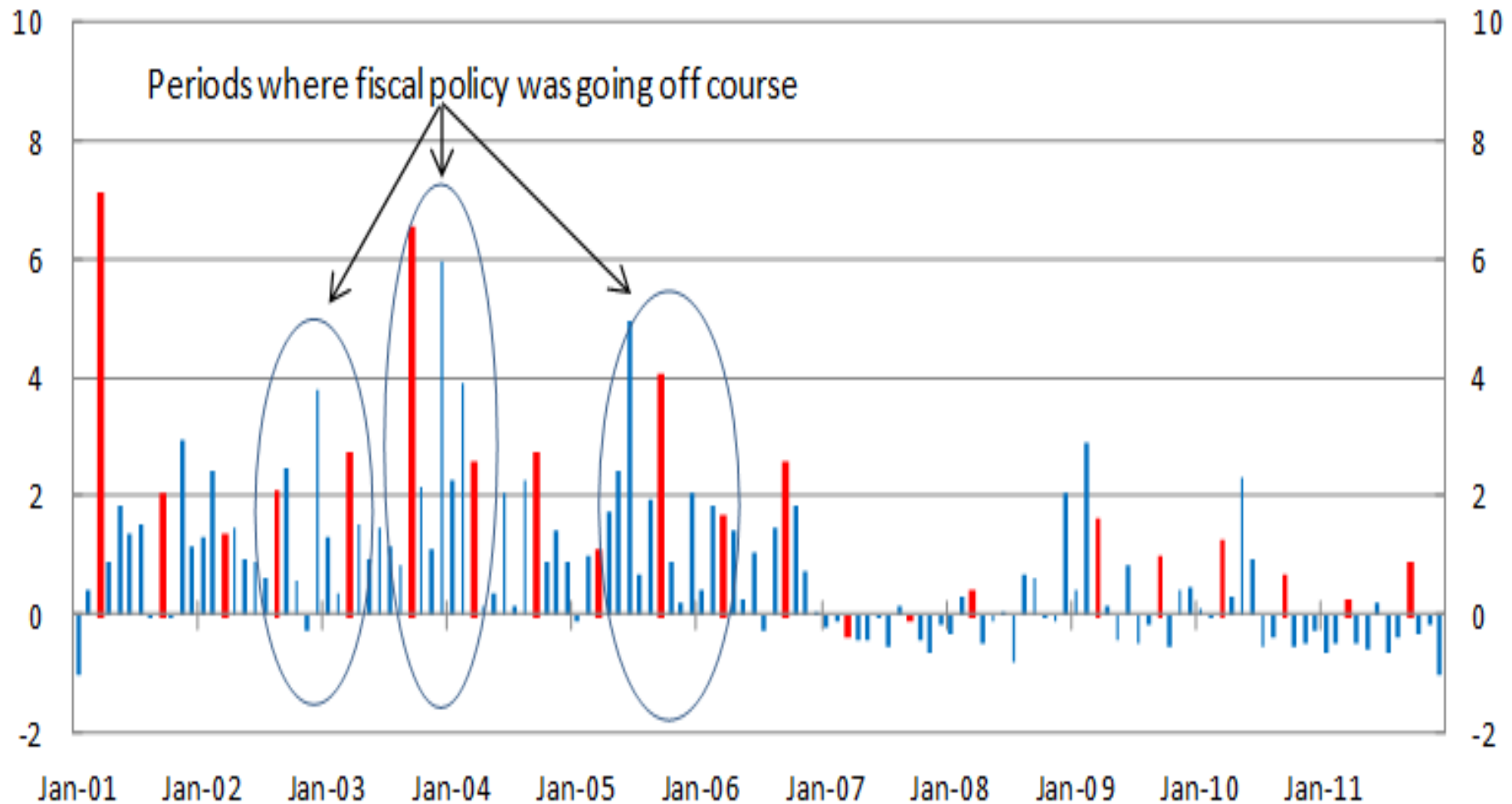
The Effectiveness of Fiscal Councils

- Countries with fiscal councils have less optimistic forecasts.



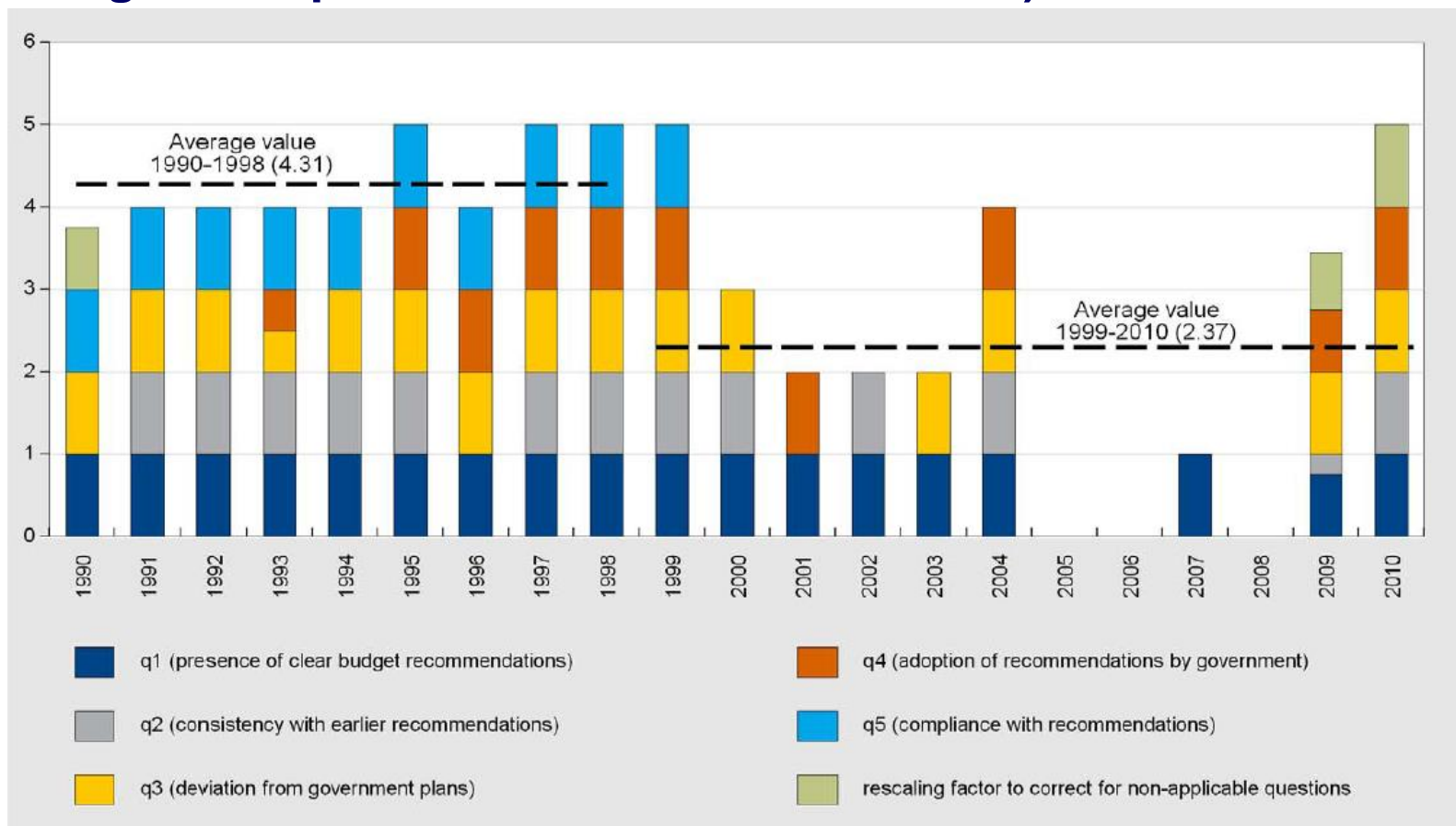
Source: IMF staff estimates.

Media Reports of the Dutch CPB- Effective Media Communication when Fiscal Policy is going off Course



Caveat: Preference Misalignment Hurts

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



Source: Coene and Langenus (2011)

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

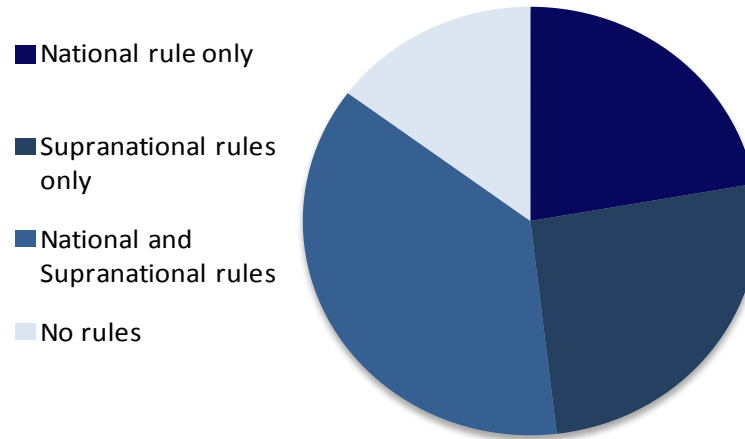
- **FCs can help implement (better) rules (ii):**
 - FC can play a role in formal enforcement mechanism. (Political enforcement does not work, as SGP showed):
 - If judicial enforcement, FC can provide expert economic opinion to Judiciary.
 - If automatic error correction (e.g. “debt brake”), FC can 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

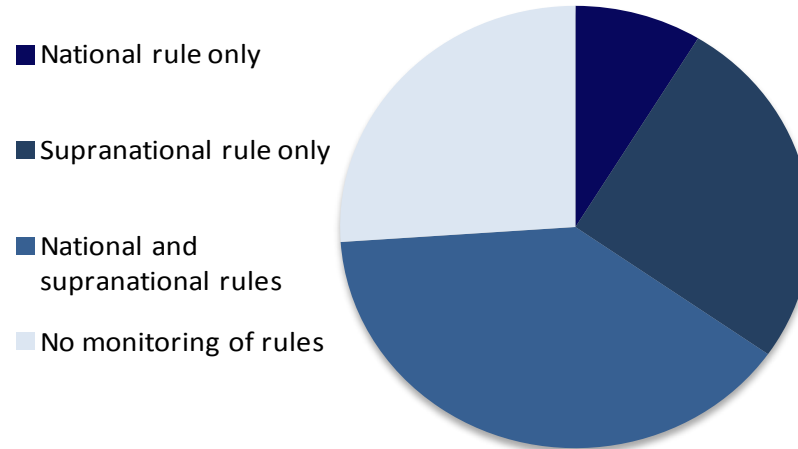
- **The rule provides a clear and transparent benchmark, facilitating FCs watchdog role:**
 - Monitoring is easier to communicate to the public → stronger media impact → greater effectiveness.
 - Helps the FC sending clearly “positive” (as opposed to normative) messages.
 - Obvious pre-condition: the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

Stylized facts

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

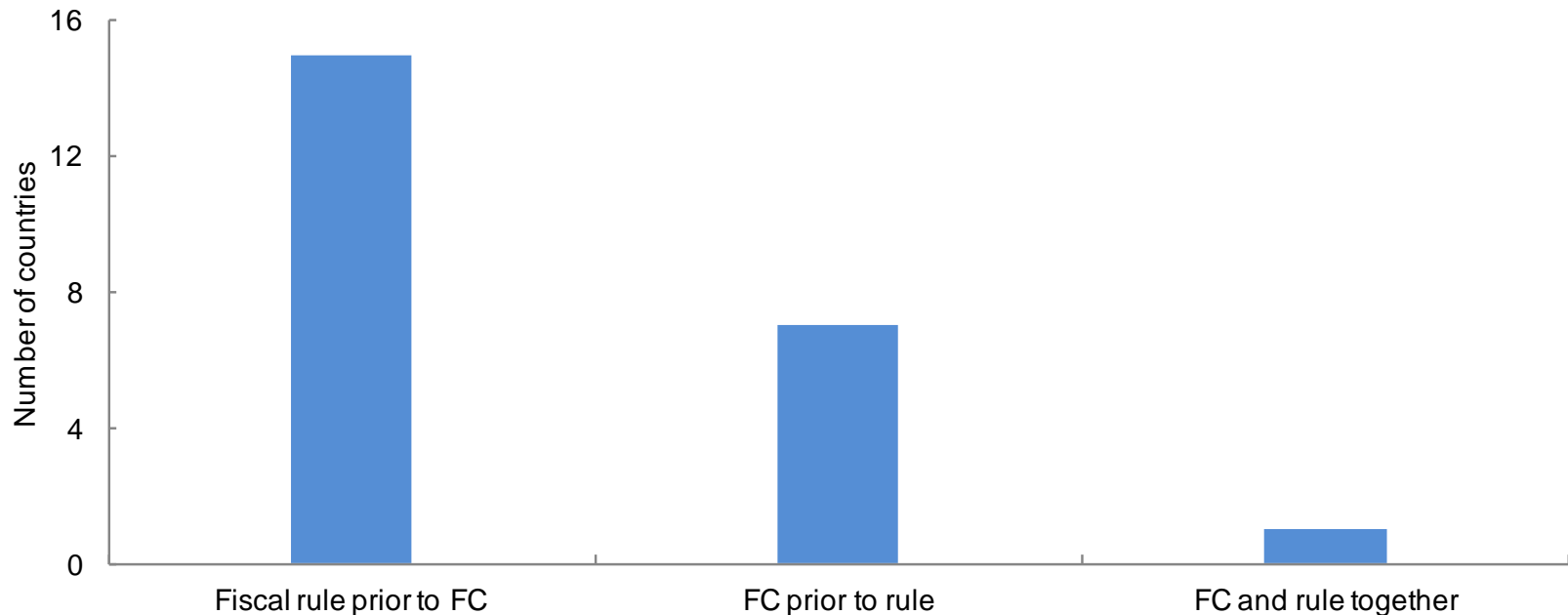


- **Among those, the FC is often mandated to monitor compliance.**



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

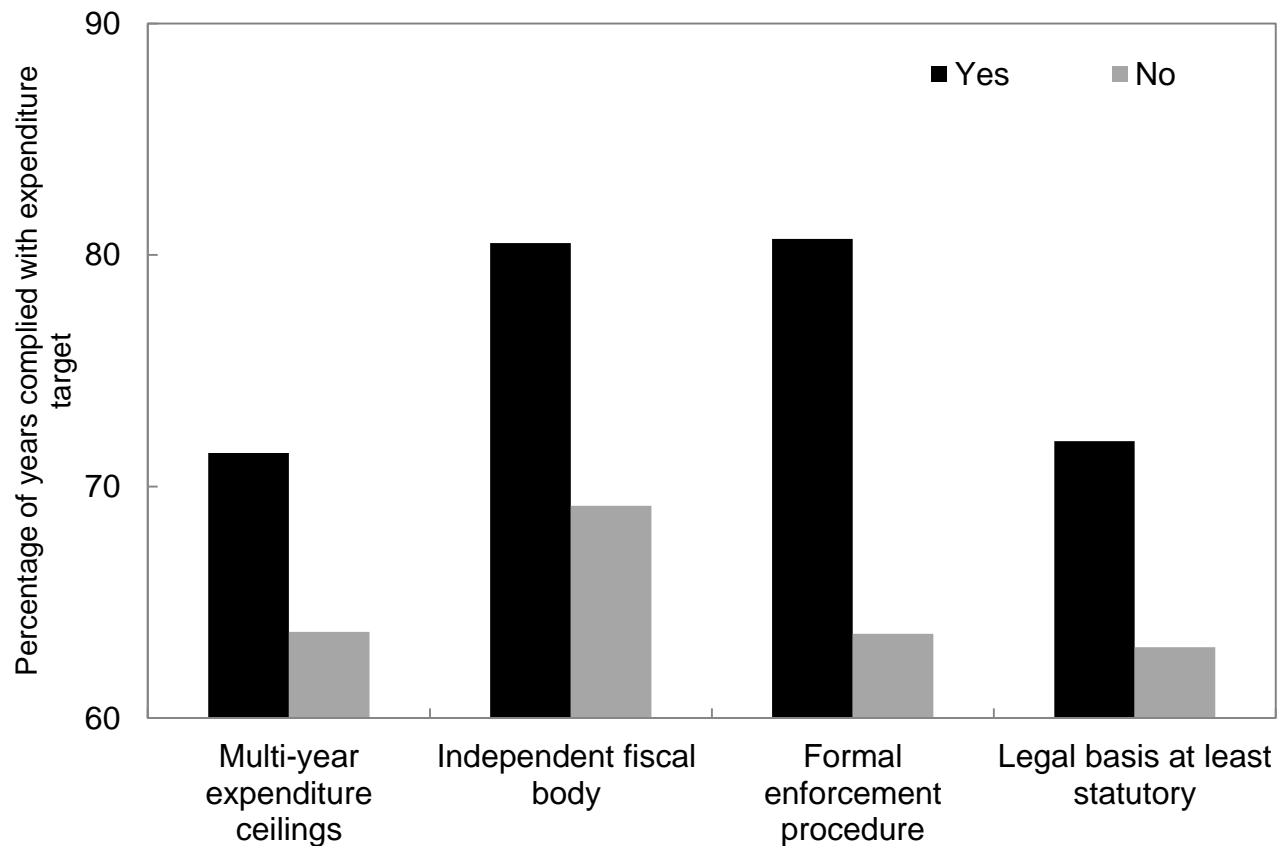
Dependent Variable: Primary Balance in percent of GDP								
Primary Balance (t-1)	0.823 (27.86)***	0.823 (27.96)***	0.826 (29.94)***	0.819 (24.29)***	0.824 (28.15)***	0.826 (28.07)***	0.825 (28.44)***	0.824 (28.05)***
Debt (t-1)	0.015 (3.00)***	0.016 (3.34)***	0.016 (3.18)***	0.022 (3.50)***	0.016 (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%.

Compliance is higher with an FC

Expenditure Rules: Design Features and Compliance (expenditure rules)



Source: FAD Fiscal Rules Dataset and IMF staff estimates.

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.

Specific challenges to EMs

- **Credibility-flexibility trade-off more challenging:**
 - More intrusive institutions?
 - But threat to independence.
- **Capacity constraints (esp. small countries):**
 - Outsourcing,
 - Foreign experts.
- **Resource constraints:**
 - Councils are often small,
 - But is size commensurate to mandate?

Everything you wanted to know...

Please visit:

<http://www.imf.org/external/np/fad/council/>

For data, background papers, research papers.