

The Scope and Limits of Fiscal Councils

Jürgen von Hagen

University of Bonn, Indiana University, CEPR, CFP

12 June 2014

Independent Fiscal Institutions: Proposals

- IFIs to improve the transparency and predictability of public finances
 - Guide expectations
 - Provide forecasts
- IFIs to strengthen the long-term orientation of public finances
 - Set time path for taxes (Blinder, Wren-Lewis, Gruen)
 - Longterm debt and annual deficit targets (Wyplosz)
 - Conduct stabilization policies to break pro-cyclicality (Hausman et al., Ter-Minassian)
- IFIs to overcome distributional conflicts in public finances.
 - Set annual deficit and debt limits

Independent Fiscal Institutions: Proposals

- What does „Independence“ mean?
 - Institutional: Created by parliamentary act, can be abolished only by parliamentary act.
 - Personal: Members appointed by parliament for fixed (non-renewable) terms
 - Budgetary: sufficient staff and resources to fulfill its task, autonomous budgetary allocation within the annual budget bill, freedom to hire appropriate staff.

Independent Fiscal Institutions

Other Independent Institutions

- State Audit Offices
 - Only ex-post evaluation, mostly legal
- General Advisory Councils
 - All sorts of topics, sometimes fiscal policy
- Parliamentary Services
 - Information for members of the legislature, no own role in the public debate

Fiscal Councils

- Ex-ante evaluations of government policies
- Clear Mandate Focused on the Annual Budget and Medium-term Fiscal Plans
- a role of its own in the public debate
- With or without „real“ decisionmaking power

Independent Fiscal Institutions: Examples

Central Planning Bureau (NL)

- Founded in 1947
- A research institute
- Provides annual economic and fiscal forecasts as input into the budget process
- Evaluates parties' election programs for fiscal consequences
- Provides ex-post evaluations of policies

High Council of Finances (B)

- Founded in 1936, reformed in 1989
- Oversees the regions' fiscal policies
- Coordinates the regions' policies with central govt.
- Sets medium-term targets for budget balances of all levels of govt.
- Proposes annual budget balance targets
- Monitors Belgian Stability Program

Independent Fiscal Institutions: Examples

Central Planning Bureau

- Leadership appointed on the basis of (academic) expertise
- Regularly evaluated by outside body

High Council of Finances

- Chaired by national Minister of Finance
- Members are political representatives of regions and communities and economic and financial experts.

Independent Fiscal Institutions: Examples

Purely advisory role

- Swedish Fiscal Council
- Austria WIFO
- Belgian Federal Planning Bureau
- Dutch CPB
- Hungarian Fiscal Council (+2011)
- Irish Fiscal Advisory Council
- Portuguese CFP
- Slovak Council for Budget Responsibility
- Slovenia Fiscal Council
- UK Office for Budget Responsibility
- Parliamentary Budget Office
Australia, Canada

With decisionmaking powers

- Belgian High Council of Finances
- Austrian Staatsschuldenrat (Public Debt Council)
- Australian Loan Council
- Finance Commission (India)
- Finance Commission (Nigeria)
- *Treasury Secretaries elected on independent tickets in US States*

Fiscal Policy Failures

- Opacity, Fiscal Illusion, Budget Maximizers
- Time Inconsistency
- Common Pool Problems

Opacity, Fiscal Illusion, Budget Maximizers

- A principal-agent problem between voters and elected politicians.
- Voters want things to be done, politicians run for office promising to do them.
- Voters are unable to understand and evaluate budgetary policies and the state of public finances, because
 - Budget documents are intransparent,
 - budget processes diffuse responsibility.
 - Use of creative accounting , extrabudgetary funds.
 - Economic assumptions are vague.
- Politicians can exploit their information advantage to pursue policies different from what voters want
 - Budget maximization (excess spending and debt)
 - Special interests (spending on undesirable policies)
 - Political business cycles (promotion of selfish interests)

Opacity, Fiscal Illusion, Budget Maximizers

- Fiscal Councils can improve voters' ability to monitor elected politicians.
 - Provide information on and independent evaluation of the quality and efficiency government policies to the general public.
 - Provide public explanations of budget documents
 - Explain budgetary responsibilities to the public.
 - Produce economic forecasts or provide public assessment of government forecasts.
 - Produce independent assessments of the sustainability of public finances.

Time Inconsistency

- Divergence between policies that are optimal ex ante and policies that are optimal ex post.
- Lack of commitment ability on the part of the government
- Equilibrium policies are suboptimal because private agents expect the government to „cheat“.
- Examples:
 - Macroeconomic stimulus
 - Bailouts of financial institutions and subnational governments
 - Taxation of capital income and wealth

Time Inconsistency

- Fiscal Councils strengthen the government's ability to commit to optimal policies by raising the cost of deviation.
 - Teaching the public about the undesirability of short-sighted policies.
 - Set long-run policy targets for public debt and the tax burden.
 - Enforce a medium to long term fiscal rule.
- Conduct short-term stabilization policies and leave medium to long term to the government.
- Requires strong enforcement powers and creates problems of democratic legitimacy in view of the distributional consequences of the council's policies

Common Pool Problems

- A coordination problem arising in the budget process.
- Results from the fact that those who pay for public policies are not the same as those who benefit from them.
- Those who benefit (and their representatives) overestimate the net social benefit of a given policy and demand too much of it.
- Excessive spending and deficits are the result.
- The coordination problem is the greater, the more fragmented the budget process is.
- Special case: „Wars of attrition“.

Common Pool Problems

- Fiscal Councils can provide a coordination mechanism for the actors involved in the budget process.
- Key is to make actors realize the full cost of the policies they decide upon.
 - Fiscal contracts setting main budgetary targets as part of coalition agreements.
 - Delegation of fiscal powers to a single actor (finance minister) who sets main budgetary targets.
 - Strong enforcement of the budget during the fiscal year.

Common Pool Problems

- Fiscal Councils can improve coordination by setting and enforcing annual ceilings for the deficit.
 - Forces policymakers to take into account the financing of any additional spending.
 - Authorize deviations from ceilings when justified.
 - Authority to mandate across-the-board spending cuts when ceilings are violated.
 - Strengthen the commitment to fiscal contracts by monitoring actual policies and their consistency with medium-term plans.
 - Strengthen the role of the finance minister by evaluating his targets and policies.
 - Break the option value of waiting in wars of attrition by imposing across-the-board spending costs.

Limits

- Cannot take politics out of fiscal policy.
- Democratic legitimacy: Representation and transparency.
- Accountability to parliament

Conclusions

- Fiscal Councils can contribute to solving problems of excessive government spending and deficits.
- They must be designed to address the specific root of these problems.
 - Opacity
 - Time Inconsistency
 - Common Pool Problems
- Existing councils address primarily
 - The opacity problem (European fiscal compact)
 - The common pool problem (in federal settings)