Can Fiscal Rules Be Enforced?

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Institutions for Fiscal Credibility—Fiscal Policy Rules and Fiscal Councils: Experience and Prospects in the Asia-Pacific Region

Tokyo, June 12, 2014

Outline

- The Basic Problem
- Enforcement:
  - Built into the rule:
    - Automatic correction,
  - Coming from other rules, legal instruments
    - Procedural rules,
    - Third-party enforcement (judiciary, supranational body).
  - Reputational devices.

The Basic problem

- **Numerical fiscal rules aim at constraining policymakers, but they are made by policymakers!**
  - Principal-agent confusion.
- **Main implications:**
  - Unless time-inconsistency is a major issue, **theoretical impasse:** politicians have no apparent incentive to create/sustain institutions that constrain their behavior.
  - **Democratic ownership** of fiscal institutions is key to their effectiveness and credibility → **Ideally, institutions must affect the interaction between voters and politicians.** For instance, genuine efforts to adhere to publicly announced objectives must be directly valued by voters and be rewarded accordingly. If not, reversals (Hungary), changes (SGP), or circumventions (Greece) are likely.

The Basic problem

- Two political parties (C, L), two periods (1,2):

$$V_Q = E_0\left[\sum_{t=1}^{2} v\left(q_{Q,t}\right) - S(b)\right]$$

$q_{C,t} = 0$ if $Q = L$ and $q_{L,t} = 0$ if $Q = C$

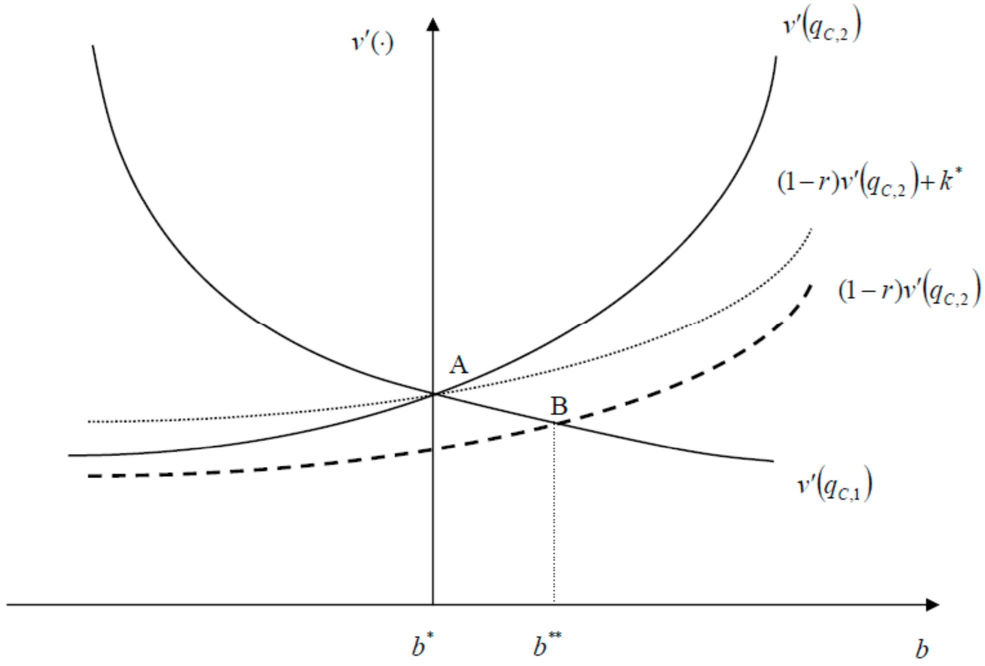
→Budget constraints are:

$$q_{Q,1} = \tau y_1 + b - \delta_1 \qquad q_{Q,2} = \tau y_2 - b - \delta_2$$

→Fiscal institutions: $S(b)$ with $S(0)=0$ if $b \leq \bar{b}$, and $S(b) = k\left(b - \bar{b}\right)$ otherwise.

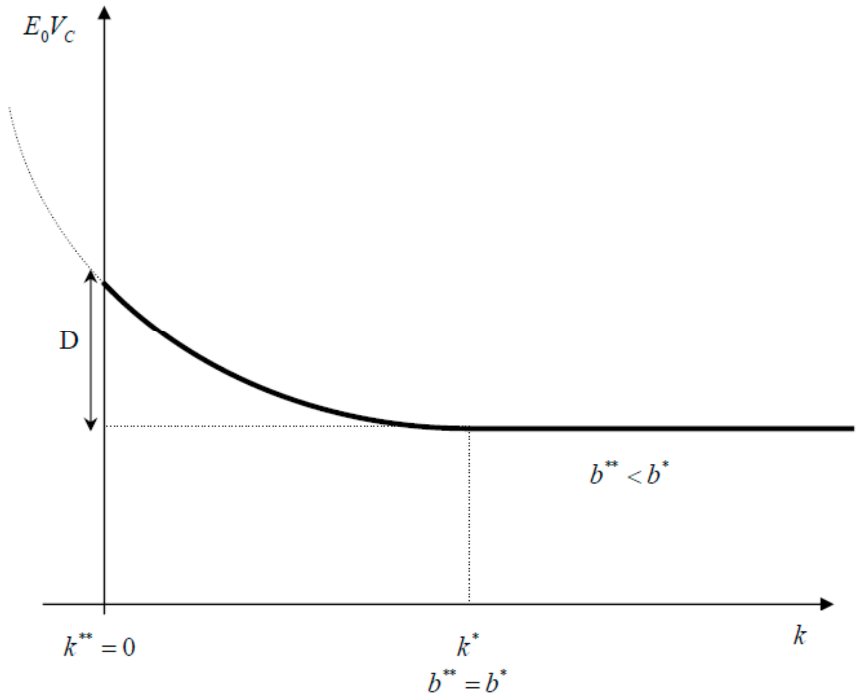
Equilibria

- With uncertain re-election probability (r<1), an elected politician behaves differently from the social planner, unless fiscal institutions bind.



The Basic problem

- But no incentive to set up binding institutions … Excessive defifit is ex-ante and ex-post optimal.



Making the rule binding?

- **Third party? Courts → Practical issues:**
  - Timeliness,
  - Technical competence (bringing "experts" means economists… burden of proof hard to administer),
  - Requires the rule to be enshrined in high legal norm (Constitution…) to allow Judiciary to tie executive's hands,
  - Requires to think about credible sanctions in case of violation.

Automatic correction

- **Principle: attach error-correction to the rule**
  - Non-random deviations trigger mandatory correction… rule becomes more binding.
  - Can work if scraping the rule entails large political/reputational/electoral costs.

- **Example: "Swiss" debt brake.**

Swiss Debt Brake: objectives

- "Stabilize overall deficits over the medium term, avoid an accumulation of structural deficits at the federal level, and reduce the debt-to-GDP ratio." (Federal Finance Department, 2001).

- "Ensure a durably countercyclical fiscal policy." (Federal Finance Department, 2001)

Swiss Debt Brake: numerical rule

- The debt brake stipulates that federal expenditure cannot exceed structural revenue (i.e. cyclically-adjusted and net of "extraordinary" items—one-offs). This applies every year → structural budget balance rule.

- Concretely, each year t, the federal budget for t+1 must be such that:

$$\tilde{G}_{t+1} \leq_t \overline{G}_{t+1} = E_t R_{t+1} \left(\frac{Y^*_{t+1}}{E_t Y_{t+1}} \right)$$

Swiss Debt Brake: numerical rule

- **Ex-post, the rule gives:** ${}_{t+1}\overline{G}_{t+1} = R_{t+1}\left(\frac{Y^*_{t+1}}{Y_{t+1}}\right)$
- **Forecast errors:** ${}_{t+1}\overline{G}_{t+1} - {}_{t}\overline{G}_{t+1} = \varepsilon_F \neq 0$
- **Breaches of the spending limit:** $G_{t+1} - {}_{t+1}\overline{G}_{t+1} = \varepsilon_B$
- **Compensation account:** $dCA_{t+1} = CA_t - (\varepsilon_F + \varepsilon_B)$
- **If compensation account shows a negative balance in excess of 6 percent of federal expenditure (0.6 percent of GDP), then the rule mandates structural surpluses consistent with the elimination of the excess overdraft over a maximum of 3 years. Issue: response to unexpected shocks are treated in the same way as deliberate overruns!**

Swiss Debt Brake: principles

- **Expenditure limit holds for the budget only:**
  - budget amendments during the budget year can exceed the limit;
  - but new laws (mandates) fall under the rule, effectively implying a PAYGO rule if the ceiling is binding.
- **Coverage of expenditure ceiling is wide:**
  - Investment and interest payments fall under the ceiling.
  - Only “extraordinary” items (one-offs) are excluded (e.g. disaster relief, state aid to companies, banks,…). The reason for excluding one-offs is that a large share of federal expenditure is mandatory (adjusting it takes time).

Swiss Debt Brake: legal basis

- **Popular vote (2001) of a motion to amend the Constitution → 85 percent majority, and majority of States (Cantons). First applied to the 2003 budget.**
- **Constitutional basis is key: it ties the hands of both Government and Parliament.**
  - Government can only submit a budget consistent with the rule;
  - Parliament cannot approve a budget inconsistent with it unless there are "exceptional circumstances," in which case a super-majority is required (requirement is waived if planned overrun is below 0.5 percent above the ceiling).
- **Automatic "sanctions:" tightening of the structural budget balance floor to offset past deviations.**

Swiss Debt Brake: implementation

- **The debt brake effectively applies ex-ante to the budget → its effectiveness relies on:**
  - the strength of budget execution and expenditure control;
  - Small and non-systematic forecasting errors.
- **Cyclical adjustment is based on HP-filter:**
  - Pros: ex-post-symmetrical (unlike PF approach), simple and transparent (no risk of manipulations).
  - Cons: end-point bias → moving target as data are revised.

Procedural rules

- **PAYGO,**
- **Sequesters,**
- **Rules-based centralization of the budget, genuine MTBF.**

Reputational devices / transparency

- **Precondition: fiscal rule is “owned”**
  - The rule must be perceived as valuable by the public.
- **Mechanism: transparency, independent oversight.**
  - Role for fiscal councils.

Fiscal Councils and Fiscal Rules

- **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 and evade responsibility for ex-post deviations.
    - 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.
  - By doing so, FC reduces the loopholes associated with "smarter" rules, **expanding the set of feasible rules** ex-ante.

Fiscal Councils and Fiscal Rules

- **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.

Fiscal Councils and Fiscal Rules

- **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).

Evidence: 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 of Fiscal Institutions

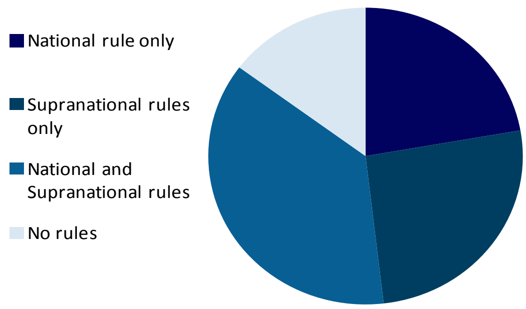
- **Regressions support robust association between stronger primary balances and more binding fiscal rules.**
- **Additional impact of fiscal council on top of the fiscal rule index.**
  - Impact is statistically significant only if one considers FCs with certain characteristics:
    - Independence, check on fiscal rule compliance, high media impact.
- **No direct evidence of strict complementarity (interactions).**

Indirect Evidence on Complementarity

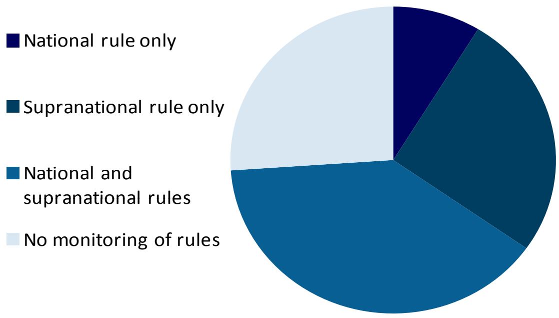
- **“Revealed preferences”**
  - Stylized facts
- **Forecasts: expand/revisit Frankel and Schreger (2012).**
  - Do FC reduce optimistic bias in budgetary forecast?
- **Media impact?**
  - Do FR favor greater media presence of FC?

Revealed Preference

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

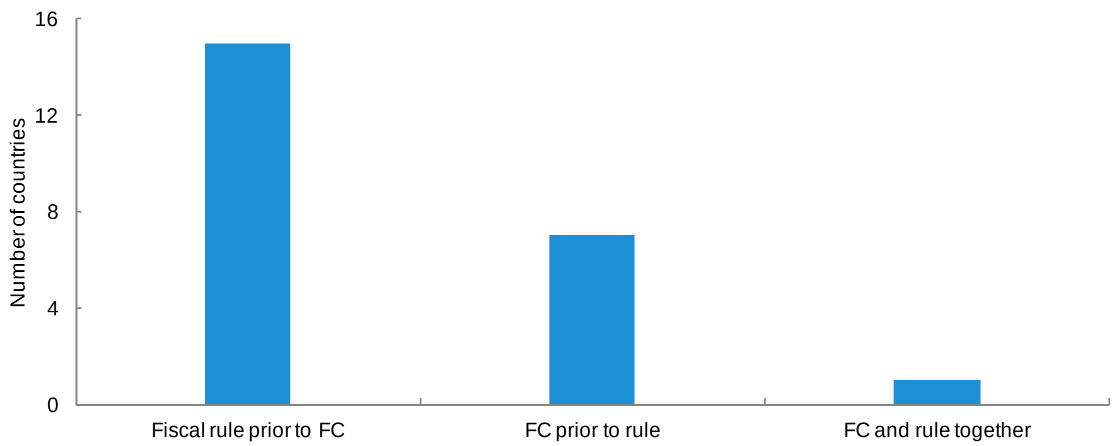


- **Among those, the FC is often mandated to monitor compliance.**



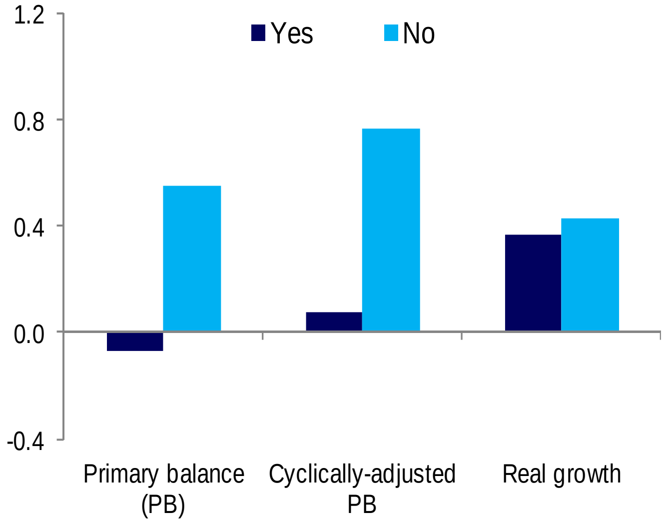
Revealed Preference

- **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.



FC Monitoring and Forecasts

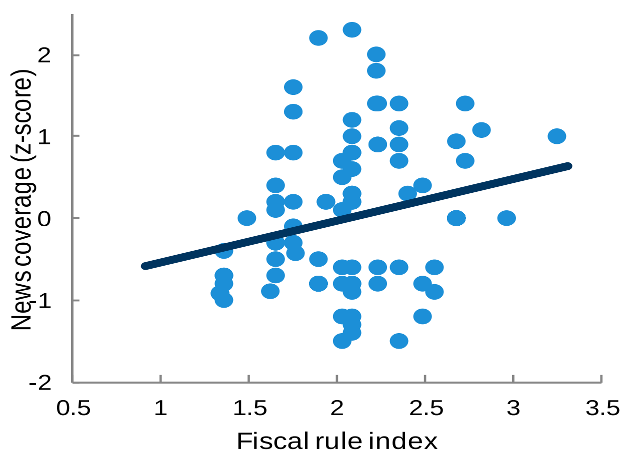
- **Countries where FCs monitor FRs exhibit no forecast bias in budgetary balances, despite a positive bias in growth forecast.**



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

A Rule Can Help the FC

- **The media impact of a fiscal council tends to increase with the extent to which fiscal rules have been designed to constrain discretion (e.g. constitutional basis), as reflected by the IMF fiscal rule index.**



Conclusions

- **Fiscal rules aim at constraining policymaker's discretion in intrinsically political matters.**
  - Credible enforcement is an issue.
- **Three, non-mutually exclusive, ways to make rules binding when they have to:**
  - The rule itself: automatic correction
    - Abandoning the rule must be very costly.
  - Other rules, legal instruments
    - Procedural rules,
    - Judiciary enforcement.
  - Independent / non-partisan oversight
    - Greater transparency leads to greater accountability (assuming the rule is "owned").