

The Theory of Independent Fiscal Agencies: What Do We Have? What Do We Need? And Where Does This Leave Us?

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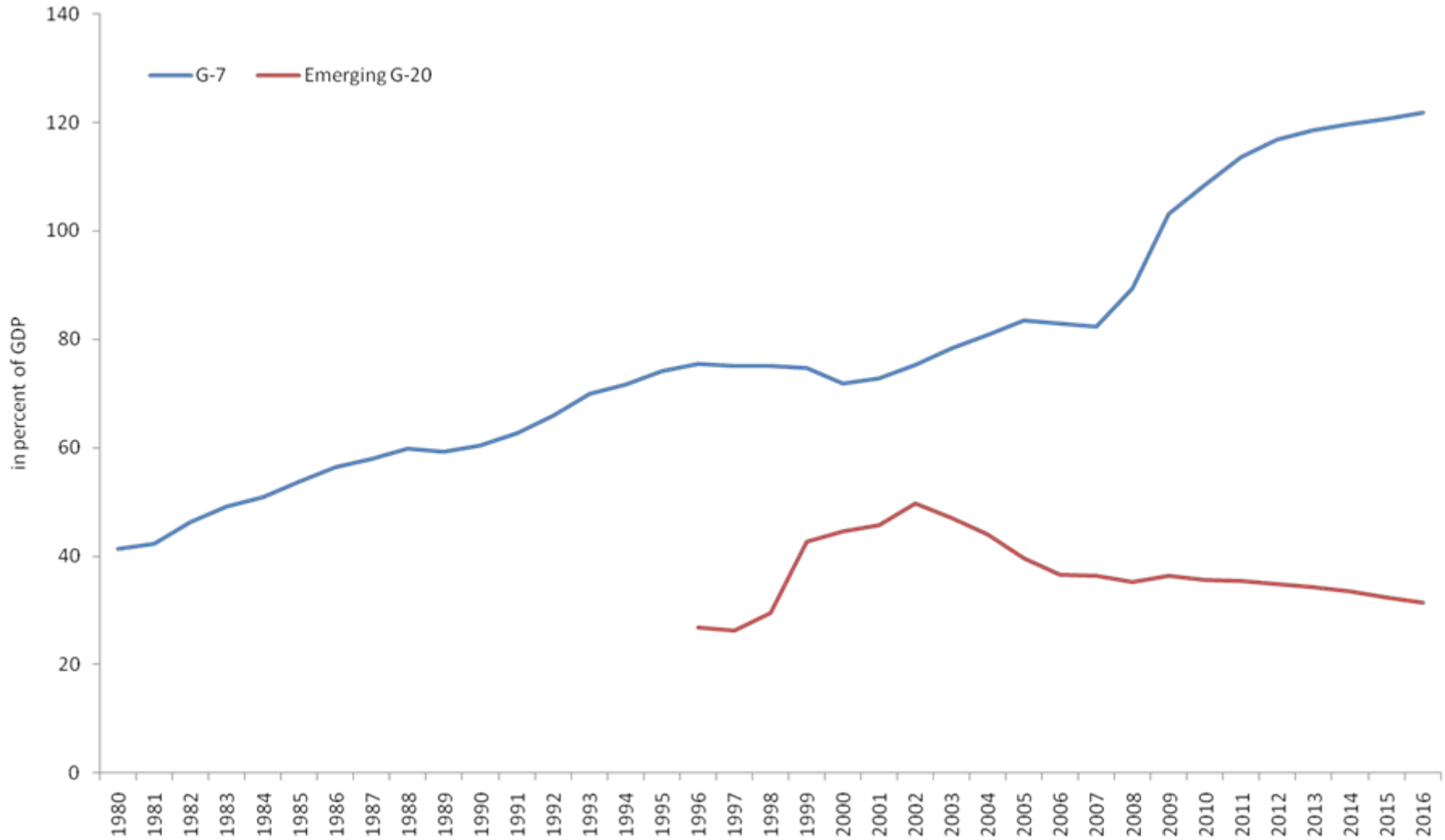
Outline

- Motivation
- What do we have? Not much
- What do we need? Models acknowledging that fiscal policy is fundamentally different from monetary policy: political economy constraints are pervasive; multiple trade-offs → concrete policy advice highly country specific.
- Where does that leave us?
 - Parallel with independent central banks is misleading.
 - Important to understand the multiple and interconnected roots of fiscal bias,
 - An independent fiscal agency is a priori much less likely to carry credibility gains than an independent central bank,
 - Democratic ownership of fiscal institutions is key for their own credibility.

Motivation

- Excessive deficits and debts have been persistent concerns → large economic literature on ways to limit the perimeter of policymakers' discretion.
- Post-crisis state of public finances is dismal in most advanced economies → fear of losing credibility → Renewed interest in discipline-enhancing institutions to anchor expectations (especially important given the desirability of backloaded adjustment in many cases).
- Prime candidate: fiscal rules.
- Strong interest in the role of independent fiscal agencies (recent, prominent example: OBR in the UK). Question: complements or substitutes?

Public debts: high and rising



What Do We Have?

- Not much... discussions typically make an informal parallel with the debate on central bank independence: “rules don’t work, delegation does work.”
- This is unsatisfactory:
 - In theory, we can show that discipline-enhancing fiscal institutions are less likely to be sustained than monetary arrangements.
 - In the real world, fiscal policy delegation (even limited to choosing the deficit) is not on the agenda,
 - Agencies we talk about often exist along with and in support of rules-based frameworks (not one vs. the other),
- So, unlike the debate on central bank independence 20 years ago, we have no theory and very sketchy (if any) evidence to guide our thinking and shape our advice.

What Do We Have?

Recent papers depart from the central bank analogy and attempt to structure the discussion, largely without formal modeling of institutions:

- Debrun, Hauner, Kumar (2009) survey the literature and propose a taxonomy → “this is not about policy delegation” (“Councils” vs. “Authorities”)
- Calmfors (2010) links types of fiscal councils to sources of fiscal bias → “different bias, different council” (inherent complexity of fiscal policy)
- Wren-Lewis (2010) shows (informally) that
 - (1) fiscal bias is not about time-inconsistency,
 - (2) the case for delegating fiscal policy is limited to certain types of fiscal bias (e.g. neglect for future generations)
 - (3) delegation is hard to conceive, as there is no consensus on optimal debt levels (as evidenced in the random walk result of modern DSGE analysis).

What Do We Need?

- A meaningful theory of fiscal councils (FC) needs to properly reflect the specific incentives of elected policymakers → **political economics** (guides should be Rogoff-Sibert (1988), Persson-Tabellini (2000), Alesina-Tabellini (2004), Maskin-Tirole (2004)... not Rogoff (1985)).
- In particular, a model of FC should have the following features:
 - **Time-inconsistency is not the most likely cause of deficit bias** → multiple and interrelated causes → this has implications for the effectiveness of institutional solutions to deficit bias.
 - **The central issue is not policy delegation** → the role of FC is more elusive; they can be seen as facilitating the execution of a “fiscal contract” through various channels (mainly reducing informational asymmetry).
 - **Be explicit on politicians’ incentives to build and sustain such institutions.** Since the decision to create an FC is discretionary, the decision to eliminate it is also discretionary. → need to formally explore ways in which it can improve fiscal credibility.

This paper...

- ... does not provide a full-fledged theory of independent fiscal agencies...
- ... but it formally illustrates the importance of the above arguments for modeling.
- These simple exercises mainly illustrate that:
 - Unless time-inconsistency is a major issue, theoretical impasse: politicians have no durable incentive to create/sustain such institutions.
 - Democratic ownership of fiscal institutions is key to their effectiveness and credibility → **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 as a sign of competence and be rewarded accordingly. If not, reversals (Hungary), changes (SGP), or circumventions (Greece) are likely.

Assumptions

- 2-period set-up combining “opportunistic” policymakers, electoral uncertainty, and rational but incompletely informed voters.
- **Information asymmetry:** voters do not observe politicians’ competence and attribute some signaling value to shocks affecting the delivery of public goods. [They can’t distinguish bad luck from bad policies.] That shock has mean zero and finite variance.
- No connection between fiscal policy and private consumption.
- Voters value public goods (constant stream over time—discount rate is zero).

Basic equations

- Voters utility: $U(c, q) = E_0 \left[\sum_{t=1}^2 \beta^{-(t-1)} (u(c_t) + v(q_t)) \right]$
- Politicians utility: $U_{\rho}(c, q) = E_0 \left[\sum_{t=1}^2 \beta^{-(t-1)} (u(c_t) + \rho v_{\rho}(q_t)) \right]$
- Public goods: $q_1 = \tau y + b - \delta_1$, $q_2 = \tau y - Rb - \delta_2$
- Assume quadratic utility and unit discount factors for simplicity:
 $u(x) = v(x) = -(x - \tilde{x})^2$ and $\beta = R = 1$
- Timing: budget is set at the beginning of period 1 and cannot be changed. Choice reflects politician expectations about shocks and re-election chances. Elections take place at end of period 2.
- First, ignore voting behavior and assume that re-election probability is less than 1.

Equilibria

- **Socially optimal policy** delivers a constant stream of public goods over time → Ex-ante-optimal deficit is zero (this is only because income is assumed constant → no fetishism about balanced budgets):

$$q_1^* = q_2^* \text{ and } b^* = 0$$

- **Political equilibrium:** electoral uncertainty creates a wedge between subjective and social discount rate → downward tilt in provision of public goods → deficit is positive.

$$b^{**} = \left[\frac{1-\rho}{1+\rho} \right] \tilde{b} \text{ with } \tilde{b} = \tilde{q} - \tau y$$

Fiscal institutions

- **Can be modeled as a simple linear deficit contract.** For instance, think of a budget balance rule with a fiscal council whose role is to make sure that deviations entail some cost for policymakers → fiscal policy now maximizes:

$$V_C = U_C - f(b - b^*)$$

- It is a priori straightforward to implement the first best.

$$f^* = (1 - \rho)\tilde{b}$$

- But, **for given electoral uncertainty, the fiscal contract violates the politicians' participation constraint!** (unlike inflation contracts for independent CBs):

$$E_0 V_C(q^*) < E_0 U_C(q^{**})$$

→ no incentive to set up such institutions!

- **The theory of fiscal institutions requires to take “commitment technologies” very seriously.** And for fiscal policy, that means studying the interaction between voters and policymakers.

Endogenous voting behavior

- **Electoral uncertainty now depends on voters' assessment of politicians' competence**, based on the signaling value they attach to delivery of public goods in period 1 (subject to shocks)
- Voters re-elect the incumbent only if, at the end of period 1, they expect her to deliver more public goods than the challenger in period 2.

$$E_1[q_2^C] \geq E_1[q_2^L]$$

- **Budgetary opacity:** voters do not observe the true deficit, but only the difference between public goods delivered in period 1 and the tax money they had to pay for it → **“notional” fiscal deficit.**

$$q_1^C - \tau y = \xi - \delta_1$$

- The “notional” deficit that they observe is thus a combination of noise (including unobserved true deficit) and a certain shock on budget execution, which they interpret as a signal of (in)competence.

Signal extraction and voting

- Voters solve a simple **signal extraction problem** → an observed “notional deficit” points to competence (because positive execution shock leads to more public goods being delivered for the same amount of tax money)

$$E_1[\delta_1] = -\frac{\sigma_\delta^2}{\sigma_\delta^2 + \sigma_\xi^2} (q_1^C - \tau y)$$

- As voters view execution shocks as a signal of competence, it implies that conditional on incumbent’s re-election, they expect persistence in the execution shock:

$$E_1[\delta_2 | Q = C] = \lambda E_1[\delta_1]$$

- At the end of period 1, voters compare their expectations of public good delivery under the two competing parties. It is easy to see that:

$$E_1[q_2^C] - E_1[q_2^L] = \lambda \frac{\sigma_\delta^2}{\sigma_\delta^2 + \sigma_\xi^2} (q_1^C - \tau y)$$

- **The incumbent (c) is re-elected if voters observe a notional deficit.**

Opportunistic vs. short-termist bias

- At the budget preparation stage (time 0), politicians internalize their influence on the re-election chances:

$$\rho = \Pr\left(\lambda \frac{\sigma_\delta^2}{\sigma_\delta^2 + \sigma_\xi^2} (q_1^c - \tau y) > 0\right)$$

- opportunistic motive for deficits. A notional deficit affects raises expectations of higher public good delivery by the incumbent, increasing re-election chances.
- Key implications:
 - Choosing a higher deficit ex-ante increases re-election prospects, which reduces the short-termist bias...
 - Aiming at full budget transparency implies that voters can perfectly observe execution shocks. Killing the opportunistic bias maximizes the short-termist bias, as $\rho = 0.5$.

Fiscal institutions

- The same simple deficit contract could work if it was credible; but political constraints affect ex-ante incentives → how can institutions be credible?
- To pass the participation constraints if institutions need to directly affect the interaction between voters and policymakers: **go at the core of the problem—INFORMATION ASYMMETRY.**
- **In my simple model: a fiscal council with a budget-balance rule and a clear mandate to inform the public debate and avoid voters to confuse bad luck and bad policies would simultaneously reduce the gains from opportunistic behaviors and reward disciplined policymakers with greater re-election chances.**
- A full-fledged model of fiscal institutions should thus explore how fiscal institutions can be “owned” by voters. This could mean that adhering to them would become in itself a signal of competent policymaking.
- Of course, if voters are really subject to fiscal illusion, delegation is the way... but in the case of fiscal policy, would this be different from a “benevolent dictator” ?

Conclusions

My discussion has highlighted and illustrated the following points:

- Parallel with independent central banks is simplistic and misleading, an independent fiscal agency is a priori much less likely to carry credibility gains than an independent central bank. bias (highly country-specific) → avoid one-size-fits-all, partial advice.
- Basic problem of institutional design: institutions must be assumed to bind. But this is unsatisfactory: no “fiscal contract” is even consistent with participation constraints.
- Fiscal institutions must work at the core of the democratic process and be fully owned: they must affect the way voters and policymakers interact, by **attacking informational asymmetry → this ultimately why we NEED fiscal councils (no rule can achieve that).**