# Fiscal policy councils and fiscal policy targets

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# Accountability in economic policy

- **Democratic control –**
  - Objectives/decisions/events/outcomes
  - Politicians: control vs. non-control

- **Avoid myopia, time-inconsistency, partisan biases (bias in assessed costs and benefits)**

- **Transparency/Thrust/Credibility - Anchor expectations**

- **How should we understand accountability?**
- **How can we strengthen accountability?**

# Accountability

- **Golden concept – who are against?**
- **Related to**
  - **Transparency**
  - **Trustworthiness**
  - **Responsiveness**
  - **Responsibility**
  - **Effectiveness**
  - 
  -

# Defining accountability

Broad:

- *Accountability ensures that actions and decisions taken by public officials are subject to oversight so as to guarantee that government initiatives meet their stated objectives and respond to the needs of the community they are meant to benefit, thereby contributing to better governance* (World Bank)

Narrow: (process)

- *A relation between an actor and a forum, in which the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgement, and the actor may face consequences* (Bovens (2006)).

# Principal: Electors

↓

# Agent: Government

- Need for control – continuous and reliable
- Elections are imperfect controls (infrequent and multidimensional)
- Information/complexity – need for experts

# Economic policy objectives

- **Trade-offs (e.g. stabilization policy vs. sustainability; efficiency vs. equity)**

**Complicated by:**
- **Dynamics**

- **State of the economy /information and its interpretation**

- **Behavioural and equilibrium responses**

# Fiscal targets/rules

- **Intermediary targets**

- **Important for planning etc.**

- **Rules are guideposts but not autopilots**

- **Shocks: No simple unconditional rule or target**

# Fiscal councils

- **Expertise/complexity**

- **Publicity – sharpens the ministry, politicians, the public debate etc.**

- **Outside control on a continuous and independent basis**

- **Control of the controllers: scientific standards, openness, appointment rules etc.**

- **Fiscal councils and intermediary targets are substitutes for accountability**

- **But there is increasing returns - both is better**

- **Denmark : Economic council and no explicit intermediary targets**

- **Sweden: explicit intermediary target but no FC (until 2007)**

# Intermediary targets

- Related to variables under political control

- Well-defined (avoid measurement problems)

- Few and simple (avoid political shopping)

- **Easy to find intermediary targets**

- **But they are all associated with problems (measurement, interpretation)**

- **Judgement is unavoidable**

- **Economic policy is not engineering control**

# Key problem

- **Short run stabilization vs long-run sustainability**
  - Debt problems
  - Approaching demograhic changes
  - Challenges for welfare arrangements

**Key measures:**
- **Cyclically adjusted (structural) budget balance**

- **Fiscal sustainability**

# Fiscal sustainability

- **Sustainable paths (not a unique path)**

- **Desirable path? – Intergenerational distribution**

- **Metric: S2 – needed permanent change in the budget balance to meet the intertemporal budget constraint**

Budget balance % of GDP
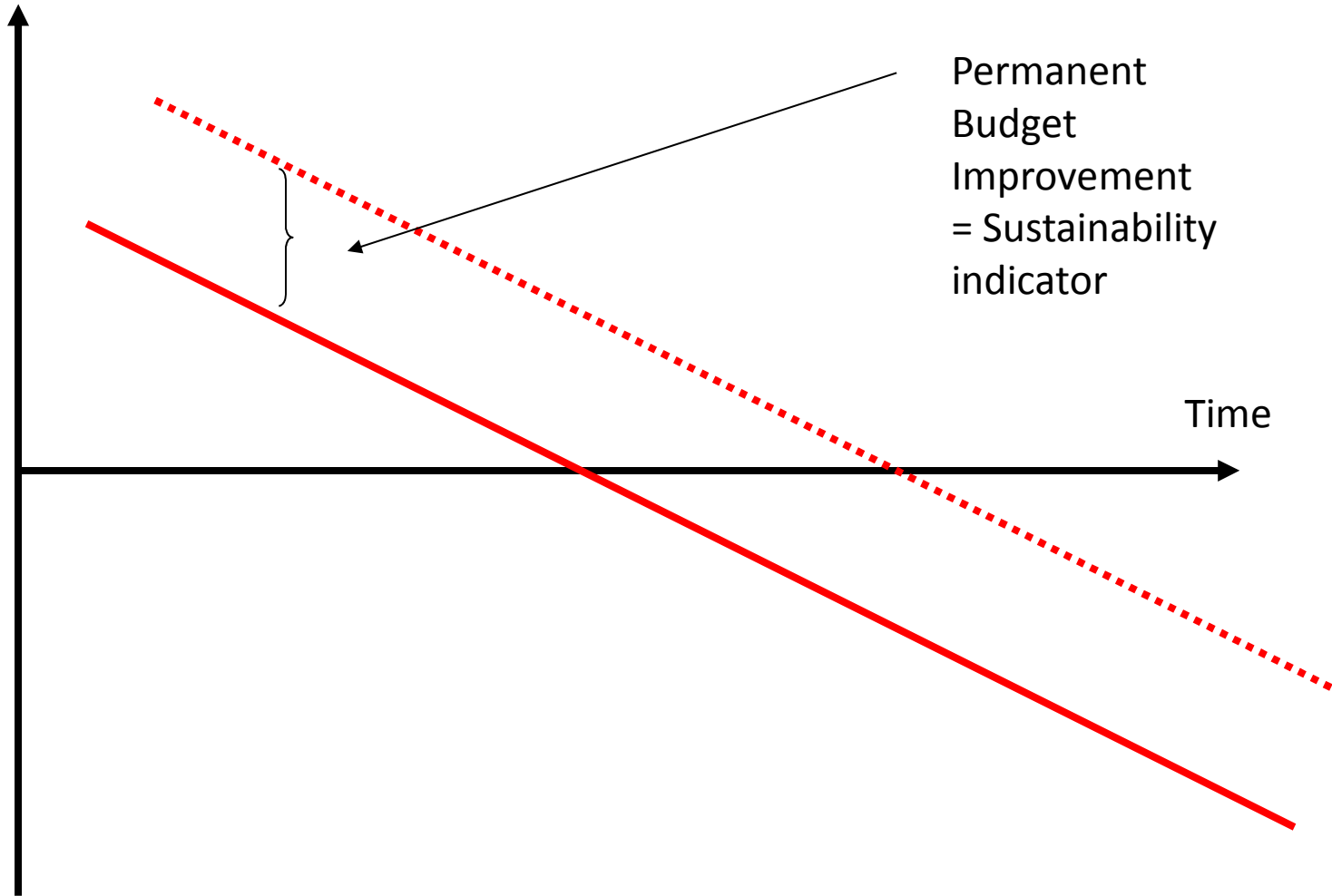
Permanent
Budget
Improvement
= Sustainability
indicator

Time

# S2 measure

- **Informational demanding to compute**

- **Sensitive to assumptions**
  - Trends:Demographics
  - Interpretation of unchanged policy
  - Discounting

- **Appropriate horizon (measurement horizon vs planning horizon)**
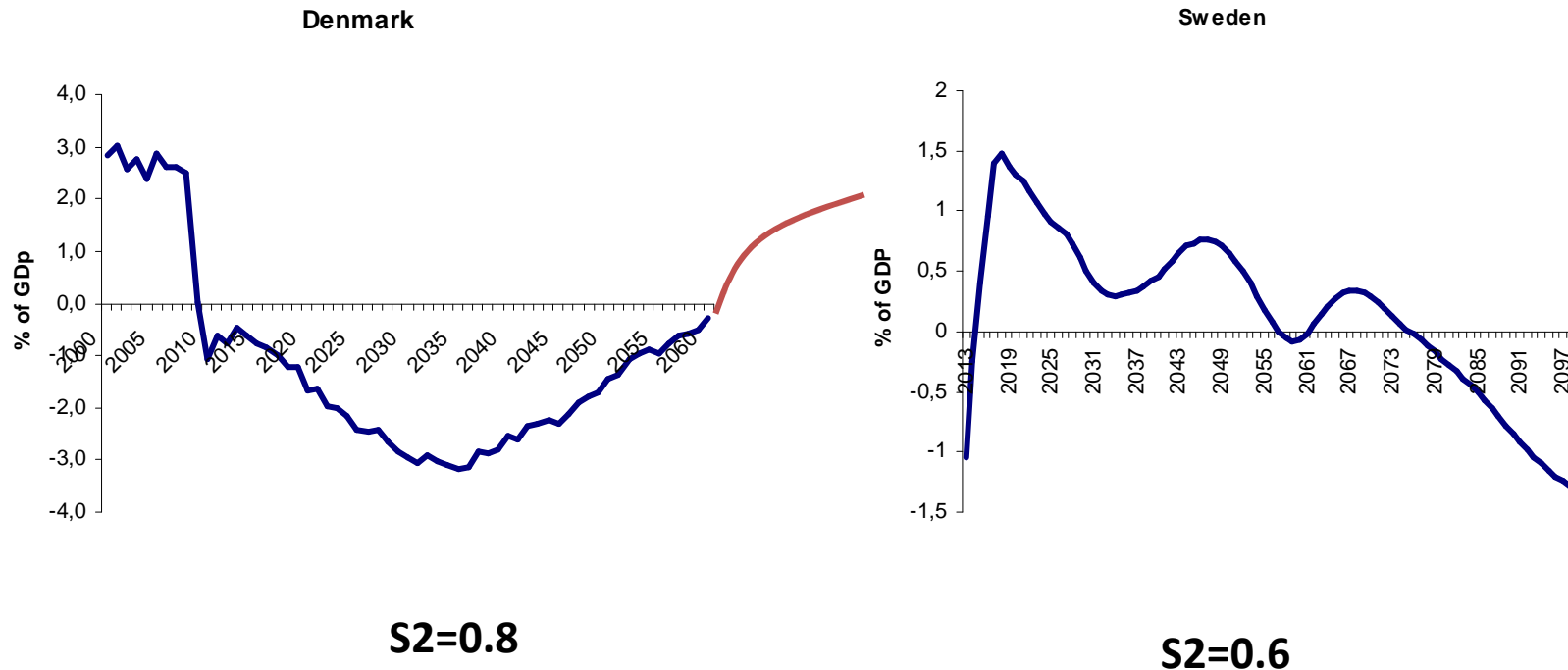
# S2 – indicator
## Alternative scenarios - Sweden

|  |  |
| --- | --- |
| Base scenario | -3.4 |
| Services – unchanged GDP share | -0.5 |
| Improved standards | -0.1 |
| Higher prices (Baumol effect) | -0.3 |
| Productivity public sector | -4.4 |
| Better integration | -3.9 |
| More leisure | 1.2 |
| Increased productivity | -3.7 |

# Don't rely solely on S2 – look at the budget profile!!!

Estimates presented in 2010

**Denmark**

**Sweden**

**S2=0.8**

**S2=0.6**

# Interpreting S2 – it is a smoother

- **Tax smoothing**
  - Keep taxes constant to minimize tax distortions
  - Expenditure variation absorbed via the budget

- **Shock smoothing (Risk diversification)**
  - Diversify shocks over time/generations via the budget
  - Temporary and exogenous shocks

- **Initial conditions:**
  - Should future generations share the initial debt – also if it reflects failures to undertake reforms?
- **Shocks:**
  - Are the shocks exogenous and temporary?
  - Shock diversification justifies only small effects on fiscal sustainability
- **Trends:**
  - Systematic trends – indicate systematic redistribution – is this justified?
  - Should current generations contribute to the financing of costs driven by higher longevity or demands for health care in the future?

- S2 is a positive metric to identify possible problems and orders of magnitude – no straightforward normative implications

- Can be consistent with smoothing arguments

- BUT has strong implications for intergenerational distribution (e.g. if the problem is driven by longevity)

- **S2 not an ideal intermediary target**
  - Difficult to understand,
  - Silent on profile,
  - Infinite policy paths are consistent with this (also some of which are time-inconsistent)

- **Targeting the flow (budget balance) or the stock (debt level)?**

# Debt vs budget balance

Debt:

- Easy to understand

- Initial condition for fiscal susatinability(intergene rational distribution)

- Gross vs net measure?

- Large changes due to asset price changes

Budget balance:

- Strongly sensitive to level and structure of economic activity

- Actual vs structural budget balance?

- Bygones are not bygones

# Cyclically adjusted budget balance

- **Metric on the position of the budget**

- **Measure of discretionary fiscal policy**

- **Method used: biased in direction of procyclicality and excess volatilty**

# Cyclically adjusted budget-balance

- **Residual method:**

  **Cyclically-adjusted balance   =   Actual balance**
                                            **– Cyclical component**
                                            **– One-off items**

- **Noise, errors and temporary changes are taken to be changes in the structural budget position – poor guide for policy planning**

- **Actual measures: large variability > growth variability**

- **Structural measure (low frequency) – hard to reconcile with such a large level of variability**

High volatility of measures of cyclically-adjusted budget balance
Standard deviation 1990-2010
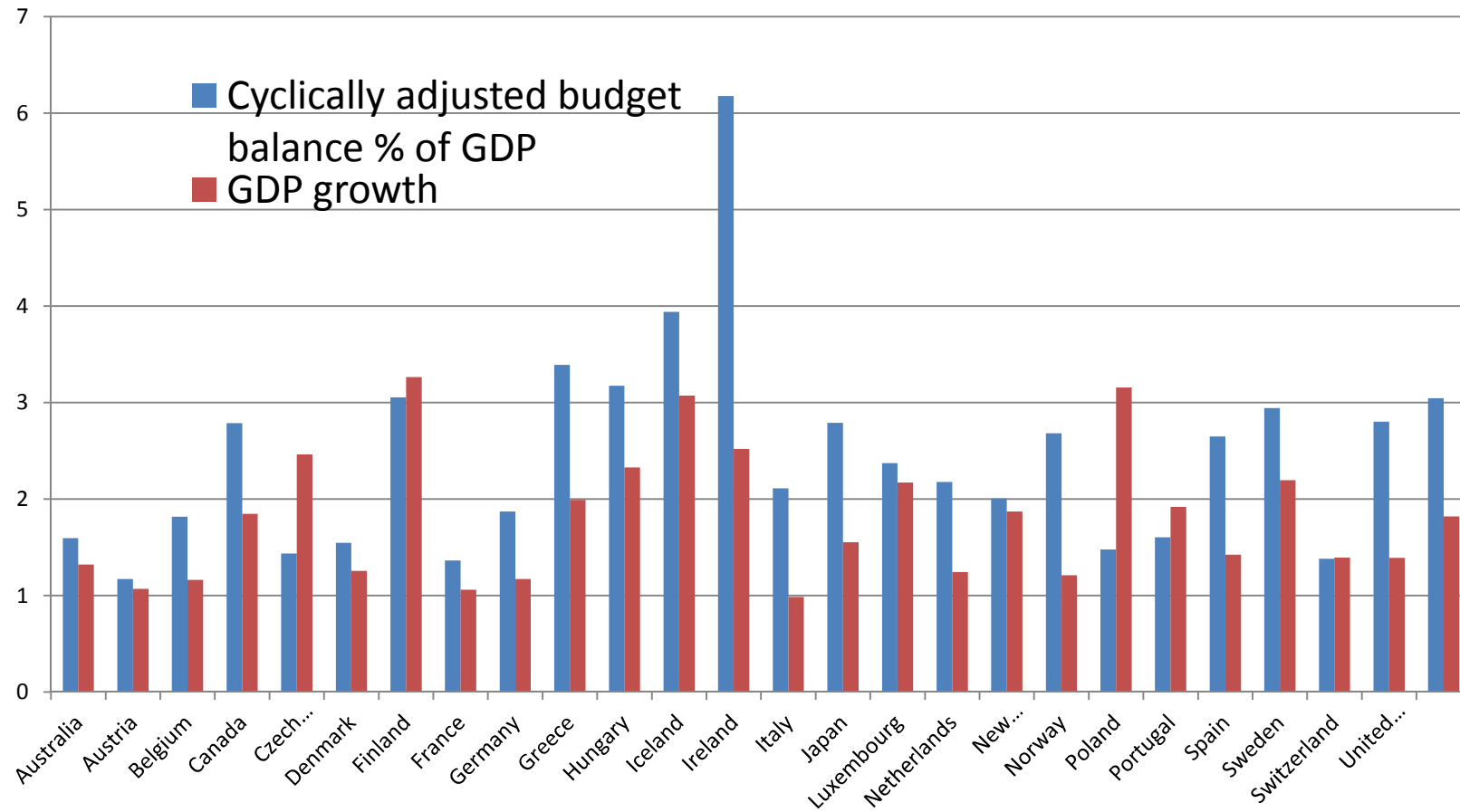
# Setting targets:

I: Control – ex post evaluation of past policies  (punishment/enforcement)

II: Planning – ex ante plans (anticipations, meeting the targets in the future)

III: Any automatic linkage from I to II? = error correction

# Setting targets

**Denmark**

- 10 years plans – targets for end points
- Real growth public consumption (0.5-1%)
- Debt reduction

**Sweden**

- Surplus target (on average over the business cycle) - continuous

- Expenditure target – top-down

# Targeting the budget surplus - Sweden

- Average actual budget balance since 2000
- Similar for structural budget balance
- Structural balance
- 7 years running average (3 past, current and 3 next years)
- Same for structural balance

- Running 10 years average
- 7 years running average (3 past, current and 3 next years)
- Same for structural balance
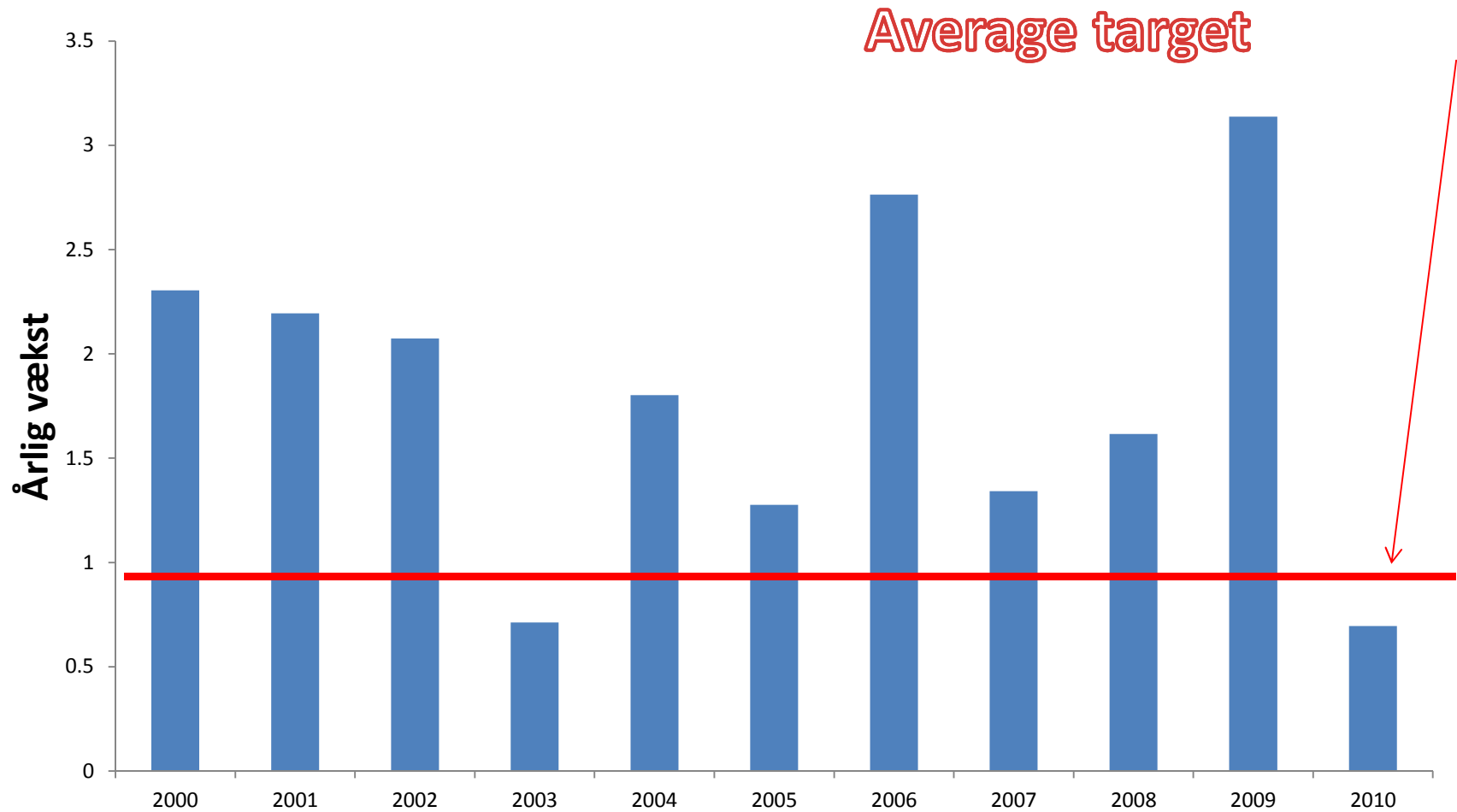
# Sweden
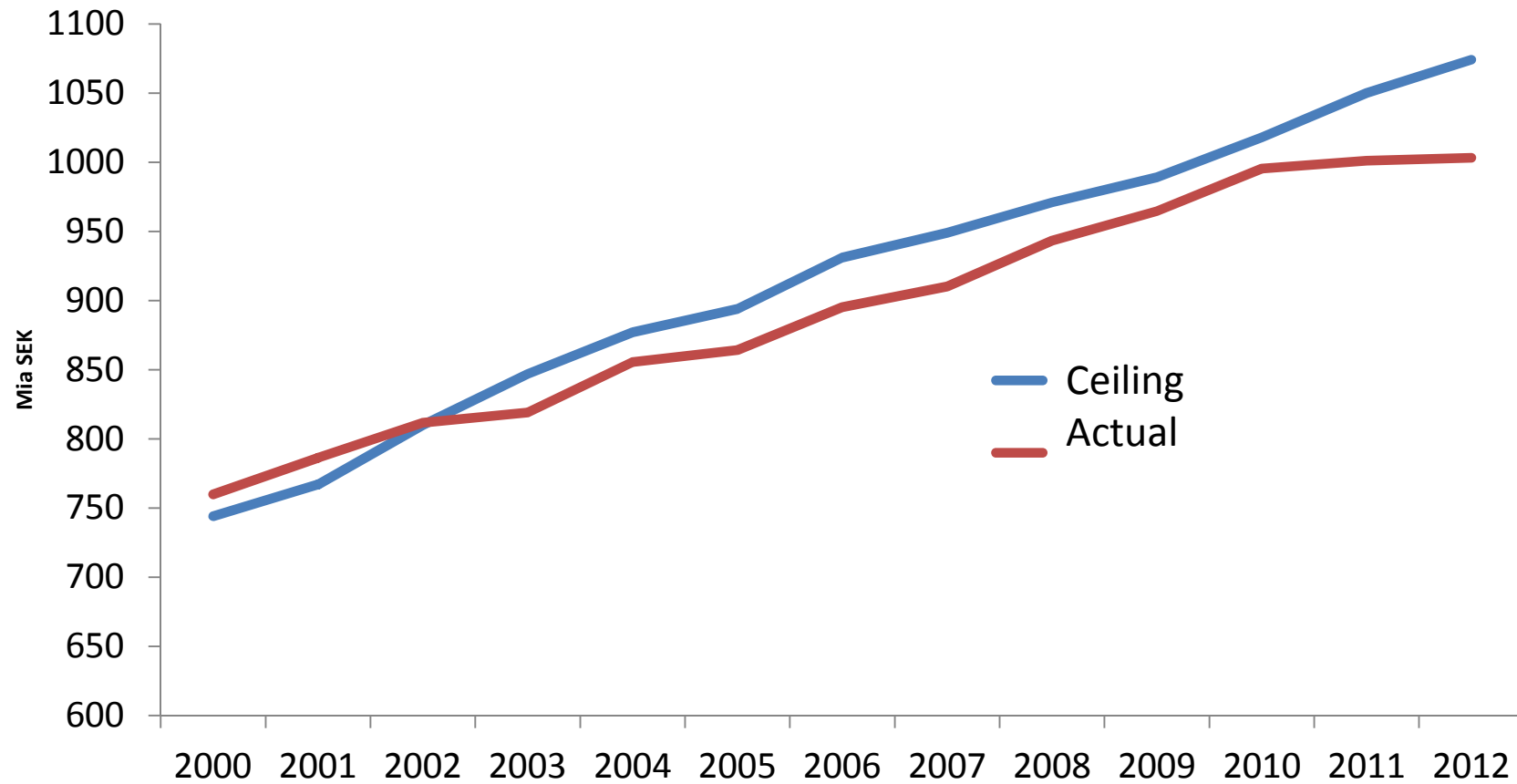
# Conclusion

- **Intermediary targets are important for accountability**

- **Few unambiguous measures – scope for interpretation**

- **Fiscal councils play an important role in maintaining a focus on targets, and in meeting them!**