FISCAL RULES AND
INDEPENDENT FISCAL INSTITUTIONS:
THEORY AND POLITICAL PRACTICE

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What has happened to public finances?

- Economic and Financial crisis of 2008/9 has led to massive budget deficits and pile up of public debt in many countries
- Threat to sustainability of public finances developed already prior to crisis in 1980s and 1990s
The deficit picture

Figure 1. Advanced Economies: Frequency of Overall Fiscal Deficits Above 0.5 Percent of GDP
(Median OECD country)

Source: Beetsma and Debrun, IMF WP 16/86, 2016
The debt picture

Figure 2. G7 and Selected Emerging Market Economies: Public Debt (1880–2020)
(In percent of GDP)

Sources: Abbas and others (2010) and World Economic Outlook.
Fundamental Issues

- Trade off between long term fiscal sustainability and short term stabilization
- Politicians tend to have short term horizon because of reelection concerns, future generations do not vote
- Government debt not bad per se (e.g., debt-financed public investment), but "golden rule" difficult to manage in practice
Possible Solution(s)?

- Fiscal Rules
- Independent Fiscal Institutions (IFI) = fiscal councils
Agenda

I. Fiscal rules and fiscal councils – an overview

II. Do fiscal rules and councils matter? Empirical Evidence

III. Political Practice: Fiscal Rules and Fiscal Council in Germany
   - Debt Brake and Fiscal Compact Implementation
   - Stability Council and Advisory Board
1. Fiscal Rules and Fiscal Councils
What is a fiscal rule?

- A fiscal rule is legal limitation of expenditures, deficits or debt level of a government entity

  - Examples: Maastricht treaty, German debt brake
  - Numeral targets (e.g., deficit < 3% of GDP)
  - First and second generation rules (e.g., cyclical adjustment)
Spread of fiscal rules

IMF datamapper fiscal rules
Types of fiscal rules in EU

EC Fiscal Governance Database
Fiscal rules strength in 2015 (EC FGD)

Dimensions: legal base, binding character, monitoring and enforcement, correction mechanism, resilience to shocks
Fiscal rules in EU become stronger...

Note: In case of the new methodology, the series were linked with the data from old methodology.
...but complexity is rising too

The number of pages of European budgetary rules in relevant publications has increased, substantially, over the last years.

CPB, Macro Economic Outlook 2016, p.18
Fiscal Councils

- Non-partisan public bodies, other than central bank, government or parliament; „fiscal watchdog“

- Diverse tasks
  - Monitor fiscal performance
  - Make or endorse macro and budget forecasts
  - Policy costing
  - Normative analysis
  - Long term fiscal sustainability analysis
Examples

- Austria: Fiskalrat
- Belgium: Federal Planning Bureau, High Council of Finance
- Greece: Hellenic Fiscal Council, PBO
- France: High Council of Public Finances
- UK: Office for Budget Responsibility (OBR)
- Slowakia: Council for Budget Responsibility (CBR)
- Spain: Independent Authority for Fiscal Responsibility (AIReF)
Channels of influence

- Public reports
- Formal consultation/hearings
- Media impact
- Binding forecasts
- „Comply or explain“-principle
Fiscal Council staff numbers
Figure 3. Number of Countries with Fiscal Rules and Fiscal Councils

a. Two waves of fiscal rules and fiscal councils
II. Do fiscal rules and councils matter?
Causal evidence on fiscal rules

- Fundamental identification problem: fiscal rules/councils are endogenous.
- Fiscal rules (and councils) are often stronger in countries that have preference for fiscal prudence („Stabilitätskultur“) and because of that have better fiscal performance.
- Introduction or strength of rules is then not causing good performance, just correlation.
Evidence on fiscal rules

- Asatryan, Castellon, Sratmann (WP 2016)
  - Cross country evidence using long time series using DiD estimation approach
  - Balance budget rule reduces on average debt-to-GDP and expenditure-to-GDP ratio by about 11 and 3 PP, (but not tax revenues), and lower probability of debt crisis

- Problem of omitted variable bias: use of time and country fixed effects
Meta regression analysis

- Heinemann, Moessinger and Yeter (EJPE, 2017)
- 51 studies published in 2004-2014
  - (weak) evidence on impact of fiscal rules on budget deficits (less so on debt)
  - On average rules reduce deficit by 1.2 to 1.5% of GDP
  - Significance and size of effect reduced with increased emphasis on identification
Why and how do fiscal councils matter?

- Addressing asymmetric information between government and voters (Beetsma/Debrun, 2016)
  - Councils provide neutral assessment whether exception to rule is legitimate, raise reputation cost of government
  - Council reduce noise in government competence signal to voters; in pooling equilibrium less debt and competent government more likely to be elected
- Fiscal councils force public statement by government: „Comply-or-explain principle“
- Often government projections are too optimistic
  - Kempkes (2014)
EC output gap estimate for Germany

Spring projection

% des Produktionspotenzial

Jahr

Real time (Spring)  Final (Latest Forecast)
Empirical Evidence

- Debrun and Kinda (2014) exploit differences in tasks and institutional design in 58 countries, 1990-2011
- Effect on primary budget balance
- Results:
  - sophisticated fiscal rules lead to better performance
  - pure existence of fiscal councils not
  - councils with sufficient man power, clear mandate, endorsement of or own projection, sufficient media coverage perform better
- Similar results by Maltritz and Wüste (2015); joint influence of rules and councils
Alternative research design

- If fiscal rules are credible, they should affect compliance expectation of policymakers
- German debt brake (“Schuldenbremse”) as a testing ground
  - Basic Law (Art. 109, 115, 143d)
  - Limits structural deficit of federal and state governments
  - Federal government from 2016: max. 0.35% of GDP
  - States (Länder) from 2020: max. 0% BIP
Approach

- Survey of members of state parliaments in Germany (1861 MPs) in 2011/2012
- Survey not anonymous, but confidentiality assured
- 639 surveys completed (response rate 34%)
- Perception of MPs:
  - Probability of complying with debt brake by all states; binary answer
  - 639 MPs times 16 states ≈ 10,000 observations
Which states are likely to comply?

Welche Bundesländer werden die Vorgaben der grundgesetzlichen Schuldenbremse ab 2020 mit hoher Wahrscheinlichkeit einhalten?
Compliance with German debt brake

Heinemann et al. JPubE 2016
Empirical analysis

- Heinemann, Janeba, Schröder, Streif (2016)
- **Insiders** (own state, incumbent government parties) are more optimistic than outsiders (other states, opposition parties)
  - Likely explanation for asymmetry view: **overconfidence**, not asymmetric information
- Current fiscal performance and perceived softness of fiscal rule matters for compliance expectation
III. Political Practice in Germany
Germany: A federal country

Four layers of government

- Federal government
- 16 State governments (Länder)
- About 11,000 local governments
- Social insurance

Expenditure share (core budget)

- (≈10% of GDP)
- ≈11% of GDP
- (≈7% of GDP)
- (≈19% of GDP)
### Germany’s Budgetary Position (% of GDP)

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<td>Surplus</td>
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<td>½</td>
<td>¼</td>
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<td>Federal govt.</td>
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<td>Länder</td>
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<td>¼</td>
<td>¼</td>
<td>0</td>
<td>¼</td>
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<tr>
<td>Local govt.</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Social Insurance</td>
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<td>¼</td>
<td>0</td>
<td>0</td>
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Source: Documents, Stability Council meeting December 12, 2016
Art. 109 Basic Law establishes that the federal government and the state governments (Länder) are autonomous of another in budgetary matters and jointly responsible for the obligations from EU or international obligations.

How can that work?

- Stability Council and Independent Advisory Board
Fiscal Performance and rules

Abbildung 2: Struktureller und tatsächlicher gesamtstaatlicher Finanzierungssaldo im Vergleich - in % des BIP

1995: Ohne die Vermögenstransfers infolge der Übernahme der Schulden der Treuhandanstalt und der Wohnungsbauunternehmen der DDR. Inklusive dieses Effekts belief sich das gesamtstaatliche Defizit auf 9,5 % des BIP.
2000: Ohne UMTS-Erlöse. Inklusive dieses Effekts wies der Staatshaushalt einen Überschuss in Höhe von 1,3 % des BIP auf.
Quelle: Bundesministerium der Finanzen.
Stability Council: 18 Ministers
Stability Council

- Introduced in 2009 („Föderalismusreform II“)
- Monitors fiscal performance/budget of federal and state governments
- Identifies budgetary emergencies, negotiates and monitors consolidation programs (currently: HB, SL)
- Compliance with Fiscal Compact: general government structural deficit of 0.5 % of GDP
  - 25 countries from EU
  - Correction mechanism
  - Independent monitoring institution
Independent Advisory Board to Stability Council

- 5 representatives of institutions: Council of Economic Experts (SVR), Deutsche Bundesbank, Social Insurances, Local Governments, Joint Economic Forecast (GD)
- Two members each appointed by Federal government and state governments
- Advises only on compliance with fiscal compact (0.5% deficit)
- Can make recommendations to eliminate excessive deficit
Arithmetic of fiscal rules in Germany

Maximal structural deficit, % of GDP

0.35  Federal Gov  (since 2016)
+  ?  Länder  (0 from 2020!)
+  ~0  Social Insurances
+  ~0  Local Gov  (Länder liable?)

<  0.5 General Gov  (Fiscal Compact)
Debate

- European Commission (2017) has found Germany in full compliance regarding de jure implementation of fiscal compact

- „Stability Council is a fiscal council but not independent; Advisory Board is independent but not a fiscal council“

- Latest reform of fiscal equalization system (Bund-Länder Vereinbarung) assigns monitoring of German debt brake to Stability Council (without Advisory Board)

- Strong fiscal outlook in short and medium term mask potential institutional problems: need to experience a crisis first?
Quellen

- Internet
  - www.stabilietaetsrat.de
  - janeba.vwl.uni-mannheim.de

- Literatur
2nd survey 2014-6

- Exploiting panel/repeat cross section structure of survey
- Recent budgetary developments: low interest rates, strong tax revenue development
- Identification strategy:
  - use refugee inflow in 2015 as exogenous shock to state government finances
  - some surveys before some after peek of inflow:
    - Late survey in BB -0.4   HB -1.1   HH -0.1   HE -0.3   SN -0.9   TH -1.2
Own state compliance (first vs. second survey wave)

Einhaltung der Schuldenbremse durch das eigene Land

1. Befragung 2. Befragung
Enforcement threat of debt brake declines