

The reform of the EU fiscal framework: an enhanced surveillance role for independent fiscal councils?*



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The European Union is facing many challenges in the post-pandemic era due to the energy crisis caused by the Russian invasion in Ukraine. In this unfavorable environment, the macroeconomic outlook remains uncertain, resulting in a significant deterioration of fiscal outcomes. In this context, the discussion about the reform of the EU fiscal framework is under way in order for countries to avoid an excessive fiscal tightening by the application of the pre-pandemic fiscal rules. This column shows that independent fiscal councils reduce fiscal policy procyclicality and increase the probability of both starting and successfully concluding a fiscal adjustment. Building on these findings we propose that the new EU fiscal framework should assign greater role to national independent fiscal councils for monitoring compliance with national and EU fiscal rules.

Introduction

The COVID-19 pandemic and the energy crisis have resulted in a significant deterioration of fiscal outcomes in many countries around the world. This creates the need to consolidate public finances in the near future. However, the timing of fiscal consolidation is critical because a fiscal adjustment in bad economic times, i.e., a procyclical response, could delay economic recovery and the decline of the debt to GDP ratio, as in the euro area at the time of the sovereign debt crisis (Darvas et al., 2018).

*Authors' note: The views expressed in this column are the responsibility of the authors and do not necessarily reflect the position of the Bank of Greece and the Hellenic Parliamentary Budget Office.

Contribution

Building on the IMF dataset presented in Davoodi et al. (2022) we classify the design features of fiscal councils under four broad categories: enhanced remit, tasks & instruments, independence and accountability and adequate resources. Relying on these fiscal councils' characteristics we investigate in two closely related papers: (a) whether fiscal councils can curb fiscal policy procyclicality (Chrysanthakopoulos and Tagkalakis, 2022a), (b) whether fiscal councils can increase the probability of initiating and successfully concluding a fiscal adjustment (Chrysanthakopoulos and Tagkalakis, 2022b).

Literature Review

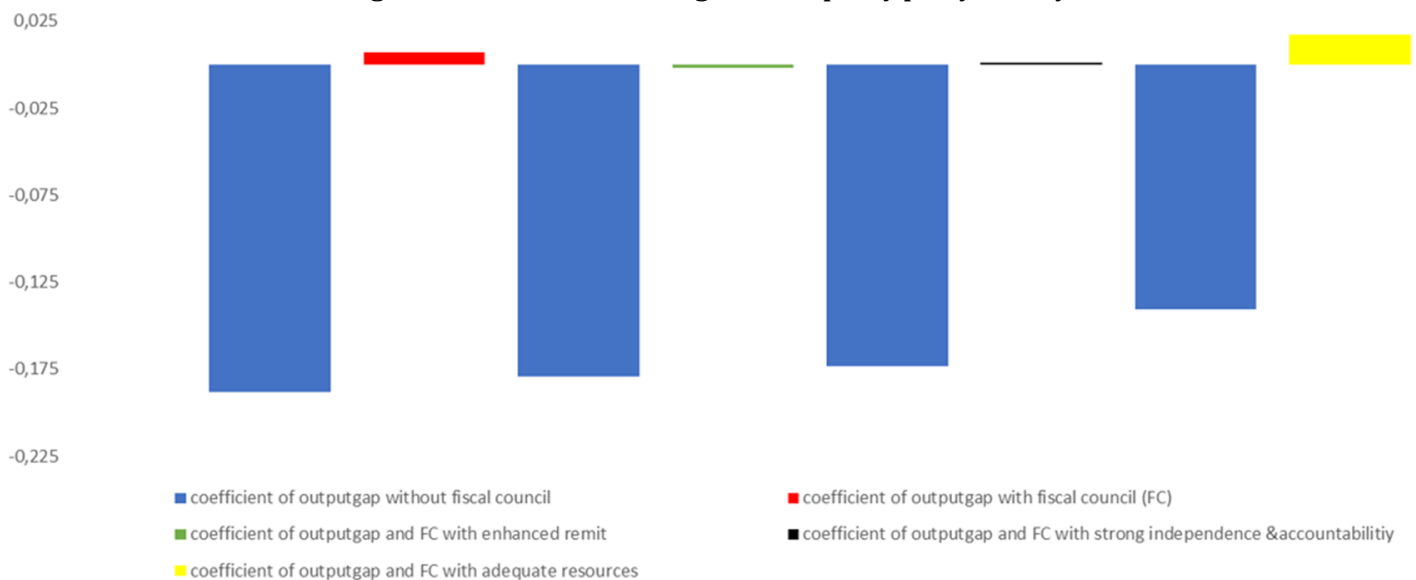
Given that discretionary fiscal policy tends to be pro-cyclical (Beetsma and Giuliadori 2010), independent fiscal institutions (rules and councils) have a crucial role to play as regards future fiscal adjustments (Beetsma and Debrun, 2018; Gootjes and de Haan 2022). Some fiscal experts view nominal forms of numerical fiscal rules (i.e., budget balance and debt rules as opposed to expenditure or revenue rules) as a source of procyclicality (Debrun et al., 2008). Moreover, it has been argued that the Stability and Growth Pact (SGP) has failed to ensure debt sustainability and curb fiscal procyclicality in the run up to the 2008-2009 Global Financial Crisis (De Jong and Gilbert, 2020 and Gootjes and de Haan, 2022). While D'Amico et al., (2021) claim that the strict applications of pre-pandemic fiscal rules could lead to excess fiscal tightening delaying economic recovery. Nevertheless, several other authors such as Bergman and Hutchison (2015) and Gootjes and de Haan, (2022) find that fiscal rules and increased government efficiency can dampen fiscal policy procyclicality. In any case, the debate on the revision of the European fiscal rules is already under way (see Feld and Reuter, 2022).

Turning to independent fiscal councils (IFCs), Căpraru et al. (2022), report that IFCs have a positive and statistically significant impact on fiscal performance and compliance with fiscal rules. Through IFCs, control, visibility, and enforceability of fiscal rules can be increased (Debrun and Kinda, 2017). According to Gilbert and De Jong (2017), fiscal councils help to mitigate the bias on fiscal forecasts caused by the 3% threshold of the SGP on the budget deficit ratio. In addition, IFCs with legal power and complete independence from government increase accountability and fiscal transparency and reduce the optimistic bias in budgetary forecasts (Beetsma et al., 2019).

Key Results

In a recent paper (Chrysanthakopoulos and Tagkalakis, 2022a), we find that independent fiscal councils can mitigate fiscal policy procyclicality. However, as pointed out by Beetsma and Debrun (2018) the design of IFCs is crucial for their effectiveness. In connection with this, we find very strong evidence that the budget oversight by a fiscal institution with enhanced remit and strong independence and accountability can mitigate procyclicality and even lead to a counter-cyclical fiscal policy response. There is also evidence that increased availability of resources and the appointment of IFCs members by the parliament rather than the government can reduce procyclicality. In more detail, an increase in the output gap leads to a decrease in the cyclically adjusted primary balance when there is no fiscal council (see the blue bars in Figure 1), i.e., a procyclical response. On the contrary, when there is a fiscal council the cyclically adjusted primary balance responds marginally positive after an increase in the output gap (see the coloured bars in Figure 1). A series of robustness checks revealed that the ability of fiscal councils to mitigate fiscal policy procyclicality is particularly relevant in EU and euro area countries, in countries with weak governance and in the period after the Global Financial Crisis. The results are robust when accounting for the likely endogeneity between fiscal councils and fiscal procyclicality.

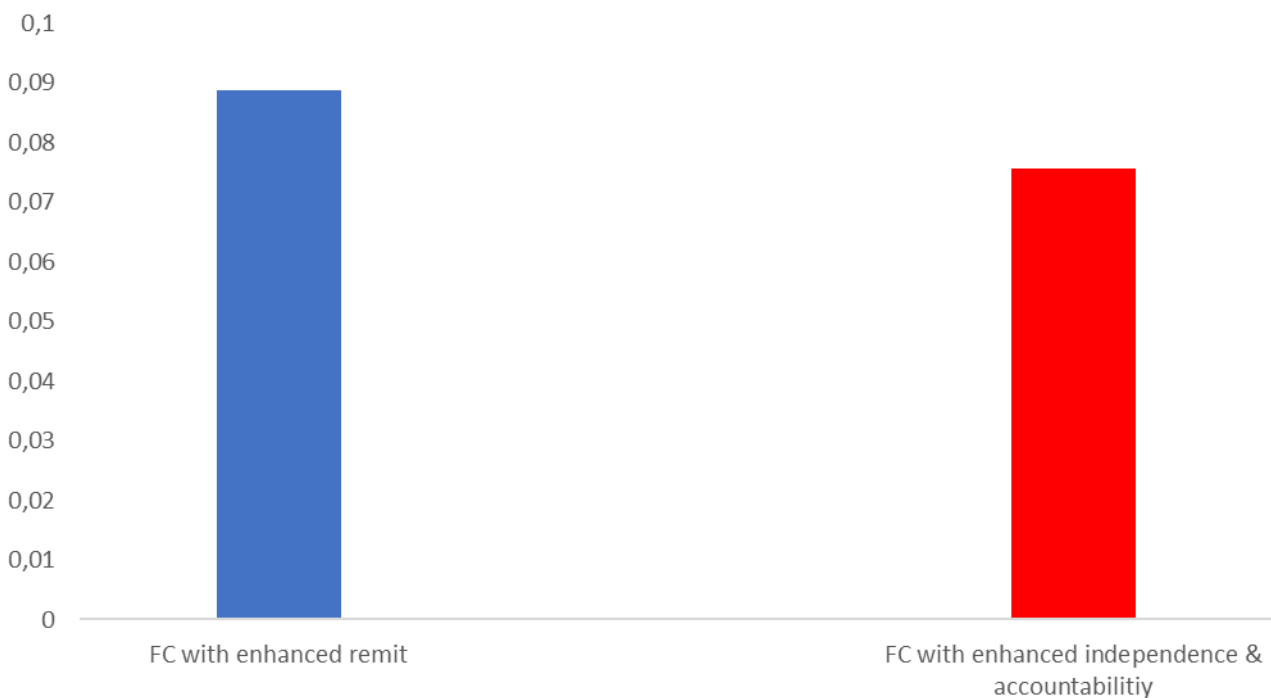
Figure 1: Fiscal councils mitigate fiscal policy procyclicality.



Notes: The figure shows the response of the cyclically adjusted primary balance after a 1% increase in the output gap with (coloured bars) and without (blue bars) a fiscal council. The following fiscal council characteristics are considered: enhanced remit, independence & accountability, and adequate resources. A positive value implies a counter-cyclical response and a negative value a pro-cyclical response

Building on earlier literature (e.g., Wiese et al., 2018; Gootjes and de Haan, 2022) in a closely related paper (Chrysanthakopoulos and Tagkalakis, 2022b), we find that fiscal councils increase the likelihood of starting a fiscal adjustment. This particularly true for a council with enhanced remit and with strong independence & accountability. In more detail, the probability of initiating a fiscal adjustment increases by about 9% in the case of a fiscal council (FC) with enhanced remit and by about 8% in the case of fiscal council with strong independence and accountability (ceteris paribus).

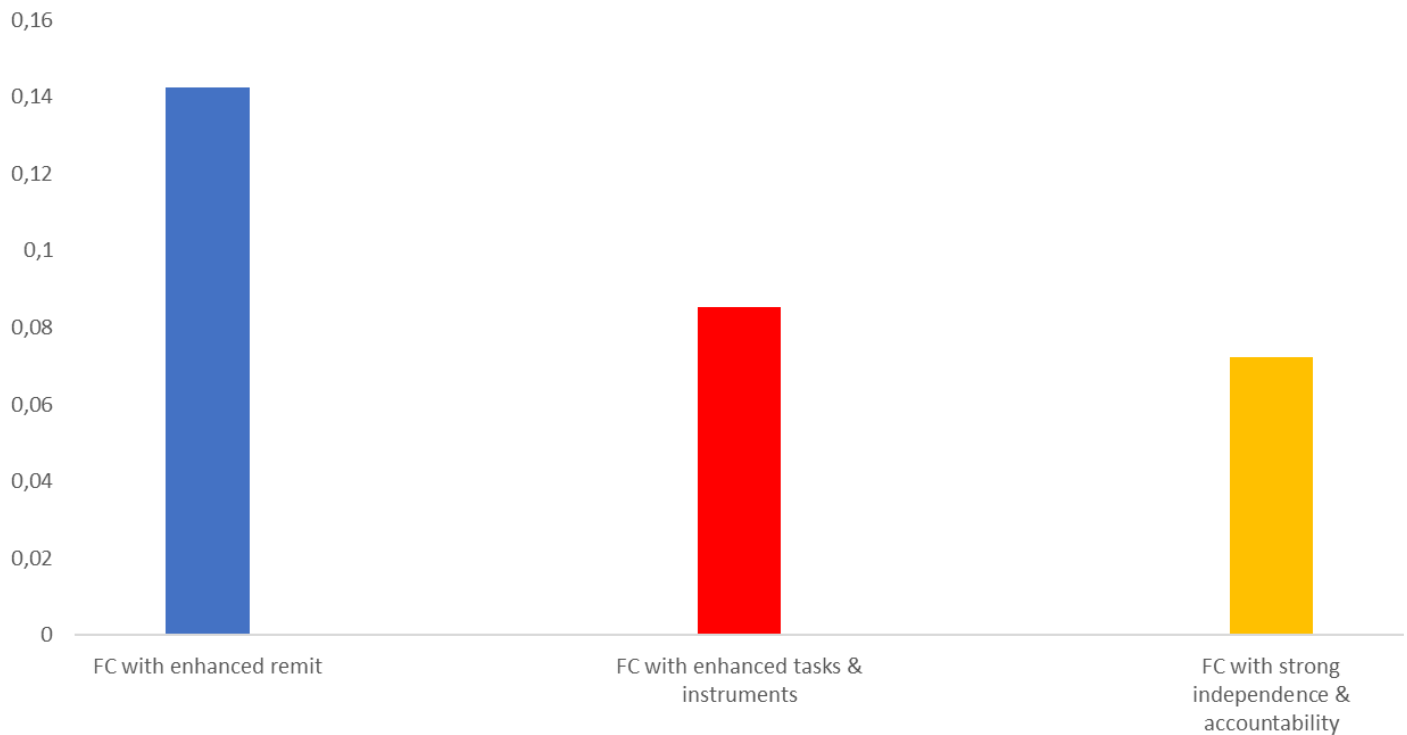
Figure 2: The probability of initiating a fiscal consolidation.



Notes: The figure shows the marginal effect of the probability of starting a fiscal adjustment in the presence of a fiscal council. The blue bar shows a fiscal council with enhanced remit and red bar shows a fiscal council with strong independence & accountability.

Moreover, we find that a fiscal council with enhanced remit, strong independence & accountability and enhanced tasks & instruments increase the probability of a successful fiscal adjustment. As reported in Figure 3, the probability of success increases by about 14% in the case of a fiscal council with enhanced remit, by about 8% in the case of fiscal council with enhanced tasks & instruments, and by about 7% in the case of a fiscal council with strong independence and accountability (*ceteris paribus*). The results control for likely endogeneity between successful fiscal adjustments and the specific design features of fiscal councils by means of the augmented inverse probability weighted estimator as in Jorda and Taylor (2016).

Figure 3: The probability of a successful fiscal adjustment.



Notes: The figure shows the marginal effect of the probability of a successful fiscal adjustment in the presence of a fiscal council. The blue bar shows a fiscal council with enhanced remit, the red bar shows a fiscal council with enhanced tasks & instruments and orange bar shows a fiscal council with strong independence & accountability.

Conclusions

Employing a panel for 35 advanced economies over the period 1990-2020, we find that independent fiscal councils can curb the procyclicality of fiscal policy and can even lead to countercyclical response. In more detail, a fiscal council with strong remit, independence & accountability and adequate resources can mitigate fiscal procyclicality. In addition, we provide evidence that a fiscal council with strong remit and independence & accountability increases the probability of initiating a fiscal adjustment. That is, it will identify a fiscal deterioration in time and contribute to its faster correction. Moreover, an independent fiscal council with enhanced remit, tasks & instruments, as well as strong independence & accountability increases the likelihood of a successful fiscal adjustment. This implies that the fiscal council will ensure that the fiscal effort is based on reliable and realistic forecasts, supervise and closely monitor the fiscal consolidation effort, and correct any deviations, thus contributing to the success of the fiscal adjustment.

These findings are particularly relevant in view of the on-going discussion on the revision of the EU fiscal framework, and the importance that the new framework should assign to national independent fiscal councils for monitoring compliance with national and EU fiscal rules (see for example, Beetsma and Debrun, 2018; Beetsma et al, 2019; Debrun and Reuter, 2022; Feld and Reuter, 2022, Beetsma et al. 2022). ■

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