

COMMENTS ON SESSION 3

NEW DEVELOPMENTS: INDEPENDENT AUTHORITIES AND EXPENDITURE RULES

*Ranjana Madhusudhan**

I would like to begin by expressing my thanks to Daniele Franco and the Banca d'Italia for inviting me to participate at the 13th Public Finance Workshop on “Rules and Institutions for Sound Fiscal Policy after the Crisis”. Once again Daniele and his staff have done a superb job of putting together another useful research workshop on a topic of interest to policy makers all across the globe at all levels. I also wish to extend my thanks to the staff of S.A.Di.Ba. in Perugia for their kind hospitality.

My primary assignment today is to provide comments on two papers that discussed specific country experiences with fiscal institutions (such as independent budget offices or IBOs). I have enjoyed reading the two papers and it was interesting to find that despite the unique characteristics there are significant commonalities¹ in fiscal institutions across countries. The paper by Bos and Teulings reviews the economic analysis of political platforms by the Dutch fiscal council (Netherlands Bureau for Economic Policy Analysis or CPB) in the last twenty five years. The second paper by Askari, Page and Tapp discusses the Canadian experience with such institutions and identifies potential measures to improve their fiscal efficacy. My approach in the comments to follow would be to highlight major strengths and weaknesses of fiscal institutions in these two countries and indicate potential areas for development.

1 The Dutch and Canadian experiences with Independent Fiscal Councils

I will begin by summarizing the main theme in the Dutch paper, which highlights issues surrounding the evaluation of proposed public policies in election platforms. The merits and limitations of twenty-five years of Dutch experience in analyzing election platforms since it started in 1986 are also discussed in this paper using an economic theoretic perspective. The authors note that such economic analysis “can help to design more efficient policies, reach consensus on economic and fiscal policy and create a level playing field for political parties not represented in the government, in particular those with limited resources for economic information and expertise”.

Table 1 presents a good overview of how the CPB analysis of political platforms during the last seven election cycles improved and evolved, including the incorporation of health care and other major current policy issues. It appears that the CPB has been playing a crucial role as a political watchdog over the past twenty-five years through its rigorous, nonpartisan, social science research and analysis, which is critical in the context of growing public interest in policy debates. The tripling of the number of political parties seeking CPB analysis would suggest that the Dutch experience has been quite successful. Table 2 is used to illustrate the economic consequences and trade-offs of the election platforms of two Dutch political parties in 2010. I would suggest some discussion of the results to help with the interpretation of the numeric values presented in the table.

Bos and Teulings raise the important question as to “how far an economic evaluation of election platforms should go without the evaluation being political intervention itself”. Table 3 is a

* National Tax Association, USA.

The views expressed are those of the author and do not necessarily represent the views of the New Jersey Department of Treasury or the National Tax Association.

¹ For instance, the provision of fiscal oversight, conducting financial analysis and costing out proposed policy measures are functions generally common to most fiscal institutions.

very useful table, which highlights the pros and cons of alternative techniques of evaluation and reflects the historical evolution of the Dutch evaluation methods. The table indicates that there is a wide range of methodologies employed in analyzing the election manifestos of political parties but each with its own set of advantages/limitations. Overall it appears that the CPB's function is limited to analyzing the effects of proposed policy measures put forward by different political parties during negotiations for a new government, but staying out of issuing policy advice.

Through its independent assessment of economic and fiscal policies, it assists with the economic decision-making process of Dutch politicians and policymakers. As noted in the paper, the underlying rules are critical in providing effective analysis of election platforms. The paper mentions three different sets of rules to ensure sufficient independence of the political process; generate good communication between political parties and the economic expert institute conducting the analysis; and ensure the quality, transparency and objectivity of the analysis. An overview of different types of rules is presented in Tables 4 to 5, followed by a discussion of the pros, cons and underlying practical problems associated with some of these rules. It is interesting to note that only policy proposals made by the central government are incorporated in the analysis, as such decisions made by sub-national governments may get ignored.

Alternative proposals are ranked by their potential impact on long-term economic growth (or on long-term GDP growth) via a universal baseline effect depending on the specific Dutch situation. Such comprehensive long-term analysis provides an explicit awareness of underlying policy trade-offs and consequences of alternative political platforms. However, as correctly noted in the paper, that quantitative analysis of long-term economic effects and fiscal sustainability is subject to substantial uncertainty and is sensitive to behavioral assumptions about firms and households; life expectancy; and the discount rate. When trade-offs are difficult to quantify, the CPB tries to come up with pragmatic solutions: providing a qualitative analysis, re-stating proposals or introducing additional rules such as designating a maximum on the budget cut for civil servants. Selected examples are provided in this context but some are a bit sketchy. I would suggest that the authors elaborate their discussion of the gross and net effects on long-term GDP growth, particularly, for major programs such as education.

Now I will move on to the second paper. The authors believe that Canada has made some progress with the establishment of a legislated budget office² but challenges remain. As they note that it is essential to establish the office properly right from the start by enacting proper legislation, attracting the right talent and ensuring long-term adequacy in funding. They also point out the importance of safeguarding the IBO's independence from political interference. They caution that the appointment process and administrative relationships with the legislature and executive branch be clearly laid out to avoid any potential for conflicts of interest. The overall goal should be to increase transparency. The CPB appears to incorporate most of these suggested characteristics and similar points are also raised in the Dutch paper. For instance, Bos and Teulings emphasize the need to have substantial resources and the right type of economic skill set to undertake a comprehensive and long-term analysis of alternative policy proposals. They also emphasize the necessity of fiscal councils to maintain independence.

In order to improve Canada's fiscal institutions and achieve "fiscal prudence", Askari, Page and Tapp suggest employing prudent underlying assumptions and having explicit contingencies for budget planning purposes. According to them, "...implicit risk provisions inhibit budget transparency and debate and can erode the credibility of government budget forecasts". Even though the Canadian budgets often contain sensitivity analysis of their budget projections to changes around central assumptions to reflect underlying forecast risks, "fan charts" are not used to quantify these risks. According to the Canadian paper, attempts to analyze and quantify risks by

² In 2006, the Canadian Parliamentary Budget Office or the PBO was created under the Federal Accountability Act.

reporting confidence intervals around budget forecasts and initial cost estimates for major policy proposals and legislations are essential.

From the Dutch paper, it is not clear if the CPB generates any “fan charts” to quantify risks or not? This is particularly crucial for increasing transparency and improving the debate and credibility of government budget forecasts. As noted in the Canadian paper, the danger with having implicit risk provisions is that it may create an illusion of real risk-adjustment. The authors recommend focusing on fiscal crisis prevention since it is better to avoid fiscal crisis than be forced into a large and painful fiscal consolidation. It would be helpful to include a discussion of CPB’s analytical framework of how risk analysis is conducted for policy proposals under alternate political platforms. This would enhance the transparency of the evaluation process. I would like to point out that the Dutch paper discusses the significance of ensuring transparency of CPB analysis as part of “rules of the game” in Table 6.

According to Askari, Page and Tapp, incorporating forward-looking frameworks and /or rules that help restore and preserve fiscal sustainability could enhance economic stability and growth and promote inter-generational equity. In this context the question that arises is whether the CPB incorporates such forward-looking rules in its analysis and how does it account for inter-generational equity? Bos and Teulings, for instance, caution that alternative E in Table 3, on long-term finance, does not include the trade-off between long-term government finance and long-term household income/profits.

It is essential to set clear, measurable policy goals at varying time horizons to provide policy guidance that would allow monitoring of progress. IFCs have a monitoring role in *ex ante* and *ex post* compliance. It appears that CPB does not necessarily monitor or track *ex post* compliance. The focus seems to be on *ex ante* political platforms. The accountability goal, according to the Canadian paper, would necessitate the IFCs to provide sufficient details, milestones and measurable objectives to allow Parliament to hold the government accountable. The Dutch focus appears to be mostly limited to the end of the election cycle and during the next period of government.

The authors of the Canadian paper suggest using structural budget balance estimates for medium term planning. In addition, they suggest that IFCs should publish estimates of their structural budget balances over their forecast planning horizons to improve understanding and policy debate but none do so currently. A similar situation was noted in the Dutch paper. Various methodological hurdles were discussed. It is important to understand that even though such a tool is not perfect, failure to employ structural balances implies one can’t operationalize a structural budget balance target. For example, one cannot distinguish cyclical from structural fiscal trends, which is very important at turning points in the business cycle or when the economy is above potential and “temporary cyclical fiscal room gets mistaken for permanent fiscal room and finally one cannot assess whether the degree of fiscal consolidation is sufficient to restore budget balance in more normal times”.³ Thus turning points pose serious forecasting challenges with adverse budgetary implications. It was noted that forecasts by the CPB are not always accurate, for instance, it was unable to predict the credit crisis and resulting economic recession in 2009. However, CPB can’t be singled out as many forecasters made substantial forecasting errors around this period. I would like to refer you to a new report by the Pew Center on the States and The Nelson A. Rockefeller Institute of Government, which finds that U.S. states have been making more serious errors in estimating their revenues during tough economic times.⁴

³ See Askari, Page and Tapp (2011).

⁴ See The PEW Center on the States and The Nelson A. Rockefeller Institute of Government Report (March 2011) for details.

Both the Canadian and the Dutch papers discuss the importance of increasing the use of long-term strategic economic and fiscal analysis and planning as the “political process generally puts too little weight on the impacts of current policies on future generations”. A long-term budgetary framework is essential to improve long-term fiscal sustainability through effective fiscal management. In this context, it would be useful to include a discussion of indexing methods for key parameters.

Increasing budgetary transparency, which is a key ingredient in keeping the public well informed, is another major feature discussed in both papers.⁵ It appears that both systems have room to improve on this front. For instance, the Canadian paper reports that there is a glaring gap between what was promised in the legislation and what is being delivered. From the paper, it is not clear how to grade the CPB in terms of the transparency goal. It appears that discretion is used by the CPB in excluding certain policy alternatives, which lack empirical info on long-term effects by changing the assumptions in their computer model. It is important to make the underlying assumptions of the analytical models and results as clear as possible. I would like to add that transparent budgetary and costing analysis should be conducted for all types of spending, including, both on-budget and off-budget programs and the latter in particular needs to be tracked carefully. During fiscal year 2010, for instance, total expenditures not budgeted accounted for around two-fifths of total expenditures in New Jersey.⁶

The authors point out that the access to necessary data may be restricted in some cases. For instance, despite the PBO’s legislation that includes information access provision, requests are routinely denied and even previously published government info (e.g., details of budget forecasts and cost estimates of major programs) has been declared a “cabinet confidence”. It is essential to ensure good access of information because the analytical quality is dependent on timely availability and completeness of the data flow. Disclosure and other data issues may be resolved either via legislation or convention. The authors recommend that public government costing of major legislations or policy initiatives be made a requirement. The Dutch practice appears to be meeting this goal at least with respect to ex ante political platforms. Additionally the Canadian paper suggests that such estimates be reviewed by the Parliament and be supported by quarterly financial reporting to track in-year spending. These analyses must be made public regardless of who conducted them (Parliament or IBO). This exercise would allow independent scrutiny of the analysis and enhance their credibility. Without budgetary transparency, informed public debate and accountability would be hindered.

2 Concluding comments

Both the Dutch CPB with its long history and the relatively young Canadian PBO play a critical role and have the potential to promote fiscally sound governments in their respective countries. However, these independent fiscal councils need to evolve further to face the growing challenges of long-term fiscal imbalance and sustainability, unsustainable debt burdens, and the fragile economic recovery in the post Great Recession era. It would serve the public well if policies of *elected* political parties were also analyzed over time, particularly, tracking how actual policies compare with the promised platforms; tracking how alternative party platforms perform over time, over business cycles, and over different election cycles; and checking the track record of a particular party over specific issues over time. Identifying patterns and divergences would be

⁵ As US Federal Reserve Board Chairman Bernanke mentioned in his Annual Meeting speech on October 4, 2010, that “... By shining a light on the problem and the range of feasible solutions, transparent policy rules clarify the budget choices that must be made, help the public understand those choices ...”

⁶ See The Governor’s FY12 Budget Summary (New Jersey State Budget document).

important in enhancing the evaluation of public policy considerations in the context of future political and economic cycles.

It is crucial to maintain independence and ensure an adequate resource base for the success of these institutions in providing objective analysis. Fiscal councils in both countries need to focus on developing appropriate methodologies, particularly, for long-term analysis of proposed policy options and evaluating long-term policy implications and trade-offs. Generating proper shadow prices is a case in point. There is definite room to improve transparency and it is also important to emphasize the translation of complex results in plain language. It is essential to keep the public well informed about the underlying assumptions being made, the true cost and benefits of different policy proposals, underlying risks and policy trade-offs, both short- and long-term. I would emphasize a more explicit incorporation of sub-national government activities in the analytical models. It is crucial to recognize the policy implications along with long-term trade-offs once the dynamics of inter-governmental relations have been factored in.

The ultimate goal is to attain long-term fiscal balance and enjoy a sustainable economic prosperity world-wide!

REFERENCES

- Askari, M., K. Page and S. Tapp (2011), "Reforming Fiscal Institutions in Canada", paper presented at the 13th Banca d'Italia Public Finance Workshop held in Perugia, Italy, 31 March-2 April 2011.
- Bernanke, B.S. (2010), "Fiscal Sustainability and Fiscal Rules", speech delivered at the Annual Meeting of the Rhode Island Public Expenditure Council, Providence, Rhode Island (United States), October, available at: <http://www.federalreserve.gov/newsevents/speech/bernanke20101004a.htm>
- Bos, F. and C. Teulings (2011), "Analysis of Election Platforms: A Task for Fiscal Councils? Merits and Limitations in View of 25 Years of Dutch Practice", paper presented at the 13th Banca d'Italia Public Finance Workshop held in Perugia, Italy, 31 March-2 April 2011.
- The PEW Center on the States and The Nelson A. Rockefeller Institute of Government (2011), "States' Revenue Estimating: Cracks in the Crystal Ball", March, available at: <http://www.rockinst.org>
- State of New Jersey, Office of Management and Budget (2011), "The Governor's FY 2012 Budget: Budget Summary", February, available at: <http://www.state.nj.us/treasury/omb>