

## **Cave Canem!**

### **The Effectiveness of Watchdogs... and their Watchers**



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# Outline

- A. The economics of Fiscal Councils.
- B. The effectiveness of Fiscal Councils.
- C. Lessons for the watchdogs...
- D. ... and their watchers.

# A. The economics of Fiscal Councils...



- Ample evidence of bias towards excessive deficits and procyclicality.
- Fiscal rules have limitations
  - not fully state-contingent; weak enforcement; incentive to manipulate forecasts and other gimmicks.
- FCs can encourage fiscal discipline:
  - Non-partisan analysis of fiscal performance → watchdog
  - Implementation of fiscal rules (conditions to activate an escape clause; managing error-correction mechanism; coordinating objectives of different levels of government; calculating structural balances, monitoring of compliance,...)
  - Unbiased forecasts, analyses of long-term sustainability, costing of specific policies.

# The economics of Fiscal Councils...

- Transmission channels to policy:
  - Better align voters and elected policymakers incentives → reduce informational asymmetries (educate and inform).
  - Close technical loopholes in the fiscal framework (forecast, costing, implementation of CABs,...);
  - Overall: increase transparency to raise the reputational/electoral rewards of sound policies.
- What distinguishes FCs from other watchdogs?
  - Specific mandate from government,
  - Requirement to benchmark assessments against stated objectives of government:
    - Alesina/Tabellini: fiscal policy is for “politicians” not “bureaucrats.” → avoid being drawn in partisan considerations and guarantee legitimacy.

## ... and their watchers.

- Implications:
  - Mandate → resources → **accountability.**
  - Premium on transparency → technical work is often a **black box** → reputation can be at risk
- For the good of all, **watchdogs must be watched... but not leashed → accountability is not meant to negate independence.**
  - Basic democratic accountability requirement
  - Check on the quality of the technical work → FC has to be an authoritative voice in the public debate: external scrutiny is important
  - Existence or perception of a (partisan) bias would negate their role.

# Questions

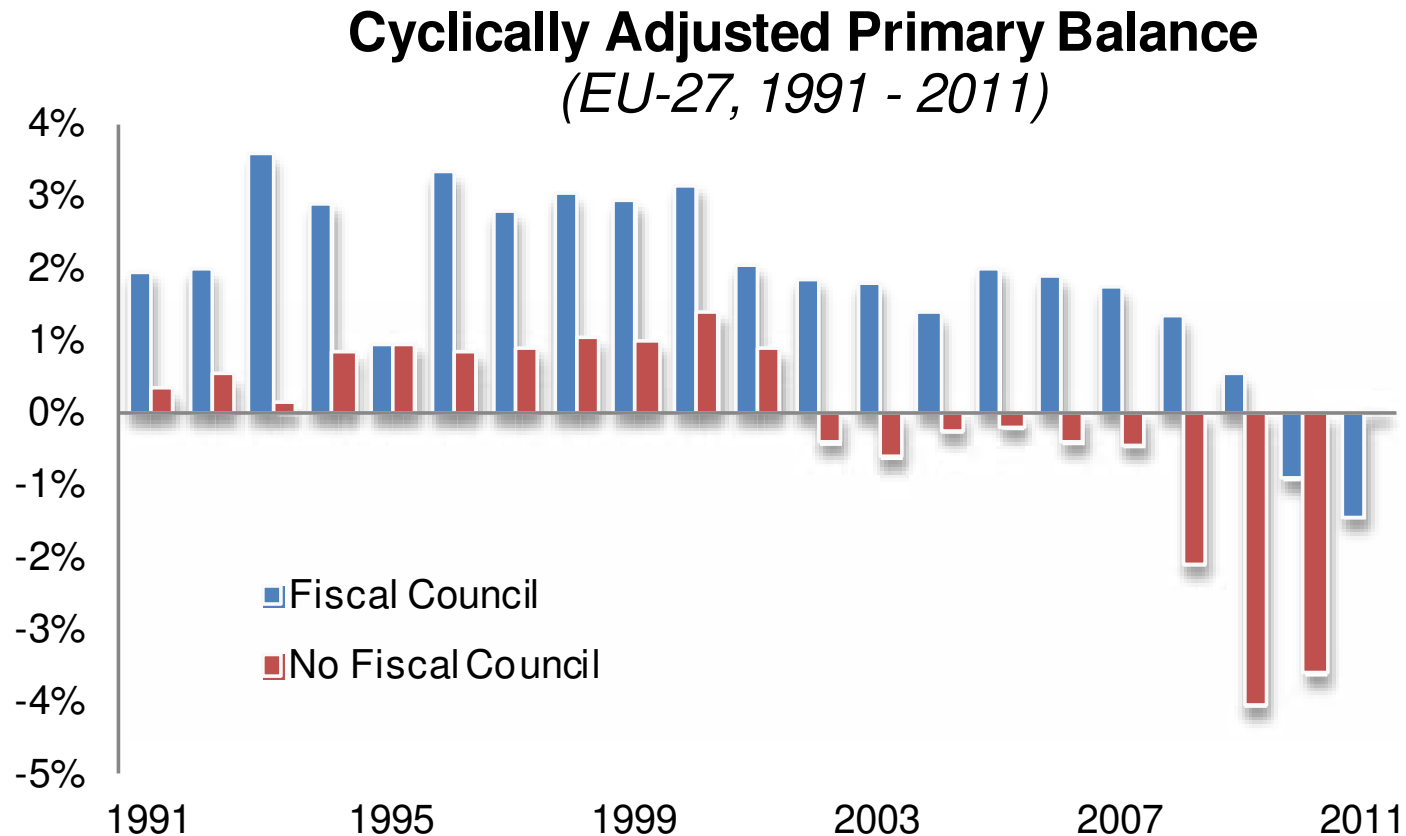
- What do we know about the effectiveness of FCs?
- What does that imply for:
  - Their design
  - The way they should be held accountable.

## B. The effectiveness of Fiscal Councils

- Ongoing work at the Fund
  - Evidence-based assessment focused on effectiveness
  - Lessons: elements of a common denominator to effective Fiscal Councils.
- Heterogeneity and small sample size are a challenge.
- Mix of methodologies
  - Correlation with outcomes (balance, cyclicity)
  - Forecasts' quality
  - Measure of media impact
  - Selected case studies:
    - Focus on diverse track record and age.

# The effectiveness of Fiscal Councils

- **Snapshot # 1:** countries with FCs appear to behave differently → stronger and less procyclical fiscal positions.





# Effectiveness of FCs

- ...and specific dimensions seem to matter...

**Table 1. Fiscal Council and Fiscal Performance**  
Bias Corrected LSDV Dynamic Panel Model

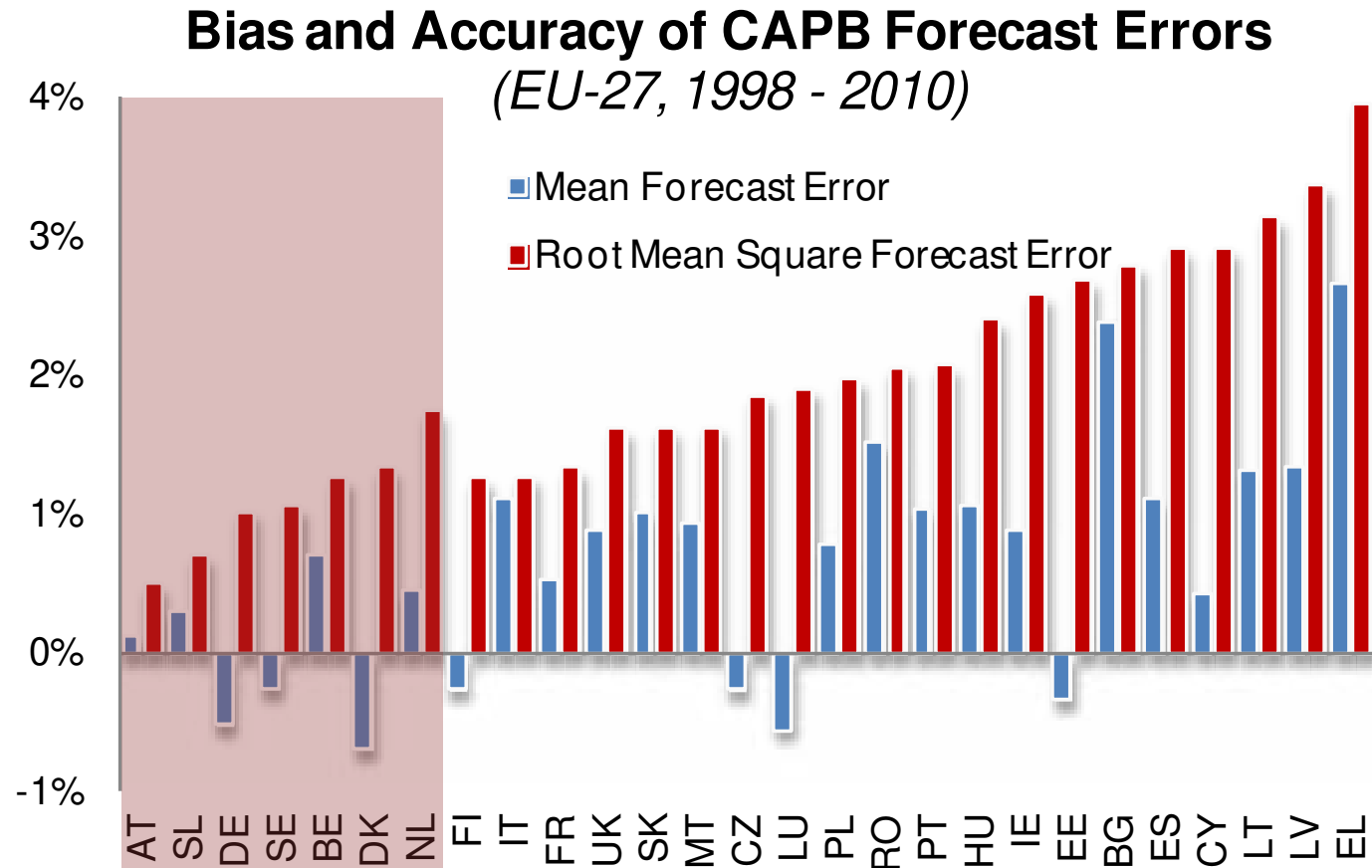
Dependent Variable: Primary Balance in percent of GDP								
Primary Balance (t-1)	0.823 (27.86)***	0.823 (27.96)***	0.826 (29.94)***	0.819 (24.29)***	0.824 (28.15)***	0.826 (28.07)***	0.825 (28.44)***	0.824 (28.05)***
Debt (t-1)	0.015 (3.00)***	0.016 (3.34)***	0.016 (3.18)***	0.022 (3.50)***	0.016 (3.24)***	0.016 (3.17)***	0.016 (3.34)***	0.017 (3.39)***
Output Gap (t-1)	-0.096 (2.74)***	-0.094 (2.70)***	-0.097 (2.87)***	-0.095 (2.62)***	-0.099 (2.84)***	-0.095 (2.72)***	-0.092 (2.65)***	-0.093 (2.67)***
Fiscal Rules Index (FRI)	0.280 (2.75)***	0.278 (2.72)***	0.268 (2.67)***	0.276 (2.44)**	0.250 (2.50)**	0.289 (2.84)***	0.292 (2.87)***	0.280 (2.76)***
Fiscal Council	0.496 (1.26)							
Legal indep		0.810 (1.98)**						
Indep. budget			1.096 (1.95)*					
Staff number (High level)				0.174 (1.89)*				
Fiscal rule compliance					1.296 (2.48)**			
Scoring						1.355 (2.44)**		
Forecast Assessment							0.993 (1.97)**	
High media impact								0.844 (2.09)**
Time dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	901	901	901	890	901	901	901	901
Countries	58	58	58	58	58	58	58	58

Absolute bootstrapped t-statistics in parentheses.

\* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

# Effectiveness of FCs

- **Snapshot # 2:** Forecasts are less likely to be optimistic and inaccurate in countries with FCs.



# Effectiveness of FCs

- While the existence of fiscal rules seems to be associated with more optimistic overall balance forecasts, more independent FCs with a high media impact seem to discourage optimism.

**Table 4. Fiscal Councils and Forecast errors**

Dependent Variable: Absolute value of Forecast Error (Overall Balance)					
Fiscal rules index	0.207 (1.84)*	0.204 (1.99)*	0.195 (1.70)	0.231 (1.92)*	0.197 (1.85)*
Overall balance	-0.074 (2.67)**	-0.079 (2.77)**	-0.078 (2.80)***	-0.072 (2.57)**	-0.075 (2.71)**
Output gap	-0.032 (0.29)	-0.029 (0.27)	-0.031 (0.29)	-0.032 (0.30)	-0.032 (0.29)
FC	-0.479 (1.27)				
Indep. budget		-0.604 (1.86)*			
Forecast			-0.307 (0.96)		
High media Impact				-0.622 (1.95)*	
FR Compliance					-0.367 (1.10)
Constant	0.743 (1.00)	0.718 (0.96)	0.708 (0.93)	0.730 (0.97)	0.701 (0.93)
Time dummies	Yes	Yes	Yes	Yes	Yes
N. of countries	26	26	26	26	26
R <sup>2</sup>	0.23	0.23	0.23	0.23	0.23
Observations	226	226	226	226	226

Absolute and robust t-statistics in parentheses.

\* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

# Effectiveness of FCs

- **Snapshot # 3:** More independent FCs appear to be more vocal in the media, and they speak out relatively more in periods of fiscal activism, particularly when a fiscal rule is in place.

**Table 2. Fiscal Councils: Independence and News Coverage**

Dependent Variable: News Coverage of Fiscal Council Activity (z-score)			
Guarantees on budget	0.919 (2.43)**		
Legal independence.		0.568 (1.75)*	
Constant	-0.616 (3.04)***	-0.526 (2.35)**	-0.677 (2.42)**
Time dummies	Yes	Yes	Yes
R <sup>2</sup>	0.34	0.32	0.33
N. of countries	8	8	8
Observation	124	124	124

Absolute t-statistics in parentheses.

\* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

**Table 3. Fiscal Councils: Forecast errors, Fiscal rules, and News Coverage**

Dependent Variable: News Coverage of Fiscal Council Activity (z-score)				
CAB forecast error (abs. value)	0.120 (1.09)		0.068 (0.58)	
One-year-ahead ΔCAB		0.258 (2.15)**		-0.055 (0.45)
Fiscal Rules Index			1.158 (2.02)*	1.709 (3.71)***
Constant	-0.235 (1.62)	-0.074 (0.54)	-2.761 (2.12)**	-3.864 (3.68)***
Time dummies	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.32	0.21	0.34	0.36
N. of countries	9	9	8	8
Observations	71	80	54	61

Absolute t-statistics in parentheses.

\* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%

## C. Lessons for the design of Fiscal Councils

- **Operational independence** seems to matter:
  - Even if FC is not de-jure independent, its activities must be perceived as non-partisan (e.g. thanks to reputation of technical competence, and absence of political interference).
  - Independence is also critical for the FC to perform its duties (hiring competent staff, determining work agenda within remit, etc).
- **A large media impact** appears to be a powerful transmission channel (magnify reputational/electoral impact of watchdog's activities).
- **Complementarity with fiscal policy rules:**
  - Rules provide a clear benchmark, facilitating the FC's assessment of fiscal policy.
  - FCs can be given a specific mandate to monitor compliance or close potential technical loopholes in the implementation of rules (forecasts, estimating CABs, managing error-correction mechanisms,...).

# Lessons for the design of Fiscal Councils

- Are all the other aspects irrelevant?
  - No, but evidence suggests that they could vary depending on country-specific needs and constraints (institutional traditions/models) without deleterious effects on effectiveness.
  - In particular, no evidence that effective FCs belongs to one particular class :
    - “Wise men”
    - Parliamentary budget offices
    - Research/think-tank
    - “Super-sized” auditors.

## D. Lessons for the watchers

- **Precondition for effective evaluation:** clear mandate and tasks of the FC.
- **Organizing dimensions:**
  - **Auditing vs. “peer” review:**
    - Efficiency, fulfillment of the mandate (check on legal obligations and limitations) → **accountability** → more the role of auditors and parliamentary committee.
    - **Quality** of the work and its impact → assessing **effectiveness** → advisory/evaluation committee reporting to “political principal” (parliamentary committee or MoF).
  - **Time dimension:**
    - **High frequency** (1 year or less): regular hearings, discussion of annual report, regular auditing.
    - **Low frequency** (2-5 years): trends in measurable performance indicators, qualitative analysis.
    - **Very low frequency** (5-10 years): comprehensive reviews, identification of reform needs.

# Lessons for the watchers

## ■ Challenges:

### ■ Evaluating *effectiveness*:

- *Multiplicity* of tasks and indicators (unlike CBs),

- Key dimensions (e.g. professional expertise) involve *qualitative* reviews.

- Find the right balance between high-frequency vs. low-frequency checks.

## ■ **Overarching principle** in designing the review process:

- **Minimize the noise-to-signal ratio.** Example: high-frequency finger-pointing on forecast errors or differences of analysis with private watchdogs



# Lessons for the watchers

When?	Mission?	Quality and integrity of the work	Accountability
High frequency (< 1 year)		<ul style="list-style-type: none"> <li>• <b>What?</b> Report on Quantitative indicators (incl. FR compliance); advice on methodologies</li> <li>• <b>Who?</b> Advisory Committee (experts)</li> <li>• <b>Question:</b> public or</li> </ul>	<ul style="list-style-type: none"> <li>• <b>What?</b> Regular hearings (see Principle 5.1)</li> <li>• <b>Who?</b> Parliamentary committee</li> </ul>
Low frequency (2-5 years)		<ul style="list-style-type: none"> <li>• <b>What?</b> Trends in quantitative indicators; qualitative assessments, recommendations.</li> <li>• <b>Who?</b> Advisory Committee (experts)</li> </ul>	<ul style="list-style-type: none"> <li>• <b>What?</b> Public review of effectiveness, based on expert inputs (ad-hoc and/or)</li> <li>• <b>Who?</b> “political” principal (legislative, executive or both)</li> </ul>
Very low frequency (> 5 years)		<ul style="list-style-type: none"> <li>• <b>What?</b> Thorough review of effectiveness, detection of design flaws, recommendations for reform.</li> <li>• <b>Who?</b> Ad-hoc committee, formal TA from IO.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>What ?</b> Eventual reform → Legislative process</li> </ul>

# Conclusions

- Watchdogs must be watched:
  - Democratic accountability and transparency;
  - Non-partisanship and expertise are key for FCs to legitimately influence fiscal performance → need to reassure the public that FC does not have its own bias.
- However, the evaluation process must be conceived to minimize the noise-to-signal ratio
  - Evaluations must not turn into a running commentary on an alleged bias or possible lack of competence of the watchdog → risk of obfuscating the public debate on fiscal policy instead of clarifying it.
  - Implication for frequency and type of reviews and for underlying institutional arrangements.
- Reviews/evaluations should be focused:
  - Fulfillment of mandate independently of partisan influence.
  - Capacity to influence the public debate through credible analyses, unbiased inputs to the operation of the fiscal framework, and effective communication.