

Fiscal policy institutions, the role of research and independent fiscal policy councils

Lars Calmfors

Interim seminar, Prime Minister's Office,
Königsted, Vantaa

12 August, 2010

FINANSPOLITISKA RÅDET

SWEDISH FISCAL POLICY COUNCIL

The role of independent fiscal policy institutions

Lars Calmfors

Interim seminar, Prime Minister's Office,
Königsted, Vantaa

12 August, 2010

FINANSPOLITISKA RÅDET

SWEDISH FISCAL POLICY COUNCIL

Structure of paper

1. Causes of excessive government debt accumulation
2. Fiscal rules
3. Independent fiscal institutions (fiscal watchdogs, fiscal policy councils)
4. The problem of securing sufficient research input into economic policy making in general

Causes of deficit bias

- Insufficient understanding of long-run constraints
 - lack of understanding of **intertemporal budget constraint**
 - overoptimism
 - overconfidence
- Politicians acting in their own interest – rent-seeking behaviour
 - lack of fiscal transparency
 - political business cycles

Causes of deficit bias (continued)

- Short-sightedness
 - higher discount rate for politicians than for the electorate
- Time inconsistency
 - optimal policy depends on the expectations of the public
 - time-inconsistent preferences: more impatience associated with short-run than long-run trade-offs
- Common-pool problems
 - concentrated benefits, dispersed costs
 - wars of attrition

Fiscal rules

- Medium-term targets or constraints as well as principles for how deviations from them should be handled
- **Intermediate objectives** designed to make it easier to attain more fundamental, higher-level objectives
- Easier to agree on policies reflecting "true" social preferences when choice framed as ex ante matter of principle
 - evaluation against well-defined benchmark

Credibility vs Flexibility

Germany

- Well-defined and binding budget-balance rule
- Deficits accumulated on an account
- Obligation to act when accumulated deficits above 1.5 per cent of GDP

Sweden

- Surplus of one per cent of GDP over a business cycle
- Imprecise target
- Many (five) different indicators

Better trade-off?

- Definition of clear threshold for well-defined fiscal-balance indicator
- Not automatic response
- Obligation for government to write to the parliament and explain why breach has occurred and whether (and if so what) response is required
- Cf Bank of England obligation to write to the Chancellor if the inflation target is missed

Independent fiscal watchdogs

Recent interest from IMF, Ecofin Council, European Commission, and ECB

Recently established institutions

- Sweden – Fiscal Policy Council 2007
- Canada – Parliamentary Budget Office (PBO) 2008
- Hungary – Fiscal Council 2008
- Slovenia – Fiscal Council 2009
- UK – Office for Budget Responsibility (OBR) 2010

Earlier existing institutions

- Belgium – High Council of Finance (HCF) 1936 (1989)
- Netherlands – Central Planning Bureau (CPB) 1947
- Denmark – Economic Council 1962
- US – Congressional Budget Office (CBO) 1975
- Austria – Public Debt Committee 2002

Academic proposals on Fiscal Policy Councils

- von Hagen and Harden (1994)
- Wren-Lewis (1996, 2002)
- Ball (1997)
- Blinder (1997)
- Wyplosz (2002, 2005)
- Swedish Government Commission on Stabilisation Policy in the Event of Membership in the Monetary Union (2002)
- European Economic Advisory Group (EEAG) (2003)
- Calmfors (2003, 2005)

A Fiscal Policy Council can increase fiscal transparency

Direct effects

- Increase awareness of future costs of deficits
- Offset tendencies to overoptimism and overconfidence
- Harder for politicians to pursue their own interests

Complement to fiscal rules

- Higher reputational cost of deviating from the rules
- But independent monitoring also allows rules to be more flexible

Tasks of a Fiscal Policy Council

- Objective macroeconomic forecasts
(CPB in Netherlands, OBR in the UK)
- Costing of government policy initiatives
(CPB in Netherlands, CBO in US, PBO in Canada)
- **Ex ante** evaluation of whether fiscal policy **will** meet its medium-term targets
(Fiscal Council in Hungary, OBR in UK)
- **Ex post** evaluation of whether fiscal policy **has** met its targets
(Fiscal Policy Council in Sweden)

Tasks of a Fiscal Policy Council (continued)

- Fiscal sustainability analysis
(CPB in Netherlands, Public Debt Committee in Austria, Fiscal Council in Hungary, Fiscal Policy Council in Sweden)
- Normative fiscal policy recommendations
(Public Debt Committee in Austria, Economic Council in Denmark and Fiscal Policy Council in Sweden)

Why does a watchdog need official status?

- Official status gives more influence
- An official council can be given a formal role in the budget process
 - an arena for repeated and public exchange between politicians and economic experts
- Commitment on the part of academics and other economic experts appointed to the council to a sustained and consistent participation in the economic policy debate

Democratic legitimacy

- Critique:
- Unelected experts should not evaluate elected representatives
- But:
 - Policy evaluation is relative to the government's own objectives
 - Better information for citizens increase the possibilities of holding policy makers accountable
- Of course:
 - Agenda-setting powers could be misused

Independence is crucial for critical assessments

- Clear mandate to pursue its remit without government intervention
- Long-term budget
- Long-term and non-renewable terms of office for council members
- Rather the parliament than the government as principal
- Appointments after proposals from the council itself
- Adequate staff – not rely on Ministry of Finance staff
- Not direct input into the preparation of the budget and provision of the forecast in the budget
- Ex post but not ex ante discussions with the government

FINANSPOLITISKA RÅDET

SWEDISH FISCAL POLICY COUNCIL

Composition of council

- Academic researchers
 - least likely to be affected by political concerns
- Public finance experts with a background in government administration
 - more detailed knowledge
 - but risk of influence of career concerns
- Analysts in the financial sector
 - unclear loyalties
- Ex-politicians
 - boost legitimacy and impact
 - but often restricted by earlier positions taken

Amount of resources

- Large variation among existing institutions
 - CBO in US: 230
 - Fiscal Council in Hungary, Economic Council in Denmark: 30
 - OBR in UK: now 8, proposal of 20
 - Fiscal Policy Council in Sweden: 4
- Scope of tasks determine resource need
 - forecasting/costing of government initiatives, detailed budget calculations
 - more overall, less-routine evaluations with heavier academic input

Too little research input into economic policy making in general

- Deficit bias can be seen as manifestation of the general problem of too little attention attached to research input in general
- Strong temptation for politicians to use research strategically to advance their aims
 - confounding of value judgements and research results on various economic relationships

Measures to increase research input into the policy-making process

- In-house advising is not enough
 - difficult for in-house advisers to assert themselves
 - in-house advisers may become co-opted
- External advising and evaluation
 - politicians must take a public stand
 - increased interest among journalists of confronting policy makers with research
- External advising/evaluation and in-house advising are complements
 - external evaluation provides incentives for more and better in-house advising

A broader remit for a Fiscal Policy Council?

- CPB in Netherlands
 - employment and regulatory policies
 - resource depletion
 - financial crises
- Economic Council in Denmark
 - tax, employment and other structural policies
 - environmental issues
- Sachverständigenrat in Germany
 - wide range of issues

Swedish Fiscal Policy Council

- Evaluate that developments are in line with long-run healthy growth and sustainable high employment
- Evaluate the motivations given for policies in the government's budget proposals and the grounds for policy proposals
- Contribute to an increased public debate on economic policy
- The Council should thus act as a "debate watchdog" as well



Pros and cons of an extended remit

Pros

- Interaction between fiscal sustainability and employment
- Greater impact from analysis of one institution with a solid reputation than by a host of institutions
- Difficult to staff many institutions

Cons

- Analytical resources may be spread too thinly
- Less tangible long-run fiscal sustainability issues may be crowded out by more tangible short-run issues
- "Monopoly" is a risk

Are there risks of a political bias?

”There is reason to assume that the Fiscal Policy Council will be another body providing false scientific clothing for the government’s right-wing policy”

Swedish Left Party

Possible bias problems are of other types

- Natural to focus on scope for improvement of government policy
 - anti-government bias if opposition party programmes are not evaluated (as CPB does in Netherlands)
 - but this would amount to a large extension of remit
- The opposition will always gain in relative terms because they have less access to analytical resources



FINANSPOLITISKA RÅDET

SWEDISH FISCAL POLICY COUNCIL

Conclusions

- Independent fiscal watchdogs are an international trend
- Direct disciplining effect as well as complement to fiscal rules by increasing fiscal transparency
- Exact remits vary
- Key questions:
 - Should they provide forecasts?
 - Should they provide normative recommendations in addition to doing positive analysis?
 - Should the remit be broader than just monitoring of fiscal policy?



FINANSPOLITISKA RÅDET

SWEDISH FISCAL POLICY COUNCIL

Conclusions

- Independent fiscal watchdogs are an international trend
- Direct disciplining effect as well as complement to fiscal rules by increasing fiscal transparency
- Exact remits vary
- Key questions:
 - Should they provide forecasts? **No!**
 - Should they provide normative recommendations in addition to doing positive analysis?
 - Should the remit be broader than just monitoring of fiscal policy?

Conclusions

- Independent fiscal watchdogs are an international trend
- Direct disciplining effect as well as complement to fiscal rules by increasing fiscal transparency
- Exact remits vary
- Key questions:
 - Should they provide forecasts? **No!**
 - Should they provide normative recommendations in addition to doing positive analysis? **Yes!**
 - Should the remit be broader than just monitoring of fiscal policy?

Conclusions

- Independent fiscal watchdogs are an international trend
- Direct disciplining effect as well as complement to fiscal rules by increasing fiscal transparency
- Exact remits vary
- Key questions:
 - Should they provide forecasts? **No!**
 - Should they provide normative recommendations in addition to doing positive analysis? **Yes!**
 - Should the remit be broader than just monitoring of fiscal policy? **Perhaps!**