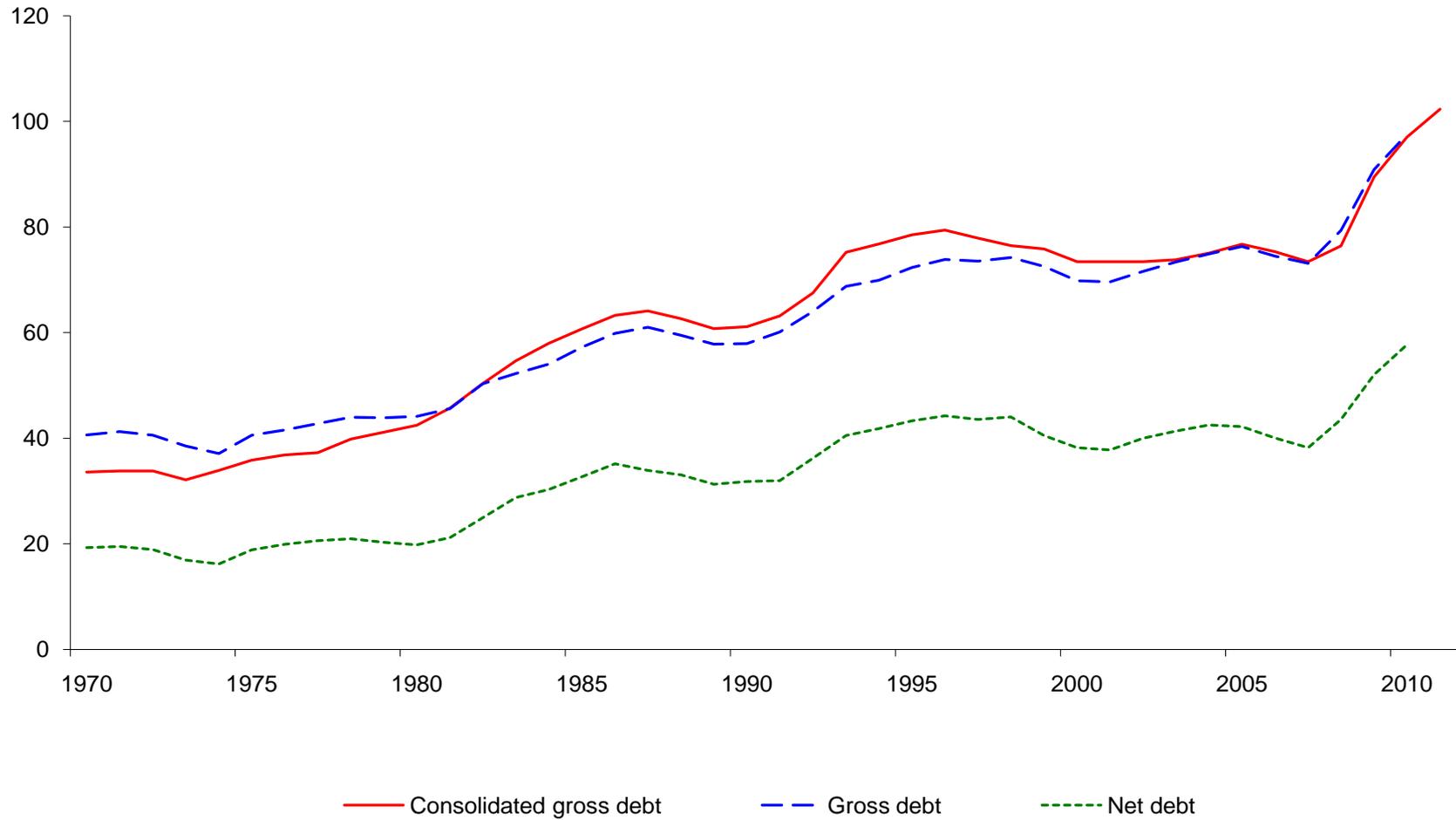


What can independent fiscal institutions do?

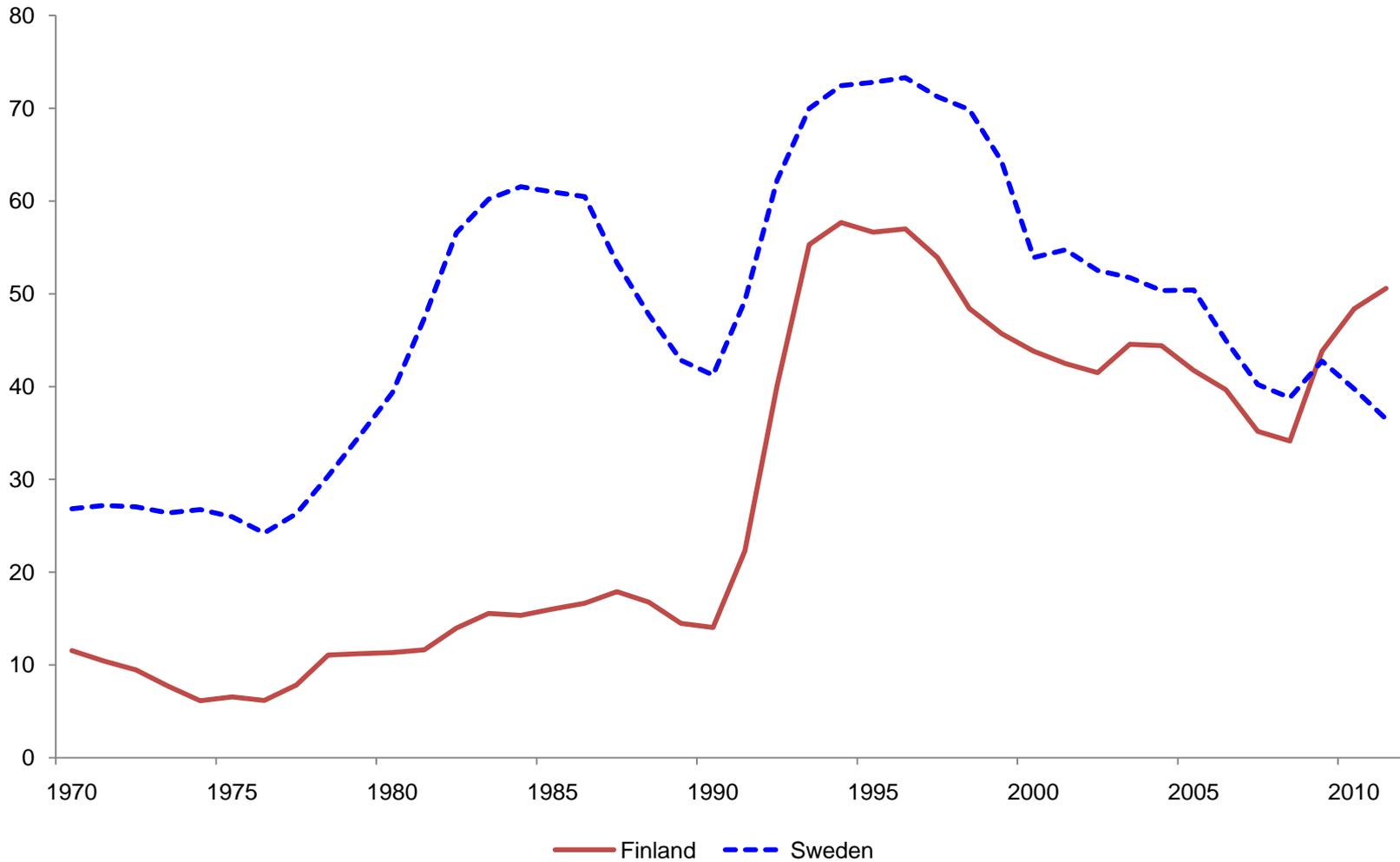
Lars Calmfors

Finnish Economic Association and Yrjö Jahansson
Foundation Seminar on Fiscal Institutions and Rules
Helsinki, 22 August 2011

Government debt in the OECD area, per cent of GDP



Consolidated government gross debt, per cent of GDP, Sweden and Finland 1970-2011



Explanations of deficit bias

1. Informational problems
 - ignorance of intertemporal budget constraint
 - overoptimism
 - informational asymmetries
2. Externalities
 - common pool problems
 - intergenerational exploitation

Explanations of deficit bias cont.

3. Impatience

- myopic behaviour
- more heavy discounting by politicians than voters
- strategic behaviour and political polarisation

4. Time inconsistency

- stabilisation policy (like monetary policy)
- time inconsistent preferences

Fiscal rules

European rules

- Deficit ceiling of 3 per cent of GDP
- Debt ceiling of 60 per cent of GDP or debt falling "at a satisfactory pace"
- Medium term objective of "close to balance or surplus"

National rules

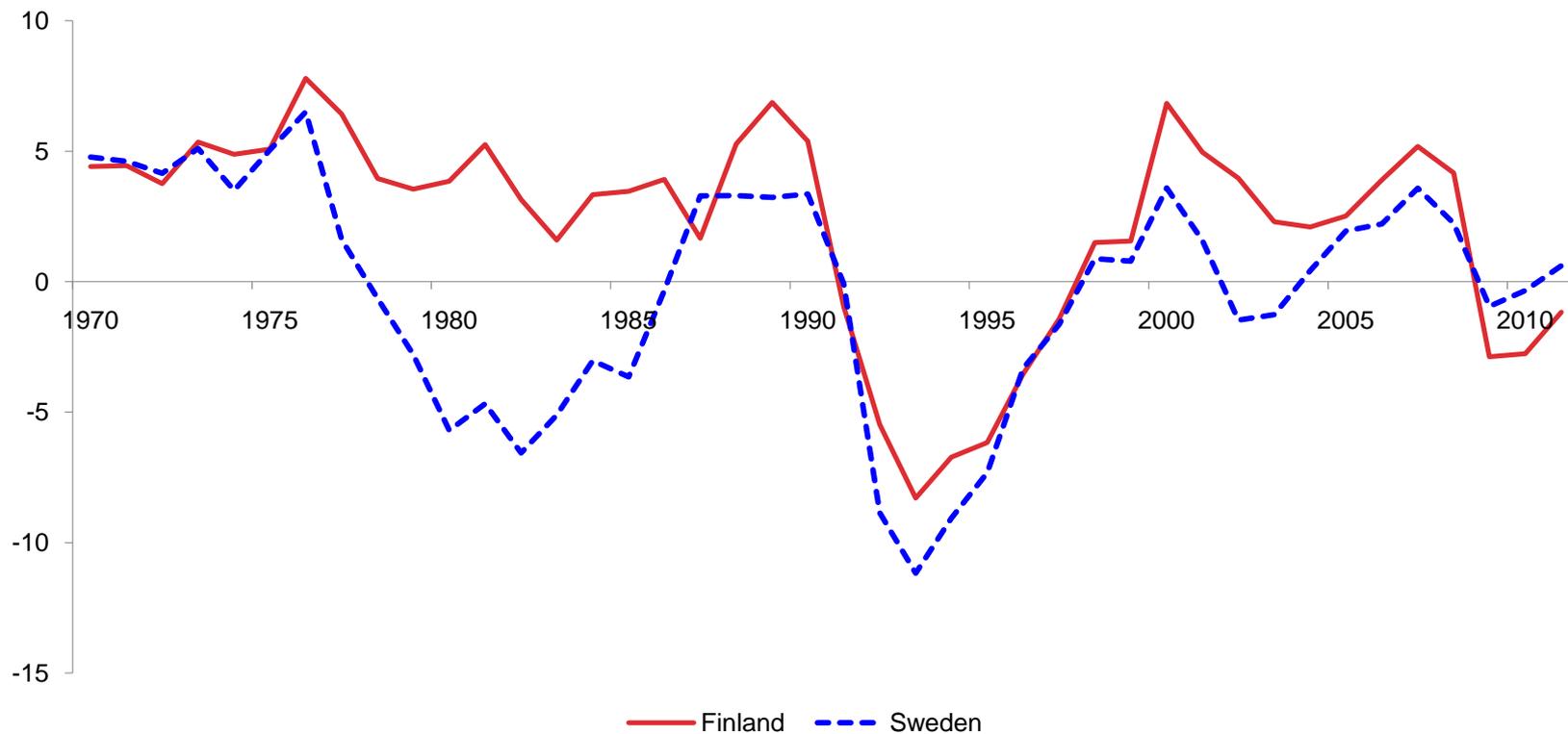
- Sweden
 - surplus target
 - expenditure ceiling
- UK
 - golden rule
 - net debt ceiling of 40 percent of GDP

Table 1 Breaches of the stability pact

	99	00	01	02	03	04	05	06	07	08	09	10
Austria	x		x			x				x	x	x
Belgium										x	x	x
Bulgaria											x	x
Cyprus						x					x	x
Czech Republic							x				x	x
Denmark												x
Estonia												
Finland												x
France				x	x	x	x		x	x	x	x
Germany	x			x	x	x	x			x	x	x
Greece		x	x	x	x	x	x	x	x	x	x	x
Hungary						x	x	x	x	x	x	x
Ireland										x	x	x
Italy			x		x	x	x	x		x	x	x
Latvia										x	x	x
Lithuania										x	x	x
Luxemburg												
Malta						x				x	x	x
Netherlands					x						x	x
Poland						x	x	x		x	x	x
Portugal			x			x	x	x		x	x	x
Romania										x	x	x
Slovakia								x			x	x
Slovenia											x	x
Spain										x	x	x
Sweden												
UK					x	x	x			x	x	x

Note: The crosses show that a country has a government deficit exceeding three per cent of GDP, or a gross government debt exceeding 60 per cent of GDP that is not falling (or both). A grey field indicates that the country, at the time, was not an EU member state.
Source: ECB.

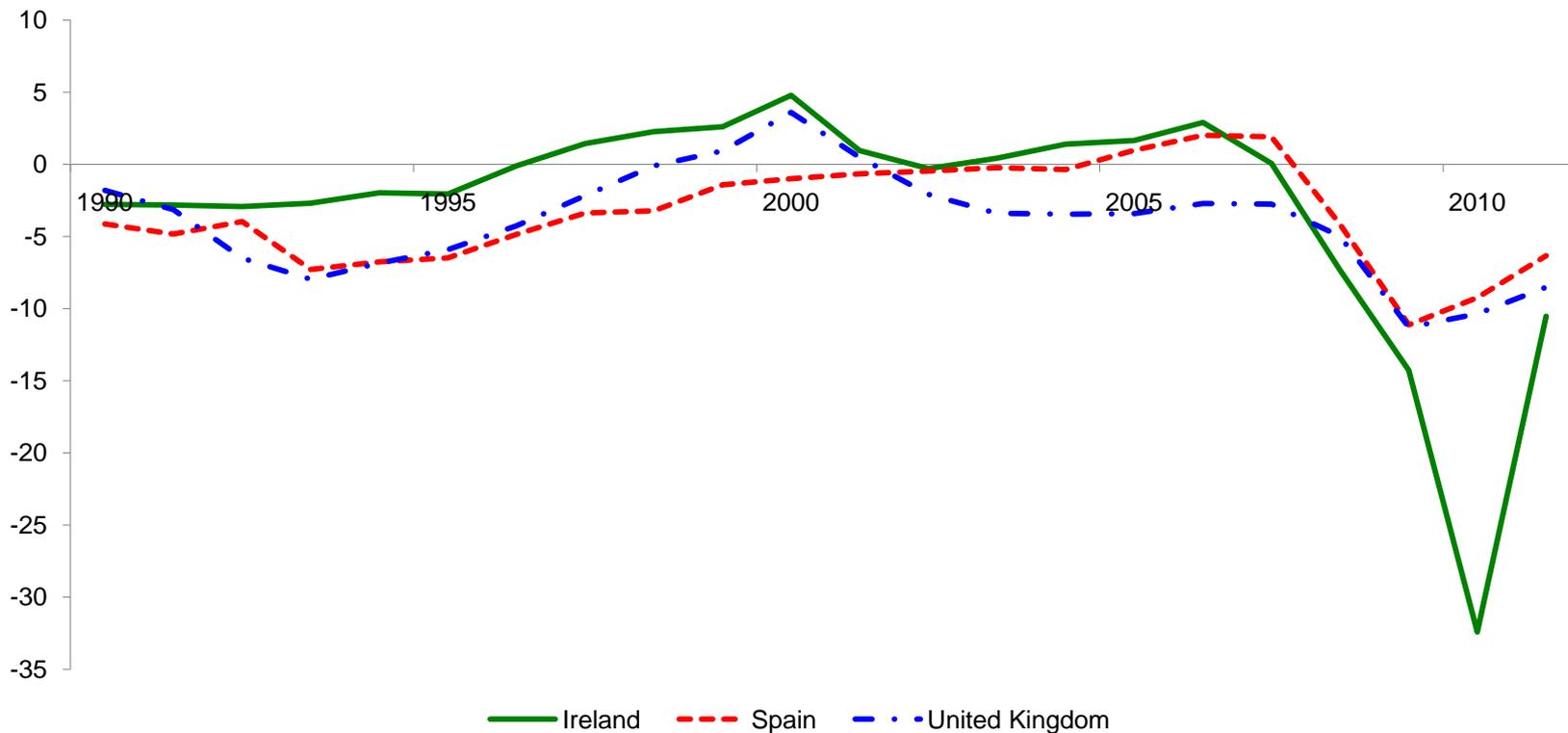
General government net lending, per cent of GDP, Sweden and Finland 1970-2011



Problems with the rules approach

1. Insufficient legitimacy for European rules
2. Insufficient safety margins and neglect of unsustainable booms
3. Conflict between **simplicity** and **flexibility**

General government net lending, per cent of GDP, Ireland, Spain and U.K. 1990-2011



Development of monetary policy regimes

- Discretionary monetary policy by politically dependent central banks
- Rules approach
 - money supply targets
 - fixed exchange rates
- Constrained discretion by politically independent central banks
 - inflation targeting

Independent fiscal institutions

- Fiscal committees with decision-making powers
- Fiscal watchdogs or fiscal councils

Earlier existing fiscal watchdogs

- Central Planning Bureau (CPB) in the Netherlands (1947)
- Economic Council in Denmark (1962)
- Sachverständigenrat in Germany (1963)
- Congressional Budget Office (CBO) in the US (1975)
- Public Sector Borrowing Requirement Section of the High Council of Finance in Belgium (1989)
- Staatsschuldenausschuss in Austria (1997)

Recently established fiscal watchdogs

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

Fiscal watchdogs underway

- Australia
- Slovakia
- Ireland
- Portugal

Fiscal watchdogs not underway

- Finland
- France
- Norway

Potential contribution of a fiscal council

1. Alleviate informational problems
 - increase accountability of politicians
2. Complement to a fiscal rule
 - increase reputation cost of violating the rule
3. Alleviate the conflict between simplicity and flexibility
 - evaluate when simple rule can be broken
 - monitor adherence to more complex rule

Why do economists need an official status?

- An official stamp gives more influence
- Formal input into the political process
- Address market failure
 - ensure consistent participation by academics in fiscal policy debate

The Thomas Becket effect

Forecasts?

Pro (OBR, CPB)

- Lack of fiscal discipline often associated with overoptimism

Con (SFPC)

- Direct involvement in political process
- Credibility risk because forecasts usually wrong

Normative recommendations?

Pro (Austria, Belgium, Denmark, Sweden)

- Clearer message
- More influence

Con (Netherlands, US, UK)

- Impartiality may be jeopardised
- Greater risk of conflict with the government

Analysis of stabilisation policy?

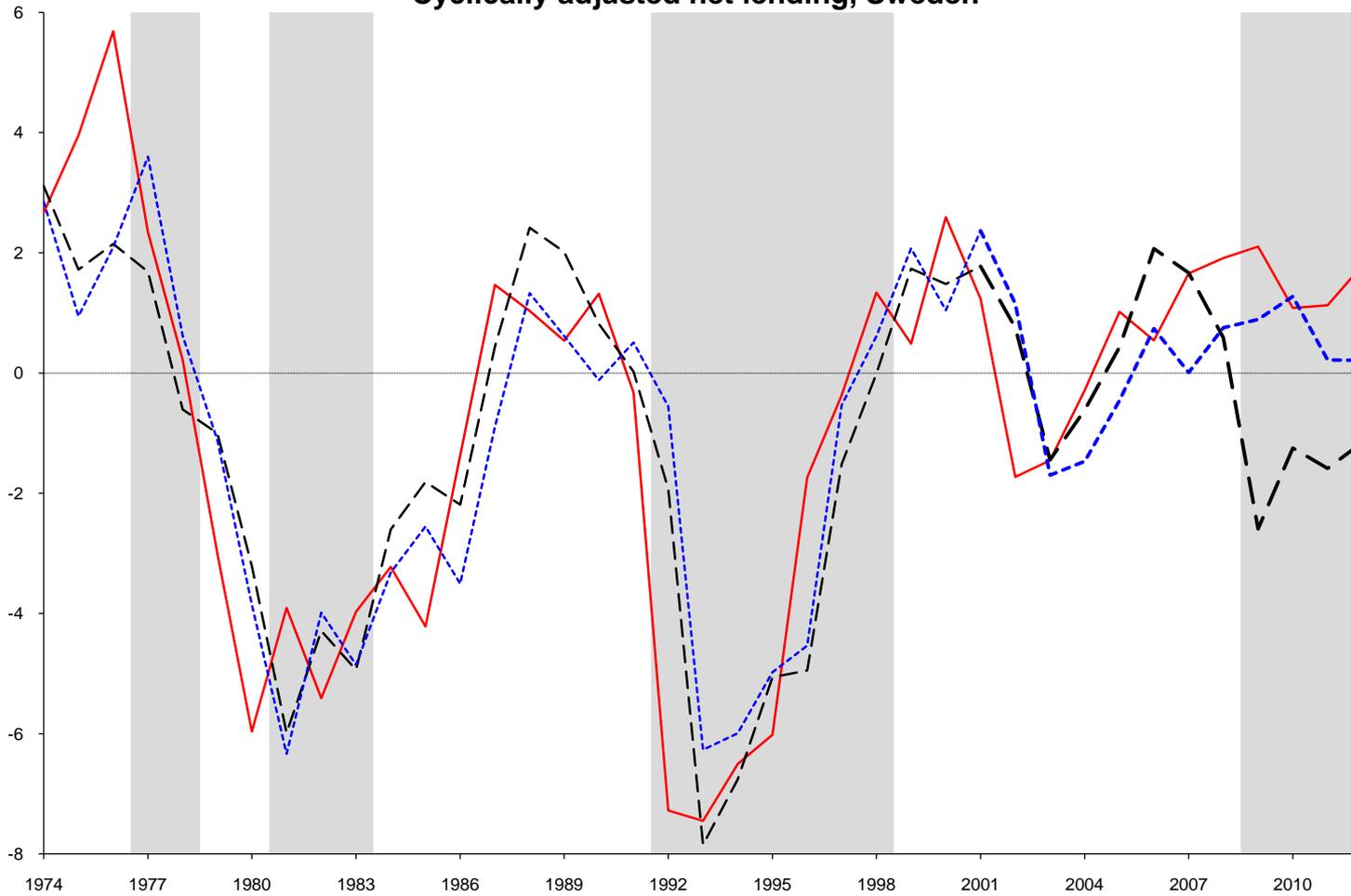
Pro

- Difficult to analyse sustainability without regard to cyclical situation

Con

- Less focus on sustainability

Cyclically adjusted net lending, Sweden



— Strukturellt sparande

- - - Modell med BNP-gap

..... Modell utan BNP-gap

Analysis of the rules themselves?

Pro

- Impossible to evaluate sustainability without evaluating rules/objectives
- Fiscal council has the competence

Con

- Problematic to police rule if council is critical of it

Employment, growth and environmental policies?

Pro (Denmark, Sweden, Netherlands)

- Issues are intertwined
- Good to use council's expertise in more areas
- Easier to uphold reputation for impartiality

Con (Austria, Belgium, UK)

- Interest in fiscal sustainability is crowded out

Independence or corporatist body?

Corporatist body (Austria, Belgium)

- Foundation for **contract solution** for fiscal discipline building on consensus

Independent body
(Denmark, Sweden)

- **Safest way to avoid that a council gives in to political pressures**

Viability of a fiscal watchdog

- Natural to get into conflict with government at times
- Time inconsistency problem for government
 - ex ante incentives to set up fiscal watchdog
 - ex post incentives to restrict its activities or even close it down

Henry II on Thomas Becket: "Cannot someone rid me of this turbulent priest?"

Examples of government pressures

- Venezuela – PBO closed down
- Hungary – Fiscal council in effect dismantled
- Canada – budget cut for PBO
- Sweden – threat of budget cut

Lines of defence

1. Building a reputation

- but it takes time
- and requires a sophisticated political debate

2. Formal provisions

- guarantees against firings
- resourcing
- long-term budget

3. International evaluations

- quality control
- but also defence against politically motivated critique