

## **The role of independent fiscal policy institutions**

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Report to the Prime Minister's Office, Finland, 1 September 2010.

\* I am grateful to Laura Hartman, Lars Jonung, George Kopits, Pekka Sinko, Simon Wren-Lewis and participants in a seminar organised by the Prime Minister's Office in Vantaa on 12 August 2010.

### **Abstract**

The paper analyses how independent fiscal watchdogs (fiscal policy councils) can strengthen the incentives for fiscal discipline. Several countries have recently established such institutions. By increasing fiscal transparency they can raise the awareness of the long-run costs of current deficits and increase the reputational costs for governments of violating their fiscal rules. Councils that make also normative judgements, where fiscal policy is evaluated against the government's own pre-set objectives, are likely to be more influential than councils that do only positive analysis. To fulfil their role adequately, fiscal watchdogs should be granted independence in much the same way as central banks. There are arguments both in favour and against extending the remit of a fiscal policy council to include also tax, employment and structural policies. Whether or not this should be done depends on the existence of other institutions making macroeconomic forecasts and analysing fiscal policy, the existence of institutions providing independent analysis in other economic policy areas, and the severity of fiscal problems

## 1 Introduction

A number of OECD countries now find themselves in a situation with soaring government debt. The immediate cause is the deterioration of public finances in the economic crisis, which has resulted from both the working of automatic stabilisers and discretionary stimulus actions, including support to the financial sector in many countries. But the public finance problems also reflect weak budgetary positions at the onset of the crisis as well as insufficient adjustment to future demographic pressures.

Earlier fiscal rules at both national and EU levels are now being violated in most European countries. It is therefore natural that much interest focuses on appropriate reforms of fiscal frameworks. There are clear parallels between current discussions of fiscal policy frameworks and earlier ones of monetary policy frameworks. In the sphere of monetary policy, an academic debate on *rules* versus *discretion* started in the late 1970s. Initially, reform proposals emphasised the importance of commitment to inflexible rules (for money supply growth or exchange rates). The last decades' approach to central banking in most countries has, however, blurred the distinction between rules and discretion. Flexible inflation targeting means following a rule for interest rate setting, but with considerable discretion on how the rule is applied.<sup>1</sup> The most important break with the past is the delegation of monetary policy decision-making to central banks with a high degree of independence from the political system.

Although there have been many academic proposals on delegating some fiscal policy decisions to independent institutions, this idea has not been applied in practice. The reason is that fiscal policy-making is regarded as inherently much more “political” than monetary policy-making. There has, however, been a recent international trend towards setting up independent fiscal policy institutions, *fiscal watchdogs*, with the task of monitoring public finances.

This paper first reviews possible causes of excessive accumulation of government debt. It goes on to analyse briefly what role fiscal rules can play for mitigating such tendencies. The main topic is, however, how independent fiscal policy institutions can contribute to fiscal discipline. This discussion draws on experiences of such institutions in various countries in general and on the experiences of the Swedish Fiscal Policy Council in particular. Fiscal indiscipline seems often too be associated with a lack of understanding of its long-run

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<sup>1</sup> It remains to be seen though whether the recent financial crisis will result in less transparent monetary policy frameworks with a larger amount of discretion as to how financial developments are taken into account. See, for example, Calmfors (2009a).

consequences. It can therefore be seen as a manifestation of the more general problem of too little analytical (research) input into the economic policy process. For this reason it is natural also to include a discussion of how to secure a sufficiently large analytical input into economic policy-making in general and how independent institutions can contribute to that.

## 2 Fiscal objectives and rules

There has been a trend towards increased government debt in most OECD countries since the early 1970s. This has led many observers to conclude that modern democracies suffer from an inherent *deficit bias* and a tendency to *excessive accumulation* of government debt. The concept of excessive debt accumulation is, however, vague. It should be taken to mean debt accumulation in excess of what is in the long-run interest of the majority of voters, but the meaning of this depends on the theoretical model at hand.

### 2.1 Explanations of excessive government debt accumulation

Since the choice of appropriate fiscal institutions is likely to depend on the underlying causes of debt accumulation, a short review of the research literature is a good starting point. A number of (partly overlapping) reasons for why unconstrained discretionary decision-making can lead to deficit bias have been identified.

1. *Insufficient understanding* among both the electorate and politicians of the long-run constraints on fiscal policy. This could include a lack of understanding of both the *intertemporal government budget constraint*, according to which government solvency requires that future primary surpluses are at least as large as the outstanding net government debt, and of the requirements on future policy if it is to compensate for current deficits.<sup>2</sup> Lack of understanding of future policy demands seems often to be associated with *overoptimism* (“this time is different”, allowing more leeway than earlier) or *overconfidence* (underestimation of the variability of future shocks).<sup>3</sup>
2. *Politicians acting in their own interest* rather than in the interest of the electorate.<sup>4</sup> This can occur through rent-seeking behaviour in a wide sense (including, for example, prestigious projects with little value for society or benefits to the own constituency and various interest groups). It is made possible to the extent that lack of fiscal transparency or insufficient knowledge on the functioning of the economy on

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<sup>2</sup> See, for example, Swedish Fiscal Policy (2009), Appendix 1, regarding the intertemporal budget constraint.

<sup>3</sup> See Reinhart and Rogoff (2010) and Rogoff and Bertelsmann (2010).

<sup>4</sup> See von Hagen (2010).

the part of voters makes it difficult for them to efficiently monitor the behaviour of politicians. According to one version of the argument, rent-seeking behaviour can together with fiscal opacity lead to *procyclical* policy, because voters demand more government consumption and lower taxes in good times to prevent higher tax revenues from being wasted on political rents.<sup>5</sup> A related argument focuses instead on *political business cycles*: the voters' difficulties of evaluating macroeconomic outcomes give incumbent governments an incentive before elections to signal their competence through deficit-increasing measures that boost the economy in the short run.<sup>6</sup>

3. *Short-sightedness* in the sense that too little weight is attached to the future. An obvious explanation is that the political parties in power may have a higher discount rate than the electorate because some of the future costs of current deficits will be borne by other parties if the current government is not re-elected. This presupposes that the preferences of politicians are not perfectly aligned with those of the electorate (as discussed in the preceding item). A possible explanation is that political parties represent different constituencies with differing preferences regarding the composition of government spending or the trade-off between taxes and government spending. This may create an incentive for the party in power to accumulate debt for the strategic reason to constrain the policies of future governments with different preferences.<sup>7</sup>
4. *Time inconsistency*, which means that policies that are optimal *ex ante* are no longer so *ex post*. The implication is that governments may initially decide plans on fiscal restraint but later renege on them. One explanation is that optimal fiscal policy depends on the private sector's *expectations* of policy which influence its behaviour. For example, it makes sense for a government *ex ante* to induce expectations of low inflation, resulting in low wage increases, but *ex post*, once this has been done, to pursue more expansionary fiscal policy to reduce unemployment, which can then be achieved at a lower cost of inflation than would otherwise be the case. But if the private sector realises this, expectations never adjust to the government's announced plans and the economy ends up in a bad equilibrium with high deficits.<sup>8</sup> Similarly, even if governments in advance rule out support to financial markets to reduce moral hazard problems, support is likely to be deemed optimal once irresponsible behaviour

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<sup>5</sup> Alesina et al. (2008) and Andersen and Westh Nielsen (2010).

<sup>6</sup> Rogoff and Sibert (1988).

<sup>7</sup> Persson and Svensson (1989) and Alesina and Tabellini (1990).

<sup>8</sup> This form of time inconsistency was first discussed by Kydland and Prescott (1977) in the context of monetary policy. Agell et al. (1996) is an early application to fiscal policy.

has caused losses involving systemic risks, which undermines the credibility of an announced non-accommodation policy. Time-inconsistent policy could also be the result of time-inconsistent *preferences* implying that people (and thus governments) are more impatient when they make short-run trade-offs than when they make long-run ones. *Ex ante* rates of time preferences may then motivate a certain pace of deficit reduction in the future, but once the future arrives decision makers could find themselves more impatient (with a higher rate of time preference) than initially and therefore choose to postpone the deficit reduction.<sup>9</sup>

5. *Common-pool problems*, which arise because government spending is usually targeted on individual groups, but financed out of general taxes. Individual groups therefore lobby for spending on their preferred programmes without considering the full budgetary costs now as well as in the future. This can lead to both overspending and excessive debt accumulation for the same reasons as the absence of clearly defined property rights over natural resources can lead to overexploitation of them.<sup>10</sup> A special case of the common-pool problem is *wars of attrition* over budgetary consolidations. They imply that, in a situation of unsustainable deficits, each group in society – and the political party representing it – tries to postpone the necessary fiscal adjustment in the hope that the burden of adjustment can be shifted on to other groups.<sup>11</sup>

## 2.2 Fiscal rules

Fiscal rules are widely seen as an appropriate method to offset tendencies to excessive debt accumulation. By a fiscal rule I mean a well-defined *target* or *constraint* for fiscal policy (or a set of targets or constraints) as well as principles (guidelines) for how deviations from these targets or constraints are to be handled.<sup>12</sup> A specific budget outcome or a specific path for government debt over a certain period are examples of targets. Deficit and debt ceilings as well as expenditure ceilings are examples of constraints. Such targets and constraints do not have a value of their own, but should instead be seen as *intermediate* objectives formulated with the aim of making it easier to attain more fundamental, higher-level objectives.

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<sup>9</sup> Modern analysis of intra-personal preference reversals was pioneered by Laibson (1997) using so-called hyperbolic discount functions (as opposed to conventional exponential discount functions). Bertelsmann (2009) has applied this analysis to public debt. See also Rogoff and Bertelsmann (2010).

<sup>10</sup> See von Hagen and Harden (1994) and Velasco (2000).

<sup>11</sup> Alesina and Drazen (1991).

<sup>12</sup> The seminal work on the principles to be observed when formulating fiscal rules is Kopits and Symansky (1998).

### *Higher-level fiscal objectives*

One can conceive of a number of higher-level objectives for budget and debt policy:<sup>13</sup>

- Long-run *fiscal sustainability*, implying that the government needs to meet its intertemporal budget constraint, that is be able to service its debt. This is, however, only a restriction, not an objective: since many paths for government debt are consistent with this requirement, it does not pin down a specific path (nor an end point).
- *Social efficiency*, which gives a motive for *tax smoothing*, that is to even out (marginal) tax rates over time. This minimises the distortionary costs of taxation and thus contributes to the smoothing of consumption over time for households, which is welfare-improving.
- *Intergenerational equity*. What should be regarded an equitable distribution of welfare across generations depends on value judgements. But a common value judgement is that each generation should pay for its own costs.<sup>14</sup>
- *Precautionary savings* to prepare for unanticipated contingencies. These could refer to both the short and the long term. In the short term, an important objective is to provide room of manoeuvre for stabilisation policy by staying clear of the critical debt level at which default premia on government bonds start rising rapidly.<sup>15</sup> In the long term, the objective is to provide buffers against, for example, future increases in equilibrium employment that put strains on public finances.

These higher-level objectives could motivate different types of fiscal rules as well as different numerical values for the targets/constraints chosen. According to most models, the tax-smoothing motive does *not* imply a target for government debt: instead debt should act as a buffer against public finance shocks and follow a random walk. This is consistent with a deficit target “without memory” where past deviations from the target should not be compensated.<sup>16</sup> In contrast, a debt target or a deficit target “with memory” is more in line with an objective for distribution across generations.<sup>17</sup> Such formulations would also square with

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<sup>13</sup> Auerbach (2008) and Finanspolitiska rådet (2008) discuss these higher-level objectives in more detail.

<sup>14</sup> This value judgement has been clearly formulated by, for example, the Swedish government. See Finansdepartementet (2010) and Budget Bill (2010). Implicit in such considerations is a rejection of the so-called Ricardian view that the current generation adequately represents future generations.

<sup>15</sup> See, for example, Bi and Leeper (2010) for an analysis of this.

<sup>16</sup> See Wren-Lewis (2010a).

<sup>17</sup> A debt target and a deficit target over a longer period are similar since a fixed annual deficit as a percentage of GDP implies that the debt ratio converges to a specific value. See, for example, Finanspolitiska rådet (2008).

the precautionary motive to the extent that interest rates on sovereign debt are related to the debt level.

In principle, it is not possible to decide an adequate intermediate fiscal target without first taking a stand on the relative importance of the various higher-level objectives. Unfortunately, this is rarely done. For example, the Fiscal Policy Council in Sweden has repeatedly criticised the government for its failure to explain how its so-called *surplus target*, according to which government net lending should amount to one per cent of GDP over a business cycle, has been derived from the various higher-level fiscal objectives.<sup>18</sup> In the long term, such lack of motivations could threaten the legitimacy of a fiscal target.

The determination of an intermediate fiscal deficit or debt target should take into account the interaction with other policies. There is an obvious such interaction with future employment developments, in particular with the development of the retirement age. *Prefunding* through fiscal surpluses now and *later retirement* can be seen as substitutes for each other when it comes to meeting the future fiscal changes arising from an ageing population. This provides a strong argument for simultaneous determination of fiscal targets and future employment targets (including policies to raise the retirement age), so that appropriate trade-offs can be made.<sup>19</sup>

#### *The role of intermediate objectives*

The rationale for fiscal rules regarding intermediary targets/constraints is that it is likely easier to agree on policies that reflect “true” social preferences when the choice is framed as an *ex ante* matter of principle rather than as a concrete policy choice in a specific situation. One should expect the risks of policy “slippage” to be smaller if policy in the short and medium term can be evaluated against a simple, well-defined benchmark rather than against more complex, higher-level objectives.

The exact logic depends, however, on the perceived causes of deficit bias under discretionary decision-making. A decision on rules can be seen as being taken under “a veil of ignorance” regarding who will be in government in the future. It should therefore help offset deficit bias arising from political rent-seeking and short-sightedness deriving from limited periods of office. Decisions on rules would also address the time-inconsistency problems (arising from either the temptation to choose other policies once private-sector behaviour has

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<sup>18</sup> Finanspolitiska rådet (2008) and Swedish Fiscal Policy Council (2009, 2010).

<sup>19</sup> This point was elaborated in Swedish Fiscal Policy Council (2009). As a response to the council’s discussion, the Swedish government made it clear for the first time in the Spring Fiscal Policy Bill (2010) that prefunding should not finance future costs arising from increased longevity and higher quality of publicly financed welfare.

adjusted to particular policy expectations or from preference reversals over time) because they are taken *ex ante* and not *ex post*. Finally, rules might also help counteract the lack of internalisation of externalities inherent in the common-pool problem, as it offers an opportunity for agents to rise above the day-to-day struggle for resources. In contrast, one should not expect rules to help if the root cause of excessive debt accumulation is insufficient understanding of the long-run consequences of fiscal policy, unless the rules are imposed by external agents with better understanding than domestic legislators (as might be the case for some countries with EU fiscal rules).

Pragmatic considerations should play a role for the choice of intermediate objectives. One aspect concerns the possibility to *verify* fiscal outcomes. The problem of distinguishing between current expenditures and capital expenditures has been used as an argument against a golden-rule formulation according to which budget targets would encompass total government net savings (including net government investment) rather than just financial government net savings (net lending).<sup>20</sup>

Pragmatic considerations also speak in favour of targets rather than constraints for fiscal policy. Experience suggests that constraints in the form of deficit or debt ceilings act as quite weak incentives for fiscal restraint, as governments often choose to stay close to these ceilings in ordinary times, which implies little leeway in the event of adverse shocks. One example is the EU stability pact, where many countries were so close to the deficit ceiling of three per cent of GDP that the violations in the economic crisis became very large. Another example is the earlier fiscal rule in the UK according to which government net debt should be below 40 per cent of GDP. Since debt stayed close to this limit, the crisis has implied a huge violation of it with the consequence that the rule was abandoned.<sup>21</sup>

### **2.3 Credibility versus flexibility**

An important trade-off in the formulation of fiscal rules concerns *credibility* versus *flexibility*. Here, it is interesting to contrast the examples of Germany and Sweden.

Germany has recently reformed its fiscal framework by enshrining a new fiscal rule in its constitution.<sup>22</sup> The rule is a balanced-budget one: cyclically adjusted net borrowing should be zero. The rule is binding in the sense that it is followed up by a backward-looking indicator with memory. Deficits exceeding 0.35 per cent of GDP are accumulated in an account. When

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<sup>20</sup> Finanspolitiska rådet (2008).

<sup>21</sup> Office for Budget Responsibility (2010a,b)

<sup>22</sup> See Federal Ministry of Finance (2009),

the accumulated deficits exceed 1.5 per cent of GDP, the government is obliged to reduce them. Although this needs to be done only in cyclical upswings, the rule implies a strong commitment with limited possibilities of discretionary adjustment to unforeseen contingencies.

As discussed above, Sweden has the rule that government net lending should be one per cent of GDP over a *business cycle*. Given the difficulties of dating the cycle, this gives the government much discretionary leeway. The government uses five different indicators to evaluate whether the target is met: (i) a backward-looking ten-year average of actual net lending; (ii) a corresponding backward-looking average of cyclically adjusted net lending; (iii) a partly forward-looking seven-year average of net lending (encompassing actual outcomes three years back and forecasts for the current and the three coming years); (iv) a corresponding partly forward-looking average of cyclically adjusted net lending; and (v) current (this year's) structural net lending.<sup>23</sup> There is an apparent lack of transparency because the indicators represent conceptually very different targets (both with and without memory) and can show very different outcomes. This approach appears to have been chosen because the government wants to retain a large amount of flexibility regarding how fiscal policy can be used as a stabilisation tool.<sup>24</sup>

The German and Swedish approaches represent polar cases. The different choices may reflect that the “production possibility frontiers” with regard to credibility versus flexibility are different. The recent Swedish fiscal track record is better than the German one and a more flexible approach therefore probably entails a smaller credibility loss.

Still, it would appear possible to find a better trade-off between credibility and flexibility than in both Germany and Sweden. One in-between possibility would be to define a clear threshold just as in the German case (for example, a deviation of a certain magnitude from a well-defined past average of actual deficits), but not let this threshold automatically trigger a fiscal response. Instead, when passing the threshold the government could be obliged to explain to the parliament why the situation has arisen and whether a, and if so what, response is required.<sup>25</sup> This would serve to highlight the situation for the general public, but also give the government an opportunity to explicitly take the cyclical situation into account and possibly to reformulate future budget targets in response to the earlier deviation. The outlined procedure has some resemblance with the stipulation for the Governor of the Bank of England

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<sup>23</sup> Structural net lending incorporates adjustment for both the cycle and one-off fiscal measures. See Swedish Fiscal Policy Council (2010).

<sup>24</sup> Finansdepartementet (2010) and Spring Fiscal Policy Bill (2010).

<sup>25</sup> Swedish Fiscal Policy Council (2010) contains such a proposal.

to write an open letter to the Chancellor of the Exchequer when there has been a deviation of more than one percentage point from the inflation target.

### 3 Independent fiscal watchdogs

A way of strengthening incentives for fiscal discipline that has recently received widespread interest is to set up independent *fiscal watchdogs*. The establishment of such institutions with a remit to monitor public finances have recently been endorsed by European institutions such as the Ecofin Council, the European Commission and the ECB as well as by IMF staff members.<sup>26</sup> Several countries have also in recent years set up such independent fiscal institutions. They include Sweden (2007), Canada and Hungary (2008), Slovenia (2009) and the UK (2010).<sup>27</sup>

The recent trend towards establishing fiscal watchdogs has two sources of inspiration. The first comes from earlier existing institutions with a similar remit. These include the High Council of Finance (HCF) in Belgium (originally established in 1936 but with an extended remit in 1989), the Central Planning Bureau (CPB) in the Netherlands (from 1947), the Economic Council in Denmark (from 1962), the Congressional Budget Office (CBO) in the US (from 1975) and the Public Debt Committee in Austria (from 2002).

The second source of inspiration has been a series of academic proposals on independent fiscal institutions. The first one was von Hagen and Harden (1994). Later ones include Wren-Lewis (1996, 2002), Ball (1997), Blinder (1997), Calmfors (2003, 2005), Wyplosz (2002, 2005) and Kirsanova et al. (2007).<sup>28</sup> In several cases delegation of some actual fiscal policy decisions to independent fiscal policy committees (“hard option”) has been proposed. For reasons of political realism the discussion here focuses only on independent institutions with advisory or monitoring tasks but without decision-making power (“soft option”). I label such institutions *fiscal policy councils*.<sup>29</sup> All existing fiscal watchdogs are of this type.

#### 3.1 Tasks of fiscal policy councils

To analyse what the soft power of a fiscal policy council can achieve, it is helpful to start out from the discussion in Section 2.1 of various explanations of fiscal profligacy. It also makes

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<sup>26</sup> See, for example, Council of the European Union (2006), European Commission (2009) and ECB (2010) as well as Annett et al. (2005) and Debrun et al. (2009).

<sup>27</sup> See Debrun et al. (2009) and von Hagen (2010) for surveys of independent fiscal institutions. Mihály (2010) and Delpla (2010) also provide informative accounts of such institutions.

<sup>28</sup> See Calmfors (2005), Jonung and Larch (2006) and Debrun et al. (2009) for surveys of such academic proposals.

<sup>29</sup> This is the terminology used by, for example, Calmfors (2005), Wyplosz (2005), Rogoff and Bertelsmann (2010), Wren-Lewis (2010a) and von Hagen (2010).

sense to distinguish between the impact that could occur also in the absence of fiscal rules and the impact that may arise in conjunction with such rules.

Fiscal councils could obviously have a direct disciplining effect to the extent that a deficit bias depends on *insufficient understanding* of the long-run consequences of fiscal policy among both politicians and voters or on *politicians acting in their own interest*.<sup>30</sup> A council could increase awareness of the future costs of current deficits. It could help offset tendencies to overoptimism and overconfidence by highlighting historical examples and providing analysis of the sensitivity of budget calculations to various risks. By increasing *fiscal transparency* a council would make governments more accountable and thus make it harder for politicians to pursue their own interests. This could be done through monitoring of off-budget items and various attempts at creative accounting as well as through sustainability analyses. Since too optimistic forecasts seem often to have been used by governments to hide prolific fiscal policies, the provision of unbiased forecasts by an independent fiscal institution may also contribute to more fiscal discipline.<sup>31</sup> Independent analysis of macroeconomic developments also makes it more difficult for incumbent governments to try to signal competence to the electorate through deficit-increasing policy that raises output and employment only in the short term.

The discussion in Section 2.1 also pointed to *short-sightedness* of governments and *time-inconsistency* problems as important causes of excessive debt accumulation and to fiscal rules as an appropriate method to address these problems. Monitoring by independent fiscal policy councils that governments adhere to such rules is a way of making the rules more binding. It is well-known that fiscal rules strengthen the incentives for creative accounting to circumvent the rules.<sup>32</sup> A fiscal policy council can help spot such attempts and renounce them publicly. A council can therefore be a *complement* to a rule: it gives the council a benchmark to evaluate government policy against.<sup>33</sup> At the same time, more elaborate monitoring of adherence to a fiscal rule by an independent institution can allow the rule to be more flexible, permitting more contingencies: independent evaluations make it less necessary for a government to earn credibility through mechanical application of a simple and more easily monitored rule. For example, a fiscal policy council could add to the public's understanding of whether a government's explanation of a deviation from the fiscal target is convincing.<sup>34</sup>

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<sup>30</sup> See Rogoff and Bertelsmann (2010) and von Hagen (2010) for elaboration of these points.

<sup>31</sup> This point has been emphasised in particular by Jonung and Larch (2006).

<sup>32</sup> See for example von Hagen and Wolff (2006).

<sup>33</sup> See also Debrun et al. (2009).

<sup>34</sup> See the discussion in Section 2.3.

To the extent that one tries to address the *common pool* problem through a fiscal rule, an independent council again helps if it strengthens the incentives to observe the rule. But some fiscal institutions have also been designed to deal more directly with the common-pool problem by acting as mechanisms for coordinating various interests through the formulation of fiscal targets that are to serve as basis for budget negotiations. The Public Debt Committee in Austria and the HCF in Belgium are two examples.<sup>35</sup> Both these institutions have members nominated by various levels of government. However, this form of “representative” nomination could make it more difficult to fulfil an independent watchdog function. This risk appears particularly great in the Belgian case as the HCF is chaired by the Minister of Finance. The risk seems much smaller in the Netherlands where the CPB, which is a pure expert body, provides analyses of the macroeconomic and public-finance consequences of draft agreements between prospective coalition partners in the negotiating process preceding the formation of a new government.<sup>36</sup>

### 3.1 Tasks of a fiscal watchdog

A number of possible tasks for a fiscal policy council can be identified from both actual practice and various proposals. They can be summarised as follows:<sup>37</sup>

- The provision of “objective” macroeconomic forecasts on which government budget proposals can be based. This is done by, for example, the CPB in the Netherlands and the newly created Office for Budget Responsibility (OBR) in the UK.
- Costing of various government policy initiatives as done by, for example, the CBO in the US, the CPB in the Netherlands and the Parliamentary Budget Office (PBO) in Canada.
- *Ex ante* evaluation of whether fiscal policy is likely to meet its medium-term targets. Two examples are the Fiscal Council in Hungary and the OBR in the UK.
- *Ex post* evaluation of whether fiscal policy has met its targets. This is a key task for the Swedish Fiscal Policy Council.
- Analysis of the long-run sustainability of fiscal policy. Such analyses are performed by, for example, the CPB in the Netherlands, the CBO in the US, the Public Debt

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<sup>35</sup> von Hagen (2010),

<sup>36</sup> Bos and Teulings (2010).

<sup>37</sup> See Debrun et al. (2009), von Hagen (2010) and Mihály for surveys of the tasks of various fiscal institutions. Bos and Teulings (2010) provide specific information on the Netherlands, Calmfors (2008, 2010a) on Sweden, Kopits and Romhányi (2010) on Hungary, Office for Budget Responsibility (2010a,b) on the UK, and Page (2010) on Canada.

Committee in Austria, the Fiscal Council in Hungary and the Fiscal Policy Council in Sweden.

- Normative recommendations on fiscal policy. Only a few independent fiscal institutions engage in this. They include the Austrian Public Debt Committee, the Danish Economic Council and the Swedish Fiscal Policy Council.

The appropriate tasks for an independent fiscal policy council depend on the institutional environment. For example, the Swedish Fiscal Policy Council specialises in broader, overall evaluations of fiscal policy of a less-routine character with a heavy academic input, but does not engage in forecasting or in detailed budget projections. This is a natural choice given the existence of other government agencies with an acquired reputation for independent analysis. These include the National Institute for Economic Research (*Konjunkturinstitutet*), which provides independent macroeconomic forecasts as well as analyses of the effects of various tax and labour market reforms, and the Office for Budget Management (*Ekonomistyrningsverket*), which is responsible for continuously updating government budget forecasts and for the government's annual financial statement. In countries where such other institutions do not exist, these activities could instead be performed by a fiscal policy council. This is the reason why macroeconomic forecasting is done by, for example, the CPB in the Netherlands, the Economic Council in Denmark, the Fiscal Council in Hungary and the OBR in the UK.

The scope of activities of a fiscal watchdog obviously determines the resources needed. These also vary strongly among countries depending on the tasks. At one extreme is the CBO in the US with around 230 employees. The size is explained by the remit which includes macroeconomic forecasting, annual analysis of the President's budget, cost estimates of bills reported by congressional committees, long-term projections of macroeconomic trends as well as of federal revenues and expenditures, and analysis of the impact of policy changes on future budgets ("scoring").<sup>38</sup> At the other extreme is the Swedish Fiscal Policy Council, which carries out its more overall evaluations with a hired staff of only four persons (and a council of eight members performing their work as side activities to their ordinary employment). In between these polar cases are, for example, the Hungarian Fiscal Council and the Danish Economic Council (with staff of around 30 persons in addition to three full-time council members in Hungary and four chairs performing their work as side activities to their normal

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<sup>38</sup> See Debrun et al. (2009).

employment in Denmark). Given the variation in tasks it is impossible to define an optimal size. However, it is the view of the Swedish Fiscal Policy Council that its resources fall substantially short of what is required for a sustainable activity.<sup>39</sup>

There might emerge goal conflicts between the possible tasks for a fiscal policy council listed above. There is a risk that making forecasts and giving normative *ex ante* policy recommendations could make it more difficult to do unbiased *ex post* evaluations of government policy. As forecasts are likely to be wrong most of the time – and sometimes very wrong – engaging in this activity could also weaken the credibility of the council in the public eye and make it harder to fulfil other tasks.<sup>40</sup>

### *Does a watchdog need official status?*

It is sometimes asked why academics and other economic experts cannot just participate in the general public debate with forecasts, analyses, evaluations and recommendations either as individuals or as groups set up by various private institutions? Why would they need the stamp of being an official fiscal policy council? There are three possible answers to these questions.

1. A first answer is that having an official status does give more influence. Since there are many players competing for media attention, an official status gives an edge. Influence in the long term must, however, mainly build on the reputation (the institutional capital) that can be built up over time only through analysis that is perceived to be impartial and of high quality.
2. A second answer is that an official council can be given a formal role in the budget process, such that an arena for repeated exchange between politicians and civil servants on the one hand and council members on the other hand are created. This can be done in several ways: through the provision of forecasts and analytical input to be used in the preparation of the budget, through explicit policy recommendations to the government at some stage of the budget process, through evaluation of government proposals or through regular hearings with council members in the parliament.
3. The most important motivation for having an official fiscal watchdog may, however, be to commit independent academics and other economic experts to a sustained and consistent participation in the public discussion about fiscal policy. Being appointed to a fiscal policy council means a commitment to be up to date on fiscal policy issues

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<sup>39</sup> Calmfors (2010a).

<sup>40</sup> Wren-Lewis (2010a).

that may be difficult to get otherwise. With increasing research specialisation and increasing requirements on academic publishing, it seems to be becoming gradually more difficult to get academics to set aside time to take part in the economic policy debate. At the same time, the number of issues that economists study has widened dramatically. The establishment of an independent fiscal policy council can be seen as an institutional arrangement to re-direct academic talent in the direction of fiscal policy evaluation.<sup>41</sup> This could be interpreted as a remedy for a “market failure”: private demand for the services that a fiscal policy council can provide may not be large enough to generate the resources needed to make academics allocate sufficient time to such work.

### *Democratic legitimacy*

A criticism sometimes advanced against independent fiscal watchdogs is that is “undemocratic” to have unelected experts evaluate elected representatives.<sup>42</sup> The obvious counterargument is that such a watchdog provides a basis for decisions that take account of both the preferences of the majority of voters and economic constraints in a more rational way than would otherwise be the case (see Section 2.1). By providing better information for citizens, the possibilities of holding policy makers accountable are also increased.

It is important how the mandate of a fiscal policy council is formulated. From a democratic point of view it is hard to see objections against forecasts or analyses of the consequences of specific proposals by an independent council. The issue is more contentious when a council evaluates policy or makes normative recommendations. Even if the council is only advisory, agenda-setting power means a large influence over policy. For this reason, a council should not itself formulate the economic-policy objectives that guide its activities but instead base them on objectives formulated by the political system. Policy evaluations and recommendations should only concern the possibilities of reaching these objectives. This is also the way existing councils function.

One cannot, of course, dismiss the possibility that a fiscal policy council could misuse its powers and define its own political agenda, although this is likely to lead to a loss of reputation and influence. How large this risk is depends to some extent on how council

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<sup>41</sup> See also Calmfors (2010a),

<sup>42</sup> When the Swedish Fiscal Policy Council was established, the Social Democrats voted against. An argument used was that “ultimately it should be the elected representatives of the Swedish people who evaluate the policy pursued”. It was stated that “for this reason we reject the government’s proposal to give a fiscal policy council the task of evaluating the contents of policy” (Motion 2006/07:Fi10).

members are chosen (see Section 3.2). One way of reducing the risk of improper “political” behaviour could be to organise recurring international “peer reviews” of council activities.

A related issue is how a fiscal watchdog should time its activities relative to the political debate. The CPB in the Netherlands has a deliberate policy of trying to be ahead of the debate but to be more cautious once a debate on a certain topic is running between the political parties or between other interest groups.<sup>43</sup> In a similar vein, the independent chairs of the Danish Economic Council do not participate in the public debate before elections. Such a stand is not, however, unproblematic. It could just as well be argued that the input of an independent council is particularly important in situations of on-going political debates if citizens are to be able to form informed opinions. For this reason, the Swedish Fiscal Policy Council has not formulated similar constraints on its activities as the CPB in the Netherlands and the Economic Council in Denmark.<sup>44</sup>

A particular problem concerns the relationship between fundamental, higher-level objectives and intermediate targets. If the government has formulated a fiscal rule entailing a medium-term, intermediate budget target, it is a straightforward task to evaluate whether fiscal policy conforms to that target. But one could very well argue that a fiscal policy council should also have the task of analysing whether such a target conforms to the higher-level objectives of fiscal policy. Indeed, given the expertise that a fiscal policy council is likely to have, it may be considered particularly suitable to make such an analysis.<sup>45</sup>

The terms of reference for the Swedish Fiscal Policy Council state that it should assess “to which extent the government’s fiscal policy objectives are being achieved. These objectives include long-run sustainability, the surplus target, the ceiling on central government expenditure and that fiscal policy is consistent with the cyclical situation of the economy.” The council has interpreted sustainability as a fundamental, higher-level objective and has for this reason evaluated the consistency of the surplus target (for government net lending) with it at the same time as it has evaluated to what extent fiscal policy has conformed to the surplus target in the medium term.

However, it could also be argued that it could be (or could be believed by the general public to be) more difficult for a fiscal watchdog to evaluate whether the intermediate target is met if it views this target as inconsistent with the fundamental, higher-level objectives. In my view, the advantages of analysing the consistency between higher-level objectives and

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<sup>43</sup> Bos and Teulings (2010).

<sup>44</sup> Another reason is that it is part of the remit of the Swedish council to act as a “watchdog in the public debate”, as discussed in Section 4.2.

<sup>45</sup> See Finanspolitiska rådet (2008), Swedish Fiscal Policy Council (2009a, 2010), and Calmfors (2005, 2010a).

intermediate objectives are likely to outweigh the disadvantages. It should be possible to distinguish between the two types of considerations provided that the analysis is transparent enough.<sup>46</sup>

### **3.2 The set-up of a fiscal policy council**

Regarding the set-up of a fiscal policy council, several aspects should be considered:

- Independence
- Composition
- Influence

#### *Independence*

If a fiscal policy council is to act successfully as a countervailing force to fiscal irresponsibility arising from inherent tendencies in the political process, independence from the political sphere should be granted in much the same way as for central banks.<sup>47</sup> A council should have a clear mandate to pursue its remit in an independent way without government intervention in its activities. There should be a long-term budget for the council so that it does not have to fear that its resources may be cut if it reaches politically unpopular conclusions.<sup>48</sup> Long-term and non-renewable appointments are a way of reducing the risk that council members are unduly affected by re-appointment concerns. The benefits of this must, however, be balanced against the risk that long periods of office could make it harder to recruit members, especially from academia (see also the next section). There is also the problem that “low turnover” of council members could hamper the influx of new ideas. The Fiscal Council in Hungary where appointments are for nine years and non-renewable is an example of long periods of office.<sup>49</sup> In contrast, appointments to the Swedish Fiscal Policy Council are only for (maximum) three years.<sup>50</sup>

An important question is whether a fiscal policy council should be an agency under the government or under the parliament. The CBO in the US and the PBO in Canada are

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<sup>46</sup> See Wren-Lewis (2010a) for a similar conclusion.

<sup>47</sup> See also Debrun et al. (2009) and Calmfors (2010a).

<sup>48</sup> Lessons from the PBO in Canada show that this is a relevant concern. Its budget was reduced in 2009-10 after publication of reports that were regarded as controversial by the government (Page 2010).

<sup>49</sup> Kopits and Rományi (2010).

<sup>50</sup> The first members were appointed for a three-year period (2007-2010). After the first three-year period, appointments were made for only one year. The probable reason is that the government wanted an option to re-organise the council.

examples of fiscal watchdogs attached to the parliament.<sup>51</sup> So is the Fiscal Council in Hungary in the sense that its members are elected by the parliament.<sup>52</sup> In contrast, for example, the Economic Council in Denmark, the Fiscal Policy Council in Sweden and the OBR in the UK are all formally government bodies with appointments made by the government.<sup>53</sup> Putting a council under the parliament rather than the government is a way of emphasising that the council has a more independent standing than an ordinary government agency. It would also mean that decisions on the council's budget are taken in a different way than for other government agencies. Still, in a parliamentary democracy the difference between being under the parliament and being under the government may not be large, as MPs usually do not act in an independent way relative to the government.

A possible protection against political appointments is to have members appointed after proposals from the council itself. This procedure has been followed for the Economic Council in Denmark and it has been replicated in Sweden. The idea is to create a reputational cost for the government of not following the proposals.

A pertinent question concerns the nature of contacts between a fiscal policy council and the government: should they be both *ex ante* and *ex post* or only *ex post*. It may be thought that a council could exert greater influence on policy if it can give advice to the government in the process of preparing the budget before the government has made its stand public which it may be difficult to back from. Such *ex ante* advising behind "closed doors" would, however, make it more difficult for the council to make an independent *ex post* evaluation. For this reason, the Swedish Fiscal Policy Council has chosen not to have any *ex ante* contacts with the government (before publication of its annual report).<sup>54</sup> The council meets the Minister for Finance only in connection with the delivery of the report. In contrast, the arrangements for the interim Office for Budget Responsibility in the UK have been less clear in this respect, as the terms of reference allow it "to consult the Chancellor in preparing documents".<sup>55</sup> The experiences of the CPB in the Netherlands illustrate the risks associated with such procedures. Bos and Teulings (2010) claim that the regular meetings that take place with cabinet ministers

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<sup>51</sup> The director of the CBO in the US is appointed jointly by the House of Representatives and the Senate and can be removed by either house (Debrun et al. 2009). Although the PBO in Canada is attached to the Parliament, the head is appointed, and can be dismissed, by the Prime Minister (Page 2010).

<sup>52</sup> The President of the Republic, the Governor of the National Bank and the President of the State Audit Office nominate one candidate each (Kopits and Rományi 2010).

<sup>53</sup> The currently existing OBR in the UK has been set up as an interim government agency, but it is stipulated in the terms of reference that it should be accountable to the Parliament. The OBR is now in the process of being transformed into a permanent office. It is likely that the Treasury Select Committee in Parliament will get the right to veto the appointment of the chair of the OBR (Chancellor of the Exchequer 2010).

<sup>54</sup> Calmfors (2010a).

<sup>55</sup> Office for Budget Responsibility (2010a,b).

are used to put pressure on the bureau to change parts of its analysis that do not fit the views of the government.

The UK provides an example of how problematic close cooperation between a fiscal watchdog and the ministry of finance can be. The institutional set-up chosen so far is that the OBR prepares a pre-budget forecast that is used by the Treasury in its work on the budget bill. But the office also prepares an analysis of the actual budget which is presented simultaneously with the budget. This timing would seem to invite problems, as it requires an on-going exchange between the office and the Treasury during the budget process that could make it difficult to make an independent evaluation.<sup>56</sup> At least it is obvious that such a procedure makes the relationship between the watchdog and the ministry of finance less transparent. A more transparent procedure would be for the watchdog to deliver its analysis of the budget *ex post*.

A risk that should not be underestimated derives from the fact that in a small county – almost – everybody in a field such as economic policy-making and economic policy analysis knows each other. This means that when evaluating government policy, council members are likely to be evaluating people they know well and may have worked or studied together with. This may create a psychological bias to be “too kind”. This problem is difficult to cope with. A partial remedy may be to recruit also foreign members to the council.<sup>57</sup>

### *Composition*<sup>58</sup>

There are at least four possible pools of people from which council members could be recruited:

- Academic researchers
- Public finance experts from various parts of government administration
- Analysts in the financial sector
- Ex-politicians

Academics and public finance experts from government administration seem to be the most common recruitment pools for existing fiscal policy watchdogs.<sup>59</sup> Academics could be

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<sup>56</sup> Indeed, the independence of the OBR’s analysis of the new British government’s first budget in June this year was immediately called into question. The credibility problem has been exacerbated by the fact that the OBR was at its start provisionally staffed by economists on temporary leave from the Treasury. See Giles (2010), Financial Times (2010) and Calmfors (2010b).

<sup>57</sup> In the Swedish Fiscal Policy Council’s first years of existence the vice chair has been from Denmark.

<sup>58</sup> See also Calmfors (2010a).

<sup>59</sup> See Debrun et al. (2009) and von Hagen (2010).

expected to apply fresh research perspectives. Another important advantage of academics concerns independence: since academics' main arena is another one than politics and government administration, their judgements are likely to be less affected by political concerns than those of most other groups. There would be a high reputational cost in the academic arena for researchers who were seen to be acting in a political way in the council rather than making research-based judgements.<sup>60</sup>

Academics are not, however, likely to have the expert knowledge of government budgets and government accounting that may be necessary to make detailed assessments of budget bills and public finance forecasts. This is an argument for also including public finance experts with a background in government administration. But there could be a risk that they are to a larger extent than academics influenced by concerns over future career possibilities in government administration. An alternative are analysts from the financial sector. A disadvantage with them might, however, be loyalties to earlier or (expected) future employers in the sector.

A final possibility is to use ex-politicians. In the Swedish Fiscal Policy Council, two ex-politicians (a former Social Democratic Minister for Finance and a former Vice Chair of the Swedish Tory Party) complement six academics. The presence of well-known former politicians, in addition to economic experts, may be important for the legitimacy of a fiscal policy watchdog. It may help fend off the usual critique that academics are too far-off from the "real world" to be able to make useful inputs in the public policy debate. More importantly, the impact of a council is promoted if politicians from different parts of the political spectrum endorse its conclusions. A possible drawback is that former politicians may be restricted in their analyses by the earlier positions they have taken in public. They might for this reason be less open than academics to new thinking when new problems arise and in this way confine the analysis.

An alternative way of linking independent evaluations to the political sphere is to let a broader set of people representing various interests express their views on reports written by pure experts. This is done in Denmark, where the Economic Council's four independent chairs produce semi-annual reports that are commented on by representatives (in fact as many as 26) of unions, employers, the central bank and the government.<sup>61</sup>

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<sup>60</sup> A similar argument has been advanced by Alesina and Tabellini (2007) when analysing the relative merits of political and bureaucratic decision-making. Alesina and Tabellini emphasise the incentives for non-political decision-making by technocrats, because the career concerns in this group are mainly related to peer evaluation.

<sup>61</sup> Debrun et al. (2009). Formally, these representatives are also members of the Economic Council, although they are not involved in the preparation of the reports by the independent chairs.

My overall conclusion is that, for reasons of independence, the majority of the members of a fiscal council should be academics, but that it could be wise to complement them with members with other backgrounds.

### *Influence*

In the long term, the influence of a fiscal watchdog is determined by the quality of its work. To be influential it must earn a reputation for good and impartial analysis. Such a reputation can create a media pressure that makes it difficult for the government to ignore the watchdog's analyses and recommendations. Examples of institutions that have over time acquired a reputation that gives them a strong position in the public debate are the CPB in the Netherlands and the Economic Council in Denmark. In contrast, similar bodies in Germany do not seem to have succeeded in this respect.<sup>62</sup>

It is important that the analyses of an independent council are not perceived as always mechanically recommending more fiscal restraint than the government, but as being genuinely open-minded and taking account of the specifics of every situation. For this reason, the Swedish Fiscal Policy Council's recommendation to the government in 2009 to take stronger stimulative fiscal action to counter the recession (at the same time as long-term fiscal restraint was advocated) probably enhanced the council's reputation for an open-minded analysis.<sup>63</sup>

The exact mandate of a fiscal watchdog matters for its impact. Ideally, one would hope that purely impartial analysis involving forecasts, analyses of the fiscal effects of various actions, sustainability calculations etc. has a strong influence on policy decisions. In my view, this is unlikely to be the case, as it requires a large effort on the part of journalists and other "consumers" of the watchdog's analyses to convert them into clear-cut policy conclusions. Normative evaluations and recommendations are likely to carry more weight – provided that they are underpinned by good analysis – as they provide the public with a clear benchmark against which to judge current policy.

In the short term, the government's attitude to a fiscal policy council is very important. A government can give it a "flying start" by committing to build on its analyses and heed its advice. The OBR in the UK provides an example: the government has committed to build its

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<sup>62</sup> According to von Hagen (2010) institutions such as the Council of Wise Men (*Sachverständigenrat*), the Council of Academics Advisors to the Minister of Finance and the Joint Business Cycle Forecasting Group "lack visibility and respect by the government and or their professional peers, with the result that their reports and recommendations do not catch much public attention".

<sup>63</sup> Swedish Fiscal Policy Council (2009a,b and 2010) and Calmfors (2010a).

budget bill on the forecasts of the office and to be guided by its assessments of whether the fiscal targets are likely to be met. The government can also enhance the status of the watchdog by institutionalising its responses to the reports produced, for example through regularly including comments to it in the budget bill and other policy documents. The parliament can contribute by regularly organising public hearings on the basis of the watchdog's reports.<sup>64</sup>

One should, however, expect the government's appreciation of a fiscal watchdog to be greater *ex ante* than *ex post*. This is clearly illustrated by the experiences of the Swedish Fiscal Policy Council, where the government's comments have over time become more critical as it has tried to defuse critique from the council through pejorative remarks on its work.<sup>65</sup> It is not clear, however, what effect this has, as it also strengthens the picture of the council as an institution that is independent of the government.

### 3.3 Fiscal watchdogs and the European dimension

A natural question is how independent fiscal policy councils fit into the European context. It is a common conclusion in the current discussion of economic governance in the EU that more stringent national fiscal frameworks are key to improve adherence to the fiscal rules in the stability pact.<sup>66</sup> The establishment of national fiscal policy councils has been pointed to as one way of achieving this. One possibility could be that the Commission and the Ecofin Council regularly ask the views of national fiscal watchdogs when evaluating the stability and convergence programmes that member states are obliged to submit. This would also represent a way of boosting the status of the watchdogs at the national level.

There are also proposals to set up an independent fiscal council at the European level.<sup>67</sup> One idea would be to let such an institution monitor that national fiscal frameworks meet certain minimum standards. A European fiscal council (possibly with an input from national council) could also have a role to play in the broader macroeconomic surveillance of member

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<sup>64</sup> For example, the Budget Bill of the Swedish government now regularly includes a section summarising and commenting the Fiscal Policy Council's annual report. The Finance Committee in the Parliament regularly organises a public hearing on the basis of the council's annual report, which is used as an input in the committee's evaluation of the government's Spring Fiscal Policy Bill (see, for example, Finansutskottet 2010),

<sup>65</sup> These include comments from the Minister for Finance like "I find it good that the Fiscal Policy Council has attained the insight that sustainable public finances are important" (Kask 2010) or that the chair of the council "sat messing with his pen while the Ministry of Finance worked day and night to rescue the economy" (Dagens Nyheter 2010).

<sup>66</sup> See, for example, European Commission (2010a,b), European Council (2010), ECB (2010), Fatàs and Mihov (2010), Lane (2010) and Wyplosz (2010).

<sup>67</sup> See, for example, Calmfors (2010c), ECB (2010) and Burda and Gerlach (2010).

states on which there seems now to be an emerging consensus.<sup>68</sup> The rationale for such broader macroeconomic surveillance is the insight from the recent Irish and Spanish experiences on how fiscal surpluses can very quickly turn into unsustainable deficits when the economy goes from boom to bust. Such surveillance must be of a judgemental character and is therefore exposed to even larger risks of political interference than pure fiscal surveillance, which can be more rules-based. This is a strong argument for why broader macroeconomic surveillance should be carried out by an independent European body.

Finally, a European fiscal council could have a role to play in overseeing national councils. It could provide the international “peer reviews” of the national bodies that I discussed in Section 3.1 as a safeguard against their overstepping their mandates.

#### **4 The general problem of providing sufficient research input into the political process<sup>69</sup>**

As is clear from the discussion in Sections 2 and 3, deficit bias can to a large extent be seen as arising from insufficient understanding of the consequences of excessive government debt accumulation. To the degree that this is the case, it is a manifestation of the general problem of too little analytical (research) input, or at least of too little attention being paid to such input, in the political process at large. This motivates a broader discussion of how to secure that available research is sufficiently taken account of in the economic policy-making in general.

The ideal process is one where policy is conducted by well-intending politicians who try to maximise a well-defined social preference function. In that case politicians are eager to obtain relevant knowledge about behavioural relationships from researchers. Given knowledge about various trade-offs, politicians then seek to achieve the best outcomes possible.

This idealistic picture is probably far from reality. One can also see politicians as representatives of various interests who try to strike a balance between their preferences and their desire to get re-elected. In this balancing act, politicians use many instruments. Research is one. For this reason, politicians have a strong temptation to use research strategically by emphasising results that give arguments in favour of their preferred policies and trying to discredit results that provide arguments against them. Whereas peer pressure in academia provides a strong incentive to separate as clearly as possible value judgements and the analysis of various relationships, politicians have a strong incentive to try instead to confound

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<sup>68</sup> See, for example, European Commission (2010a,b) and ECB (2010).

<sup>69</sup> The discussion in this section builds to a large extent on Calmfors (2009b, 2010a).

value judgements and research results to further their political aims. To the extent that they succeed in this, they are likely to be rewarded by both their political parties and the electorate.

#### 4.1 In-house advising or external evaluation

My discussion raises the issue of finding institutional forms for securing a sufficient impact on the economic policy-making process from research input. One can distinguish between two ways of doing this: *in-house* advising inside government ministries and agencies and analysis/recommendations from *external* evaluators.

Although the scale varies, most governments make widespread use of panels of outside economic experts, mainly from academia, who are used for in-house policy-advising. This form of providing research input, however, suffers from the drawback that (active) researchers, on temporary assignments, have great problems in asserting themselves against other, more permanent, interests in the internal decision-making process within a ministry or a government agency. To do that is just not the comparative (nor the absolute) advantage of researchers.<sup>70</sup>

External analysis and policy recommendations that are made public have the advantage that policy makers must take a public stand regarding them and provide explanations if they are not taken into account. In, for example, Sweden there seems to be a media logic involving an increased interest among journalists of confronting policy makers with external expert opinions.<sup>71</sup> External evaluations also imply smaller risks that the researchers involved will become co-opted in an ongoing advising process than in-house advising. Clearly, it may be much more difficult to criticise sharply the policies of decision-makers if policy recommendations are given repeatedly in cosy in-house meetings than if they are given at arm's length distance.<sup>72</sup>

One should not see in-house advising and external evaluation as substitutes. Instead, they should be regarded as complements. To the extent that external evaluation exposes lack of analytical competence within ministries and government agencies, there is an incentive to acquire more such competence to match the external monitoring. There are also often ongoing struggles within government ministries between civil servants wanting more research

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<sup>70</sup> See Calmfors (2009b) regarding experiences from the Economic Council of Sweden, which was an in-house committee providing academic input to the Swedish Ministry of Finance in 1988-2006. The conclusion is that the publicised recommendations of the Fiscal Policy Council have had much larger impact than the in-house advice of the former Economic Council.

<sup>71</sup> Calmfors (2009a).

<sup>72</sup> To the extent that in-house advising takes the form of published reports it is likely to have a larger impact than otherwise and the risk of co-optation is reduced.

input and politicians wanting to press ahead with various policies on their agenda. In such cases, the hands of civil servants will be strengthened by external monitoring.

#### 4.2 A broader remit for a fiscal policy council?

A natural question is whether a fiscal policy council could be given a broader remit than just to evaluate budget outcomes. Some of the existing independent institutions discussed in Section 3 have such a broader remit. The CPB in the Netherlands undertakes research on a broad range of economic issues including also employment and regulatory policies as well as resource depletion and financial crises.<sup>73</sup> Similarly, the Economic Council in Denmark provides judgements also on tax, employment and other structural policies as well as on environmental issues.<sup>74</sup> The Council of Wise Men (*Sachverständigenrat*) in Germany analyses a wide range of issues.<sup>75</sup>

The Swedish Fiscal Policy Council, too, has a much broader remit than just budget policy.<sup>76</sup> It is also to “evaluate whether economic developments are in line with healthy long-run growth and sustainable high employment”. This has motivated analyses of, for example, the reforms of unemployment and sickness insurance, changes in labour market policy, the introduction of an earned income tax credit and tax deductions for household-related services, and the use of regular education as a countercyclical tool. In addition, the council is instructed to examine “the clarity of the government’s budget bill and spring fiscal policy bill, in particular with respect to the grounds given for economic policy and the motivations for policy proposals”. This is complemented with a general instruction to “work to achieve an increased public discussion in society of economic policy”. One can interpret these latter tasks as a general one of being a “debate watchdog” helping to raise the general quality of the economic policy discussion.

How should one regard such an extended remit for a fiscal policy council? There are both drawbacks and benefits. A drawback is that the resources of the council are spread more thinly. There is also a risk that interest in less tangible long-run fiscal sustainability issues among the general public is crowded out by more concrete short-run issues concerning youth unemployment, specific tax proposals etc. The experiences of the Swedish Fiscal Policy Council indicate that these risks are real: the analyses of employment and tax issues have received much more media attention than the analyses of fiscal sustainability and fiscal

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<sup>73</sup> Bos and Teulings (2010).

<sup>74</sup> See [www.dors.dk](http://www.dors.dk).

<sup>75</sup> von Hagen (2010).

<sup>76</sup> Förordning 2007:760.

frameworks. A benign interpretation is, however, that this could reflect the strong public finances in Sweden, which make fiscal sustainability issues less pressing than elsewhere.

There are also great benefits with the Swedish council's broad remit. An argument for simultaneous analysis of fiscal sustainability and employment is the strong interaction between them. All the additional tasks are also important ones. If one wants to have high visibility for economic policy analyses, it may not be possible to have a host of different evaluating agencies (as witnessed by the experiences of Germany).<sup>77</sup> At least in a small country, it might be difficult to fill a multitude of independent evaluating institutions with sufficiently competent staff. There may also be a greater impact if several types of analysis are made by one institution with a solid reputation than by a large number of institutions that the public may have difficulties to identify. At the same time, a "monopoly situation" for an policy-evaluating institution may entail risks.

It is not obvious how one should trade off the advantages of an extended remit for a fiscal policy council against the disadvantages. There is not likely to be a unique solution that is optimal for all countries. If there already exist other independent or semi-independent government institutions that do more detailed macroeconomic forecasting and analyses of public finances – as is the case in Sweden – it seems more appropriate than otherwise to extend the remit of a fiscal watchdog in the way that has been done there. The argument for this is much weaker if independent institutions analysing and evaluating policy in other areas have already been established. Another important factor is the economic situation. In countries with severe fiscal problems it is probably wise, at least initially, to focus an independent council's activities only on them.

### **4.3 Is there a risk of a political bias?**

When the Swedish Fiscal Policy Council was set up, the concern that there would be a political bias in the council's analyses and recommendations was raised. The position of the Left Party was that "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".<sup>78</sup> In the UK there might be similar concerns that the Office for Budget Responsibility has been established to provide analytical support for traditional Tory policies.

To the extent that there is any political bias in the activities of an institution like the Swedish Fiscal Policy Council, I would expect it to be of another type. With a remit to

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<sup>77</sup> See Section 3.2.

<sup>78</sup> Motion 2006/07:Fi7.

evaluate government policy, it is natural that such analysis focuses mainly on the scope for improvement rather than on praising the already good. So the reports of an independent council with such a task is likely always to contain substantial parts that are critical of various government policies and recommendations on what is perceived as better policies. But if the political opposition's proposals are not subjected to similar critical evaluations, an impression may be created that the council is more critical of the incumbent government's policies than of the alternatives proposed by the opposition, even when the reverse is the case.<sup>79</sup>

In the long term, such a bias problem is likely to be less severe than in the short term, as the public will learn that the council makes critical evaluations of the policies of all governments. But to correct such a bias in the short term, the remit of an independent council would probably have to be extended to evaluations also of the economic policy proposals of the opposition. Although this would amount to a substantial extension of the remit, it could be justified from the point of view of providing voters with a more complete basis for their decisions.<sup>80</sup> An example of how this can be done is the CPB in the Netherlands: a practice has developed according to which the larger political parties before elections submit their political platforms to the bureau for assessment.<sup>81</sup>

There is one sense in which the opposition is likely always to benefit more than the government from an independent council. This is because a government has access to more "research" resources than the opposition. The opposition is therefore likely always to gain in relative terms from independent policy analysis of the type that an independent council provides.<sup>82</sup>

## 5 Conclusions

The current public debt problems in many advanced economies have focused interest on fiscal frameworks. In particular, there has been an increasing interest in independent fiscal watchdogs (fiscal policy councils). Several countries have recently established such institutions. They include Sweden (2007), Canada (2008), Hungary (2008), Slovenia (2009) and the UK (2010). One source of inspiration has been earlier existing institutions of a similar type, such as the Central Planning Bureau (CPB) in the Netherlands, the Economic Council in

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<sup>79</sup> See also Calmfors (2010a).

<sup>80</sup> Wren-Lewis (2010b) has proposed that the remit of the OBR in the UK should be extended to also costing the budget proposals of the opposition before an election.

<sup>81</sup> Bos and Teulings (2010).

<sup>82</sup> See also Calmfors (2008, 2010a).

Denmark and the Congressional Budget Office (CBO) in the US. Inspiration has also come from a series of academic proposals over the last fifteen years.

Fiscal watchdogs could have a direct disciplining effect on government budgets by helping to increase awareness of the future costs of current deficits. Such watchdogs could increase fiscal transparency through monitoring of off-budget items and various attempts at creative accounting. Fiscal policy councils can in this way also act as a complement to fiscal rules by monitoring that they are observed.

Possible tasks for a fiscal policy council include:

- The provision of “objective” macroeconomic forecasts on which government budget proposals can be based.
- Costing of various government initiatives.
- *Ex ante* evaluation of whether fiscal policy is likely to meet its medium-term targets.
- *Ex post* evaluation of whether fiscal policy has met its targets.
- Analysis of the long-run sustainability of fiscal policy.
- Normative recommendations on fiscal policy.

The exact remit varies among the existing fiscal watchdogs. Some of them do only positive analysis. Others make normative judgements. When this is done, it is based on the fiscal objectives formulated by the political system itself. Councils making normative judgements are likely to carry more weight than those that do only positive analysis, as they provide the public with a clear benchmark against which to judge policy.

In the long term, the influence of a fiscal watchdog is determined mainly by the quality of its work. To be influential it must earn a reputation for good and impartial analysis. Such a reputation will create media pressure that makes it difficult for the government to ignore the watchdog’s analyses and recommendations. In the short term, a government can give a watchdog a “flying start” by committing to build on its analysis and heed its advice. It is important to establish institutional forms for the interaction between the watchdog on the one hand and the government and the parliament on the other.

If a fiscal policy council is to act successfully as a guardian of responsible fiscal policy, independence from the political sphere should be granted in much the same way as for central banks. A council should have a clear mandate to pursue its remit in an independent way without government intervention. It should have a long-term budget. The independence of a

fiscal policy council is promoted if the majority of council members is made up of academics, since they do not depend on the political sphere for their careers.

To the extent that deficit bias arises from insufficient understanding of the consequences of excessive government debt accumulation, it can be seen as a manifestation of the general problem of too little analytical (research) input into the economic policy process at large. This raises the question of whether fiscal policy councils should have a broader remit than just to monitor fiscal policy. Indeed, independent institutions in some countries have such a broader remit, involving also tax, employment and other structural policies. This is the case for the Central Planning Bureau in the Netherlands and the Economic Council in Denmark. The Swedish Fiscal Policy Council, too, has such a broader remit. It includes the role of a “debate watchdog”, since one of the tasks is to examine the clarity of government budget and policy bills and the motivations for policy proposals.

There are both drawbacks and benefits with such an extended remit. A drawback is that resources are spread more thinly. There is also a risk that interest in less tangible fiscal sustainability issues among the general public is crowded out by more concrete short-run issues concerning specific labour market reforms, tax policies etc. An argument in favour of an extended remit is the strong interaction between fiscal sustainability and high employment. A broad remit has also the advantage that there may be a greater impact if several types of analysis are made by one institution with a solid reputation than by a host of different institutions that the public may have difficulties to identify. In a small country, it might also be difficult to find sufficiently qualified staff for a multitude of independent monitoring institutions.

It is not obvious how to trade off the advantages of an extended remit for a fiscal policy council against the disadvantages. Desirable solutions are likely to differ among countries. If there already exist other independent government institutions that do detailed macroeconomic forecasting and analyses of public finances, there is a stronger case than otherwise for a broader remit. The argument for this is weaker if independent institutions analysing and evaluating policy in other areas have already been established. In countries with severe fiscal problems, it is probably wise to focus an independent council’s activities only on them, at least initially.

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