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Fiscal policy councils: Unlovable or just unloved?

Charles Wyplosz *

Summary

■ Independent Fiscal Policy Councils (FPCs) share the attractive features of independent Monetary Policy Committees in central banks. They offer many of the advantages of both rules and discretion, without their drawbacks. Rules are bound to be counterproductive sometimes because unexpected events occur. Discretion, the most frequent practice so far, has been accompanied by debt buildups that are testimony of fiscal indiscipline. The question is why so few countries have adopted FPCs and why, when they did, they chose a soft version. This paper argues that there are serious difficulties, none insurmountable, and many misconceptions, which are examined one by one. It also asserts that the true reason why FPCs are not loved by governments is the same that lies behind fiscal discipline: the presence of highly effective interest groups. ■

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* *Charles Wyplosz is Professor at Graduate Institute of International Studies, Geneva and CEPR.*

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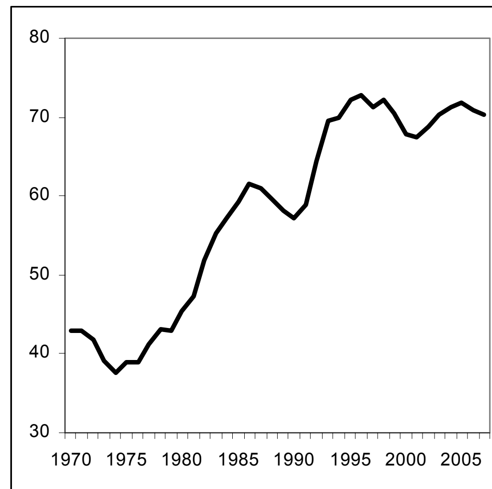
There is little doubt that fiscal indiscipline is a widespread problem. Since the mid-seventies, the average gross debt of OECD countries has risen from about 40 percent to about 70 percent of GDP, see Figure 1. There is nothing necessarily wrong with rising debts, provided that they contribute to raise future income. Herein lies the central policy issue: how do we know whether a deficit is justified or not? The experience of the last four decades is that there is no presumption that governments have carefully considered the issue, quite the contrary. Under these conditions, two objectives need to be tackled simultaneously. First, the tendency toward debt accumulation must generally be held in check. Second, debt should be allowed to rise whenever this is justified. It is usually recognized that the need to avoid a pro-cyclical policy stance is one justification; another is the financing of productive public investment.

The first objective has gained popularity in recent years, leading to the adoption of a number of fiscal rules in several countries. The European Stability and Growth Pact (SGP) is a prime example with its stark 3 percent deficit ceiling. Other examples include the Swiss "brake", which mandates spending cuts to maintain the cyclically-adjusted budget in balance and Norway's rule limiting the budget deficit to 4 percent of its Petroleum Fund over the length of a business cycle. A common feature of these rules, however, is that they allow for some flexibility over the business cycle. Sometimes, as in Britain's Code for Fiscal Stability, they include a "golden rule" according to which public investment is excluded from current spending. Thus, the second objective is typically also taken into account.

However, as they allow for some flexibility, most rules open up breaches that may ultimately undermine them. *A contrario*, inflexible rules eventually clash with unplanned contingencies. For instance, the SGP had to be put in abeyance in 2003 because it had not been anticipated that a long period of slow growth would erode budget balances to the point where fiscal policies had to become strongly pro-cyclical to respect the 3 percent limit. Finding the right balance be-

tween strict and flexible rules looks like mission impossible. So far, we do not have enough evidence to assess whether the few existing rules adopted in recent years can withstand the passage of time.

Figure 1. Average gross public debt in the OECD countries (percent of GDP)



Source: Economic Outlook 2, 2007, OECD

While improving fiscal rules is a valid research agenda, another approach looks at least as promising. Inspired by the so far highly successful performance of independent central banks, a number of authors have proposed the setting-up of independent fiscal policy councils (Eichengreen et al., 1999; Calmfors, 2003; Wyplosz, 2002, 2005). This alternative is based on the premise that adequate institutional arrangement can deliver better outcomes than rules. Yet, in spite of its logic, this argument has so far failed to convince most policymakers.

This paper reviews the logic behind Fiscal Policy Councils (FPCs) with the aim of understanding why this—otherwise lovable—idea is apparently so unpalatable—so little loved—by politicians. I will argue that there are two main reasons. The first, partly mistaken, is that it is seen as clashing with the time-honored principle that only elected representatives of the people should have the right to make budgetary decisions. The second is that the proposal is perceived as a threat by those interest groups that lie at the root of the deficit bias, and rightly so.

1. The problem

A large body of literature has developed convincing explanations for why many countries seem to suffer from a deficit bias and end up uselessly accumulating large public debts. The first and most convincing interpretation is the common pool problem. This label recalls the "tragedy of the commons", initially described and interpreted by Hardin (1968). The idea has been applied to the case of fiscal indiscipline by von Hagen and Harden (1995) and Krogstrup and Wyplosz (2006). According to this interpretation, interest groups vie for ever larger transfers or spending items for which they care, because they expect to pay for only a fraction of the corresponding costs. Governments and Parliaments should realize that this constitutes an externality but, if they are captured by the interest groups, they agree to economically excessive deficits. Another interpretation involves time inconsistency (Alesina and Tabellini, 1990). The idea is that governments may wish to saddle their successors, which have a non-negative probability of being occupied by rival political parties, with a large debt that will limit their ability to carry out spending of which they disapprove. This can be seen as the result of an intertemporal externality (Krogstrup, 2006).

These interpretations capture what can be called a political failure. Indeed, the deficit bias arises with democratically elected governments. Under the common pool interpretation, it is enough that a sufficient number of voters be member of one of the interest groups or the other. The second interpretation results from the existence of partisan politics: voters support rival parties on ideological grounds, but shifting preferences allow for different parties to alternate in power. The political failure is the consequence of an externality, which justifies some intervention.

The mode of intervention is complicated by the fact that governments have no electoral interest in eliminating the political failure. Being captured or partisan is socially bad, but this is the game that politicians need to play to be voted into power. Individual interest groups or ideologically-biased voters would like to prevent others from acting as they do, but individually wish to continue. Therefore, it is not clear how a majority could be assembled to reduce the political failure. Put differently, the externality that gives rise to the deficit bias also prevents its treatment by adequate measures.

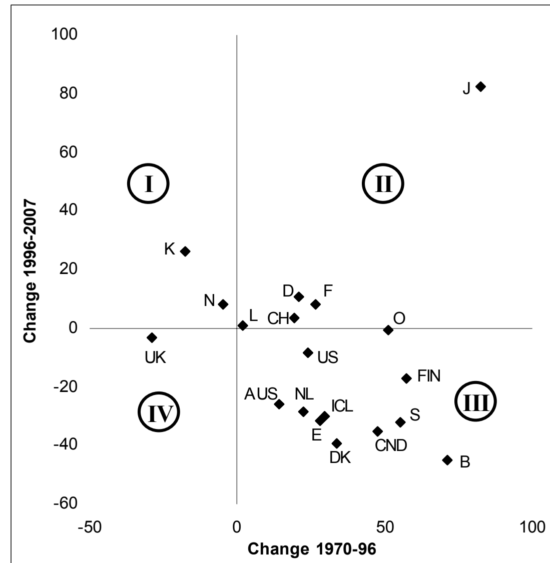
This observation may explain why so few governments have adopted budget rules. As I argue below, it may also explain why the proposed creation of FPCs has met with little success. It also provides an interpretation of the SGP. The externality among national interest groups can also spill into an international externality if the interest groups also hope that some of the costs of the expenditures that they champion can be passed onto foreign taxpayers. Under this interpretation, it is logical that governments wish to block claims on their resources by foreign interest groups since these are not domestic voters. This is even more so if some countries fear that the externality, and the associated deficit bias, is worse in other countries. In the case of the SGP, it is Germany that insisted on adopting deficit limits, reportedly because it feared the indiscipline of Italian politics.

As is the case with every externality, a coordinated approach can be Pareto-superior to the uncoordinated one. In the presence of pecuniary externalities, the coordinated solution is to establish property rights and rely on market forces. In the present case, the externality is political in nature and the solution is unlikely to be market-based. It remains possible that the voters recognize the inefficiency of the outcome and support a coordinated solution. Indeed, fiscal discipline seems to have been established in a number of countries.

This is illustrated in Figure 2, which compares the change in the gross public debts over 1970-1996 and over 1996-2007 in the OECD countries. Quadrant III shows the ten countries that managed to established previously lost fiscal discipline since they managed to bring down—or stabilize in the case of Austria—their debt-to-GDP ratios over 1996-2007, which had been allowed to increase over the period 1970-1996. Only four countries, shown in Quadrant II, display continuous indiscipline.[1] Quadrants I and IV, with loss of discipline and continuing discipline, respectively, jointly include only three countries. Work by von Hagen and Harden (1995), Alesina and Perotti (1995), Alesina et al. (2006), and others has started to shed light on the political and institutional conditions that explain how and why several countries have managed to adopt a coordinated solution. Most of the time, institutions have been changed.

[1] Italy is missing from the sample due to lack of data for the entire period.

Figure 2. Changes in gross public debts (percent of GDP)



Source: Economic Outlook 2, 2007, OECD.

2. The solution, in principle

2.1. Fiscal rules

The simplest way of establishing fiscal discipline is to forbid deficits. This is the solution adopted, for instance, among most states in the US. Simplicity comes at a cost, however, since it implies foregoing the use of fiscal policy as a counter-cyclical instrument. In fact, it often implies that fiscal policy becomes pro-cyclical when downswings worsen the budget balance and it becomes necessary to tighten up policy. The cost is limited for US states for two reasons. First, the federal budget can be used to conduct counter-cyclical policies, which is valuable when the states business cycles are positively correlated. Second, as in most federal states, there exists a transfer mechanism which smoothes about 10-15 percent of the asymmetric shocks.[2]

This explains why the balanced-budget principle has not been generally adopted at the national level. A closely related idea is a rule that

[2] See von Hagen (2007) for a review of the empirical literature.

sets a limit to the size of the deficit. The European Union's Stability and Growth Pact is a prime example of such a rule. A variant is the golden rule, which applies the balanced-budget principle to current expenditures, leaving out public investment spending on the grounds that productive spending pays for itself through its effect on growth. Germany has operated a golden rule for a long time, largely by assuming a rule of thumb according to which public investment represents about 3 percent of GDP. The Stability and Growth Pact, at least in its early incarnation, can be seen as implementing a German-type golden rule.

By definition, rules must occasionally be binding. Well-designed rules are binding when needed. For instance, it is desirable to prevent a government from running a budget deficit in the hope of winning an election. But rules may also be binding in circumstances when it would be desirable that they were not. For example, in 2003, in the third year of a generalized slowdown, many Euro area countries hit the 3 percent deficit limit and were contemplating being forced to conduct pro-cyclical fiscal policies. Unsurprisingly, the pact was then declared "in abeyance". To avoid such a situation, rules can be contingent, but the contingencies must be precisely described, otherwise they can be used as loopholes that undermine the rule. In fact, the Stability and Growth Pact is contingent: the rule does not apply in a year when the GDP declines by 2 percent or more. However, the 2001-2003 recession was shallow and long, not deep and sudden. This example serves as a reminder that it is generally impossible to anticipate all situations where it would be desirable to suspend the rule. As a consequence, any rule, even a contingent one, is bound to be counter-productive one day. The issue, then, is whether it is worth bearing the associated costs.

2.2. Institutions

The question of whether rules are an appropriate solution is not new, nor is it specific to fiscal policy. Much of the literature, starting with the seminal paper by Kydland and Prescott (1977), has been dedicated to the case of monetary policy. Like fiscal policy, monetary policy must be constrained to deliver price stability but can also be used to stabilize output and employment over the business cycle. The evolution of the literature is interesting.

Initially, the idea that rules dominate discretion was widely accepted and led many central banks to adopt one form or another of

the money growth rule that had been proposed long before by Friedman (1968). The unforeseen instability of money demand led to the realization that institutional arrangements may dominate both rules and discretion. The inflation targeting strategy, as described in Bernanke et al. (1999), was then seen as a way of preserving the benefits of both discretion and rules without facing the costs of either. As expressed by these authors, "by imposing a conceptual structure and its inherent discipline on the central bank, but without eliminating all flexibility, inflation targeting combines some of the advantages traditionally ascribed to rules with those ascribed to discretion." (p. 6).

Thus, how to "impose a conceptual framework"? Inflation targeting relies on an institutional arrangement, which takes the form of delegation. The central bank is given independence, i.e. exclusive authority to decide on monetary policy, along with a specific objective, price stability. When well designed, the delegation also includes an accountability mechanism.

Delegation via an institutional arrangement is not specific to monetary policy, where it has—so far—been spectacularly successful. Law is another prominent example of delegation. Even though judges are elected in some countries like the US, in most cases they are appointed and enjoy a high degree of independence; they are given a precise task—apply the law—with full authority and some degree of appreciation, which gives rise to jurisprudence. Another example is the financing of scientific research; in many countries, this task is delegated to independent committees composed by recognized researchers. There are many more examples (examining boards, patenting offices, etc.) of delegation. All these examples share the following features:

- they are given a precise mandate
- their decisions cannot simply be a rule, some judgment is needed
- the decision-makers are experts in the relevant field
- the decision-makers are granted full independence.

In addition, the decision-makers are generally accountable to elected officials.

2.3. Fiscal policy councils

It is fairly straightforward to reinterpret the central bank remit to suit the needs of fiscal policy. Before doing so, however, it is essential to

clearly define what is meant by fiscal policy. What follows only concerns the macroeconomic role of fiscal policy. It explicitly excludes all other aspects, such as income redistribution, the provision of public goods and services, the size of public spending and the tax burden. All these aspects are microeconomic in the sense that they affect relative prices and incomes or that they affect economic effectiveness. Because of their redistributive impact, decisions concerning the microeconomic aspects of fiscal policy must be in the hands of elected officials who are accountable to voters. On the other hand, the macroeconomic role of fiscal policy is similar to the macroeconomic role of monetary policy in that it has limited redistributive effects and its aim is exclusively to affect aggregate variables.

Monetary policy is dedicated to long-run price stability; in the shorter run, it can also be used to smooth the effects on the economy of various shocks, but only to the extent that such actions do not put the price stability objective in jeopardy. Similarly, fiscal policy should be dedicated to achieve public debt sustainability, which leaves room for stabilizing the macroeconomy in the short run.

Both long-run goals are defined in vague terms but can easily be made more precise with quantitative targets and a horizon over which the targets ought to be reached. Price stability is usually defined as a range within which the inflation rate should be within 2 to 3 years, since this is the time taken for monetary policy effects to work out. Similarly, debt sustainability can be made operational by the choice of a debt-to-GDP ratio to be achieved within a period commensurate with business cycles.

In the realm of monetary policy, delegation has long been granted to central banks, a universally found institution. It is only recently, however, that central banks have been granted independence.[3] There is no such tradition of delegation as far as fiscal policy is concerned, although a number of countries have adopted institutions that bear some resemblance, see the next section. Yet, it is possible to delineate what is to be done.[4]

Delegation is to be made to an FPC, which is composed of persons chosen for their competence in fiscal policy and budgetary planning. Their independence is guaranteed by irrevocable long terms, pretty much as is the case of central bankers. The FPC is given a pre-

[3] For some evidence, see Arnone et al. (2007).
[4] More details are provided in Wyplosz (2005).

cise mandate in the form of a debt target and a horizon. Ideally, for accountability purposes, the target should be set by a government at the beginning of its legislature, to be reached by its end. Since legislatures usually last 4-5 years, they are indeed commensurate with business cycles. The FPC is accountable to the Parliament, as is the case for central banks.

Central banks are given an instrument, the short-term interest rate. The FPC's instrument is the budget balance. Largely in the same way as some central banks indicate the interest rate path that they intend to follow, the FPC should focus on defining the most desirable budget balance path. This path should optimally combine the long-run debt target with the initial debt and budget position and be adjusted when unforeseen shocks occur. Yet, the path must always be such that the debt target is reached at the end of period.

2.4. Two variants

The previous description intentionally leaves aside many aspects. The most controversial issue is how much should be delegated to FPCs. The following variants are meant to illustrate how this issue can be dealt with. Obviously, an infinity of other variants can be imagined.

Soft FPCs

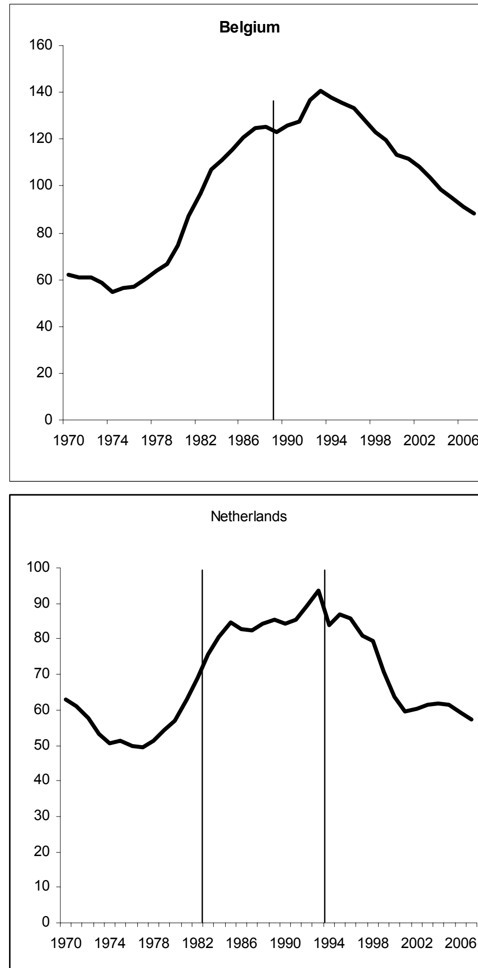
Soft FPCs only have an advisory role. Based on the target and the remaining horizon, they recommend a particular budget balance outcome each year. The recommendation is issued publicly. Yet, the decision is made by the government and parliament, following usual practice.

The effectiveness of this arrangement rests entirely on the public debate. The soft FPC effectively acts as a pro-discipline pressure group and it can have an impact if the other pressure groups, which have an interest in raising spending or reducing taxes, are not too powerful. Obviously, the FPC will have to build up its reputation for expert judgment and independence from pressure groups and the government.

Soft FPCs of one form or another already exist in some countries such as Belgium, Denmark, Chile, the Netherlands and now Sweden. Many of them have been established fairly recently, so it is too early to assess their track records, especially since they differ considerably from each other. Two examples might be of interest. In 1989, Belgium beefed up its High Council of Finance, giving it more independ-

ence and prominence. The High Council's remit is to comment on past and future budget balances. The left-hand side chart in Figure 3 shows that the gross public debt peaked in 1993, four years after the institutional.

Figure 3. Gross public debts (percent of GDP)



Source: Economic Outlook 2, 2007, OECD.

The other chart presents the case of the Netherlands, where the Central Planning Bureau (CPB) has provided governments and political parties with independent analyses and opinions since 1945. What is of interest is the evolution of the arrangement. Three changes are

noteworthy.[5] First, in 1983, the CPB shifted its emphasis to a reduction of the deficit by 1 percent of GDP every year, independently of the cyclical position of the economy. The strategy was too rigid and failed, leading to the adoption of expenditure ceilings for the whole legislature in 1994 while the automatic stabilizers were explicitly allowed to operate freely on the tax revenue side. It was followed by a focus on long-term debt sustainability and, in 2005, by the setting up of a Council of Economic Advisers, which is a policy advisory body. As the figure shows, the debt has declined since then, which supports the view that the adoption of a long-run path along with shorter run flexibility is key to regaining effective control of public debt.

Hard FPCs

A harder version follows the central bank model all the way to delegating decision power to the FPC. In this variant, the FPC sets the budget balance each year, without expressing any view on the size of the budget itself (spending and revenues) nor on any item in the budget. The FPC's decision is binding on the government and parliament. These elected bodies can freely set all budget parameters under the binding condition that the balance—the net of spending and revenues—meets the FPC's decision.

This variant implies that by the end of each legislature, the FPC must deliver the debt that the government has targeted at the beginning of the legislature. The FPC can freely set the path of annual budget balances, taking into account the impact of its decisions on the economy as well as reacting to shocks as they arise. The logic is that the government is not allowed to amend the target during the legislature, although escape clauses can be designed to cope with large unforeseen shocks.

Very Soft FPCS

A number of other variants rely on expert judgment to be incorporated in the budgetary process, but only as inputs in the government and parliament. Examples of such arrangements include the German Council of Academic Experts, the Fiscal System Council in Japan and the Congressional Budget Office in the US, with similar arrangements in Korea and Mexico.

[5] For more details, see Bos (2007).

3. Resistance: Good and bad reasons

The fact is that today, there does not exist any hard variant of FPC and very few soft ones. It may be that the idea has been developed too recently to already have been adopted. Yet, given that many countries have tried, some successfully so, to deal with fiscal indiscipline and bring down their public debts, one would have expected the idea to have been tried somewhere. In this section, I ask whether the idea is in fact inadequate or just misunderstood. In brief, are FPCs unlovable or just unloved?

From a pure economic viewpoint, the logic is quite compelling, especially as it closely mirrors the successful arrangement adopted for monetary policy. The fact that FPCs are not popular, therefore, must reside either in implementation problems or in opposition by interest groups. I now examine these aspects, focusing on the case of hard FPCs.

3.1. Misunderstandings

A common reaction to the idea of FPCs is that a time-honored principle holds that, in a democracy, the budget is a prerogative of governments under parliamentary control. It is asserted that this principle precludes any delegation to unelected officials. The principle, of course, cannot and should not be challenged. The reason is that budgets are redistributive—money is taken from some citizens and given to others—and that redistribution is a highly political issue that can only be decided by elected officials. As argued in Section 2.3, however, the budget balance is no more redistributive than monetary policy. Its main redistribution effect is between present and future generations. Given that future generations are not electing current officials, the democratic principle does not apply. On the contrary, the presence of a deficit bias suggests that future generations must be protected from the effects of pressure groups and the failure of governments to properly discount the future.

This is why the remit of FPCs should be strictly limited to the budget balance. FPCs should not be allowed to express any view on any of the other components of fiscal policy. The size of public spending, the tax burden, the spending items and the tax structure are

to be explicitly excluded from the purview of FPCs.[6] In addition, when the debt target is set by the government, the FPC's choice of annual budget balances is severely constrained. The contribution of the FPC is twofold: first to enforce the government's own target and second, to use whatever flexibility is available to deal with shocks. Exactly like inflation targeting, the FPC institution is based on constrained discretion.

3.2. Implementation problems

The setting-up of (hard)FPCs is not a panacea and, indeed, a number of limitations can be anticipated. First, there is no guarantee that the FPC will not let the target slip away. With a long-run target that will generally imply a declining debt, the FPC must optimally spread the adjustment burden over the whole length of the horizon. If it starts too slowly, either because of miscalculation or political expediency, or because of initially adverse cyclical conditions, the FPC will be forced to implement tight, possibly pro-cyclical, policies in the last part of the planning horizon. This is bound to be unpopular and undermine credibility, not just of the FPC but of the principle of fiscal discipline. This is a serious concern, but one that sets the incentives straight. Any responsible FPC will anticipate this risk and, most likely, will frontload the adjustment as much as possible. Under favorable conditions, this means that the FPC will actually achieve a lower debt level than targeted; under adverse conditions, the FPC should still hit the target and thus establish the value of the arrangement.

Another concern is that the government will set too ambitious a target, under the misguided assumption that "it's the FPC's problem". This would put the FPC in a difficult position and lead it to be too restrictive, thus undermining its function. Once more, the concern is not too serious because the incentives work in the right direction. The FPC should be able to clearly communicate that it is an agent of the government, bound to respect its decision. If it must accept that the debt target is its own decision, the government should not have any incentive to fix an excessively ambitious target. The risk is actually in the other direction, that the government will opt for an insufficiently

[6] Bos (2007) indicates that the key to the successful rollback of public debt in the Netherlands has been the adoption of spending ceiling paths. This observation indicates that spending ceilings are an effective tool for combating the deficit bias. While this may well be true, FPCs should not base their action on spending ceilings precisely because decisions on the spending level belong to elected officials.

ambitious target because it will know *ex ante* that the FPC will have no choice but to deliver on the target.

A third concern is that the FPC could be disbanded when its decisions are perceived as too constraining by the government and/or parliament. This could leave the country without any fiscal discipline instrument. As before, incentives work in the right direction. A decision by the government and/or parliament to revoke the FPC is bound to be highly visible and highly controversial. Since the result is likely to be missing a target that was initially presented as desirable, the political authorities will find themselves in a politically difficult situation. This anticipation is bound to act as a powerful restraint on the government.

Finally, as any unelected agent to whom power is delegated, the FPC must be accountable. How this can be arranged in practice is a difficult problem with no perfect solution. Independence means that the FPC should not be accountable *ex ante*; it must be free to make its own decisions based on its best analysis. *Ex post* accountability implies that the FPC must be compelled to carefully explain each decision and justify the effects of its actions when they become visible. This is a tricky exercise. Suppose, for instance, that the economy slows down while the FPC is trying to lower the debt, as instructed by the government. The slowdown can be due to adverse shocks, but it can also be the result of restrictive fiscal policies. Disentangling the causes of the slowdown cannot be done precisely. If in addition to the slowdown—in fact because of the slowdown—the debt target is not achieved, the FPC may be censured even though it has acted optimally. The same problem affects central banks. They are to some degree protected by their track record, which will not be available for quite some time in the case of FPCs. In addition, the effects of monetary policy are much better known that those of fiscal policy, as the recent literature amply illustrates.[7] Under these specific conditions, the accountability process could become politicized, which is a serious risk. In addition, accountability requires some form of sanction. It is not easy to combine sanctions and independence. Once more, examples from monetary policy provide a number of solutions but, as noted, the lack of previous experience and the limits to our knowledge of how fiscal policy operates expose the process to numerous risks.

[7] For a recent review, see Favero and Giavazzi (2007).

3.3. Debt measurement

A different issue concerns the debt target. Most countries only measure gross public debt. As is well known, this is a very misleading concept. The correct one is government net worth. Ignoring public assets, as the gross debt measure does, may give a much distorted view of the net worth. Unfortunately, there is no uncontroversial measure of the value of public assets. Worse, the gross debt measure ignores the so-called implicit assets and liabilities. In particular, in most countries, governments are legally committed to significant entitlements which are *de facto* liabilities and yet appear nowhere in standard accounts. The growing literature on the demographic transition well illustrates the problem; it also shows how difficult it is to evaluate with any degree of precision the often huge liabilities created by retirement and health benefits. In many countries, measured gross public debts are believed to be but a fraction of the actual indebtedness of the government.

The same argument is sometimes used to argue that, even though it is not theoretically adequate, targeting deficits has the merit of focusing on a reasonably accurate measure. After all, it is argued, if the budget is balanced or in surplus, the true but unknown debt is bound to decline. This argument is incorrect as illustrated by the following example. Suppose that a government increases the taxes used to finance retirements but, at the same time, raises the retirement benefits, a plausible political *quid pro quo*. The budget balance will instantaneously improve but the debt will have increased. All that will have been achieved is to transfer an even harder task to future governments, which is a classical source of deficit bias.

In fact, defining fiscal discipline in terms of the future path of the debt has the merit of bringing to the surface the question of debt mismeasurement. Currently, most governments prefer to ignore the issue and dismiss the problem on the grounds that any other measure than gross debt is too imprecise to be taken seriously. This is convenient—no government wants to acknowledge that the true debt is much higher than the official one—but it is not just irresponsible, it is illogical. Any evaluation of the net debt, including contingent assets and liabilities, is bound to be closer to the truth than the gross debt, no matter how imprecise it is. For this reason, one of the first tasks of an FPC would be to evaluate the true net debt, which could then become the target.

3.4. Democratic principles

The distinction between the budget balance and the overall role of fiscal policy, abundantly described above, is a fine one. While clear to professional economists, this distinction is not easily grasped by the wider public, including among politicians. This opens up a window of opportunity for the interest groups that believe that fiscal discipline is bound to hurt them. The widespread existence of a fiscal bias is testimony of the ability of interest groups to steer policy in what they perceive to be a desirable direction, even if it goes against collective welfare.

This interpretation may well explain why FPCs are not loved. In countries where fiscal discipline is a serious problem, and where FPCs are most desirable, interest groups and captured governments can easily use the democratic principle that the budget cannot be delegated to unelected officials to muddle the distinction between the budget balance and the overall role of fiscal policy. It is probably much easier to use this argument to convince the public opinion than to justify spending on pet projects. Even *bona fide* governments may fear that the institution will be too constraining when and if they need to court the favor of interest groups.

4. Conclusions

Fiscal indiscipline is the result of a political failure. FPCs are a second best solution since they do not directly address the source of the failure; they only intend to mitigate, possibly eliminate the implications of that failure. In the absence of a possible first-best solution, FPCs provide a desirable solution. Its main drawback seems to be that it must be accepted and promoted by those very agents who are responsible for political failure. Is the proposal naïve, then?

On the one hand, the proposal seems economically sound. It rests on the fact that debt sustainability is a long-run concept.[8] Recognizing the potential usefulness of fiscal policy as a counter-cyclical instrument, it combines short-run flexibility with a long-term commitment. It does so by delegating the task of achieving debt sustainability—a clear objective—to experts able to optimally exploit whatever flexibil-

[8] Formally, it boils down to the transversality condition, which takes an infinite horizon.

ity is available. It leaves the key political decisions (spending, taxes) in the hands of elected officials.

On the other hand, the proposal asks the culprits to put in place an arrangement that will not just bind them, but will also force them to take full responsibility for identifying a debt target and uphold the policy implications as set forth by the FPCs. In that sense, it is indeed naïve. Yet, there are two good reasons to believe that the proposal may eventually be adopted.

A first reason is that, over the last decade, many governments have started to kick the deficit habit. They have done so in diverse ways, sometimes by voluntarily bringing fiscal discipline to the top of their agendas, sometimes by adopting binding rules. However, voluntary discipline is unlikely to remain at the top of the agenda for very long and a relapse into indiscipline cannot be ruled out. As for rules, they are bound to become counter-productive when unforeseen shocks occur. Yet, the important observation here is that many governments are indeed looking for ways of establishing and strengthening fiscal discipline. It is not unrealistic to expect that they will eventually look for a better way of achieving that aim. After all, the FPC offers a responsible government an argument to turn down pressure from interest groups.

A second reason is that some countries have started to move in that direction. So far, the chosen approach has been to establish soft FPCs. We have now entered a period of experimentation. The recently established FPCs now have to prove their mettle, to establish credibility and demonstrate the quality of their proposals. It is quite likely that, as their reputation grows, they will want to expand their powers. Soft FPCs stand to become hard FPCs.

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