ISSN 1648-2603 • VIEŠOJI POLITIKA IR ADMINISTRAVIMAS • 2006. Nr. 15

# The Concept of the Independent Fiscal Council

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Describing contemporary problems of coordination between monetary and fiscal policy in the European Union (the EU) as a whole and in each particular member state it is easy to notice that the monetary policy mechanisms are much better protected from biases created by the political cycle. The implementation of the concept of the central bank independence in various national mutations and the European Central Bank version introduced more stability into the European monetary policy though it did not solve the problem of transparency of that policy.

As the monetary tools became unavailable or less available for politicians to play with they increased their interest in fiscal policy, what led to reappearance of difficulties with growing budget deficit and public debt in the majority of the EU countries in the beginning of the 21st century. The framework of the Stability and Growth Pact (the SGP) proved to be insufficient in enforcing fiscal discipline on the Economic and Monetary Union (the EMU) member states and faced numerous attempts of dilution hidden under the cover of reform proposals.

Prevailing opinion in literature is that the SGP despite of its weaknesses is well constructed and helped to reduce laxness in fiscal policy but to be more operational it requires among other amendments redesigning of the national institutional frameworks of the fiscal policymaking. One of the most controversial solutions from economic and political point of view is creation of the independent fiscal body with powers and competence constructed in different manners by various proponents (Herzog, 2004).

The purpose of this article is to discuss chosen aspects of the institutional arrangements in fiscal policy based on the concept of the independent fiscal body. From the terminology point of view, there is no difference between the independent fiscal committee and the independent fiscal council. The British in their parliamentary debates for example seem to use the term committee more frequently to council but do not state any substantive, factual differences between the terms. For the purpose of this article, mainly the term independent fiscal council will be used interchangeably with the short for it - the IFC.

Considering subjective side of the concept, it is worth to mention that the independent fiscal council is discussed as a solution for the fiscal discipline problems affecting both developing and developed countries but of course with some differences in detailed construction. On the European ground, the IFC is considered mainly on the national level because potential introduction of such an institution on the EU level would require much deeper political unification than is possible in the near future. At present much more interest involves the question whether the shape of the IFC should be different for the old EU-15 countries and for the new accession 10 countries or not. Another form of this problem stemming from duality of the enlarged EU is the question which group of countries is appropriate to introduce the IFC first (Annett, Decresin, Deppler, 2005).

The paper will address the above-described questions but general focus will be on the significance of the IFC concept for improving the SGP, on arguments for and against establishing the IFC taking into account that its scope of powers is disputable and on some potential consequences of the introduction of the IFC to taxation.

## The Stability and Growth Pact and Monetary Diversity in the European Union

There is no place for disputing what the European Union should be in a future – a lax confederation of states or the one political and economic organism resembling the United States of America on the European ground. Beyond discussion is existence of the European common currency in the twelve out of twenty-five member states of the EU and readiness of many others to give up their national currencies as soon as their economies are ready to meet the criteria. In the same time there are some countries participating in the EMU that send signals of being disappointed by current performance of their economies under common currency dwelling on return to national currency as for example Italy. Additionally, the United Kingdom, Denmark and Sweden do not present political commitment to join common currency despite their strong capabilities compared with the ten new accession countries (The United Kingdom Parliament, 2003).

The twelve countries that are using common currency have sufficient economic weight to affect economies of those having national currencies both willing and reluctant to join the eurozone. Although the SGP as fleshing out the provisions of the Maastricht Treaty is directed to all members of the EU its influence is different depending on the relation of every particular country to the euro.

The SGP leans on two corresponding sets of rules and procedures where the first of them is preventive, leading to multilateral surveillance and extorts the avoidance of excessive deficits, and the second one is dissuasive dealing with excessive deficits that have already managed to occur. The country within the eurozone should fill obligation to try to obey the SGP rules knowing that its fiscal problems can undermine soundness of the common currency shortcomings of which may be painful for the rest of the eurozone members. On the other hand, knowing about non-excludable characteristics of the monetary stability in the common currency area as a public good, the country with fiscal policy deficiencies can be tempted to gain from the 'free rider' behaviour counting on the efforts of the others to stabilise the euro and to continue moral hazard as long as it pays back. Theoretically, the reaction of the exploited the eurozone countries to such behaviour should be faster and stronger than in case of the country breaching the SGP rules but staying outside the EMU.

The countries aspiring to join the EMU at the first glance seem to be forced to comply with the SGP rules as it is a precondition of their membership but their capability to do so is reduced by their economic and political weaknesses rooted deep in their history. One could say that their stronger commitment is offset by more difficult starting point. Formally, before joining the EMU the new accession countries have their own monetary policies at the disposal to balance their economies and are not forced to rely exclusively on fiscal policy. In practice this comfort is reduced by the EMU accession requirements to be fulfilled which lead to coordination of their monetary policies with the eurozone.

For the United Kingdom, Denmark and Sweden it should be easier to obey the SGP rules because these countries preserved their independent national monetary policies, their economies are stronger and more stable. What is more, in case of change in their attitude towards the euro the countries do not need to reform their mon-

Table 1. **A summary of some the SGP reform proposals**

| Authors | Radical proposals | Modification proposals |
|---|---|---|
| Bofinger | | Inflation targeting |
| Buiter | | Permanent Balance rule |
| Buti | Higher degree of fiscal integration | the medium budget target and the IFC |
| Casella | Tradeable deficit permits | |
| De Grauwe | | Contingent debt and deficit targets |
| Eichengreen | Rating Agency | Deficit Index and the IFC |
| Eijffinger | | Structural balance targets |
| Ohr / Schmidt | | Fully independent council (the IFC) |
| von Hagen | | Independent council (the IFC) |
| Wyplosz | | Fully independent council (the IFC) |

Source: Bodo Herzog, *The stability and growth pact and its institutional inconsistencies*, Second Pan-European Conference, Standing Group on EU Politics, Paper no. 473, Bologna, 24-26 June 2004.

etary and fiscal policies from scratch to join the EMU. On the other hand, these countries are not entangled in the common currency net of interrelationships what frees them from fiscal responsibility for the soundness of the euro but also makes all problems with free riding and moral hazard pointless in the context of the euro.

Above-mentioned differences in reaction to the SGP rules do not exhaust possible combinations because not only position towards the euro matters. To answer question why the SGP does not guarantee sound fiscal policy thoroughly involves much wider considerations. A commonly accepted view that the SGP needs reform of its environment more than reform of itself directs search for alternative solution towards institutional frameworks of domestic fiscal policies of the EU member states. Amongst moderate reform proposals, the idea of an independent fiscal council finds many followers.

## The Scope of Activities of the Independent Fiscal Council

The rationale behind equipment of the central banks with independence from their governments and from their parliaments was to protect monetary policy from political games leading to excessive money supply and too high interest rates creating inflationary instability in the economy (Grilli, Masciandaro, Tabellini, 1991). In majority, positive results of separation of the monetary policy from politics encouraged some economists to suggest adaptation of the central bank independence mechanisms to the institutional framework of fiscal policy. However, fiscal policy proved much more complex compared to monetary policy.

The monetary policy councils are mainly responsible for choosing inflation targets and setting interest rates and using other monetary policy instruments to achieve the targets. In case of fiscal policy, the question about extent of powers that it is worth to shift from government and parliament to the independent fiscal body is answered in many different ways. The least controversial is to entrust the IFC with setting the level of budget deficit and public debt as preconditions for the government preparation of the budget. In some cases, such task is seen as sufficient to constrain government's irresponsibility in conducting fiscal policy.

The problem lies in providing the IFC with reliable information necessary to assess a proper level of the deficit and debt matching properly the needs of the economy at present and in the future. There is a danger that if the government is directly or indirectly the sole source of considerable part of information required, the data could be initially processed in accordance with the government's interest and therefore misleading. To ensure that defining, classifying and calculating of economic phenomena is done properly a need for functional independence of an institution responsible for national statistics from the government seems to be out of question. Then the problem arises which authority should provide the guidelines for and assess correctness of that defining, classifying and calculating of economic phenomena. One of possible solutions is to grant this task to the IFC (Annett, Decresin, Deppler, 2005).

Introduction of the IFC with powers mentioned above is in fact reducing government's room for manoeuvres but it is very far from taking fiscal policy over from the government. Much stronger interference is hidden in a proposal to allot the IFC a right to vet accuracy of the government's investment decisions but such a solution is not too popular. Nevertheless, expenditures' side of the budget attracts more attention than revenues' side because limitation of budget deficits presumed as the main purpose of establishing the IFC means in practice reduction of spending ability and creates some pressure on increasing non-returnable revenues to finance government's obligations. There is no direct proposal aiming to entrust the IFC with the power to vet the government's taxation policy although some taxation assessment is natural when the IFC is entitled to choose deficit and debt targets.

Another task for the IFC suggested in literature of this field is to extort from government a possibly maximised transparency of its fiscal policy. Passing over the discussion whether fiscal policy can and should be transparent or not, it is worth to notice that the very existence of the IFC introduces more transparency to the government's fiscal policy in terms of budget balance conditions and of quality of statistic data. However, there is undeniable interrelationship between real transparency of fiscal policy conduct by the government and real transparency of the IFC activities (Balls, 2004). The question why parliamentary supervision of fiscal policy transparency is not sufficient will be addressed further in this paper.

Another aspect of constructing the IFC is its personal composition and the procedure of appointment of its members. Both problems are interrelated because to guarantee the IFC independence it is not enough to proclaim in the bill that its members are to be chosen from among specialists in the field of fiscal policy but it is equally important who is granted the authority to choose. Problems with composition and appointment of the IFC are of the same kind like with the monetary policy councils and there are various combinations possible. Should there be a representative of the government in the team of the IFC, should that representative be entitled to vote or only as an observer.

Even more important than representation of the government is the question about democratic accountability of the IFC and about mechanisms of appeal against the IFC decision or even of its cancellation. The fact that deciding about the permitted levels of budget deficit and public debt by the IFC would affect the government's activities much more directly and profoundly than any decisions of the monetary authorities independent from government (as monetary policy councils setting interest rates is commonly accepted). Much higher complexity of fiscal policy than monetary policy makes leaving decisions of the IFC indisputable and irreversible at all very controversial.

Amongst different proposals how to solve this problem one can find a concept of resembling on the fiscal policy ground a solution known from practice of the monetary policy institutional arrangements in New Zealand. The governor of the Federal Reserve Bank of New Zealand signs a contract with the government about providing well-defined level of price stability and in case of problems with fulfilling the contract parliament plays a role of arbiter (Eijffinger, De Haan, 1996). In the IFC case, the roles would be reversed. The IFC sets the fiscal policy objectives and the government takes responsibility for achieving them. There is no place to discuss this problem in deep details but in almost every potential design of relations between the IFC and the government there is a significant role to play for parliament in case of conflict over fiscal policy guidelines.

For better clarity of relations between the IFC and the government, it would be justified to establish a national statistical office as an institution independent both from the government and from the IFC. Otherwise, many mutual accusations could be based on incredibility of data not only those describing fiscal policy and overall economic performance but especially on accuracy of economic prognoses as base for next fiscal decisions.

## Arguments for Creation of the IFC

A set of arguments in favour of establishing the IFC resembles to large extent a list of deficiencies of contemporary fiscal policy. Some points of this list are universal and some of them are region or country-specific. On the EU ground, considerable part of the IFC idea popularity is generated by above discussed necessity to support the SGP solutions on the national level. To strengthen economic convergence for the sake of common currency a sound and disciplined fiscal policy of each particular member country is essential and neither institutional (ECOFIN, the European Commission) nor legal (the SGP itself) arrangements of the existing European authorities proved sufficient to induce many of the EMU members to abide by the Maastricht Treaty and the SGP rules. The SGP needs support of the national level institutions better adjusted to local specifics and acting preventively but according to the same economic philosophy as the SGP (The United Kingdom Parliament, 2003; House of Lords, 2004).

Considerable set of indications of destructive fiscal policy experienced during the 1980s or early 1990s that led to the Maastricht Treaty and later on to the SGP rigidity of fiscal solutions gradually reappear. First, many countries have just returned to running deficits that may become persistent and unsustainable and that feed through to rapid public debt accumulation. Second, majority of the EU countries run highly procyclical fiscal policies, especially during upswings. Third, governments in most countries again tend to make long-term welfare state promises with scant attention to how they would pay for them, leading to the accumulation of large implicit liabilities. Fourth, electoral considerations affect fiscal policy outcomes across European democracies (Annett, Decresin, Deppler, 2005).

Table 2. **General government deficit / surplus**
*(as a percentage of GDP)*

| Country | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| Belgium | 0.6 | 0.1 | 0.4 | 0.1 |
| Germany | -2.8 | **-3.7** | **-3.8** | **-3.7** |
| Greece | **-3.6** | **-4.1** | **-5.2** | **-6.1** |
| Spain | -0.5 | -0.3 | 0.3 | -0.3 |
| France | -1.5 | **-3.2** | | |
| Ireland | 0.9 | -0.4 | 0.2 | 1.3 |
| Italy | **-3.2** | -2.7 | **-3.2** | **-3.2** |
| Luxembourg | 6.2 | 2.3 | 0.5 | -1.1 |
| Netherlands | -0.1 | -1.9 | **-3.2** | -2.5 |
| Austria | 0.3 | -0.2 | -1.1 | -1.3 |
| Portugal | **-4.4** | -2.7 | -2.9 | -2.9 |
| Finland | 5.2 | 4.3 | 2.5 | 2.1 |
| **Euro area** | **-1.7** | **-2.5** | **-2.8** | **-2.7** |
| Czech Republic | **-5.9** | **-6.8** | **-11.7** | **-3.0** |
| Denmark | 3.2 | 1.7 | 1.2 | 2.8 |
| Estonia | 0.3 | 1.4 | 3.0 | 1.7 |
| Cyprus | **-2.3** | **-4.5** | **-6.3** | **-4.2** |
| Latvia | -2.1 | -2.7 | -1.5 | -0.5 |
| Lithuania | -2.0 | -1.4 | -1.2 | -1.4 |
| Hungary | **-3.7** | **-8.5** | **-6.2** | **-4.5** |
| Malta | **-6.4** | **-5.9** | **-10.5** | **-5.2** |
| Poland | **-3.9** | **-3.6** | **-4.5** | **-4.8** |
| Slovenia | -2.8 | -2.4 | -2.0 | -1.9 |
| Slovakia | **-6.0** | **-5.7** | **-3.7** | **-3.3** |
| Sweden | 2.5 | -0.3 | 0.2 | 1.4 |
| United Kingdom | 0.7 | -1.7 | **-3.4** | **-3.2** |
| **EU** | **-1.2** | **-2.3** | **-2.9** | **-2.6** |

Figures in bold on gray background mean breaching the Maastricht Treaty rule that budget deficit should not exceed 3% of GDP.

Sources: For euro area data: ECB; for data relating to EU data and countries' deficits / surpluses:

European Commission.

In case of the monetary union, such tendencies portend badly for its future in many ways but prevailing set of concerns described in literature (Annett, Decresin, Deppler, 2005) is as follows:

– Jeopardizing price stability by a pressure exerted on the European Central Bank to lower interest rates what help countries that ran profligate fiscal policies to reduce costs of debt servicing and facilitates an access to additional loans. It would undermine any credibility of the inflationary targets announced by the ECB. The results of counteractions undertaken in such circumstances by other countries committed to protect the euro from harmful depreciation could be costly and of unpredictable spillovers.

– Loosening of the link between domestic fiscal policy and interest rates because expansionary fiscal policy in one country generates increase of interest rates in monetary union as a whole and domestic policymakers are not able to assess and predict properly interest costs of borrowing and debt servicing.

- Worth of wider examination is a hypothetical case when a country having problems created by its own profligate fiscal policy is bailed out through purchase of its debt by other countries or by the ECB. The Maastricht Treaty proscribes such practices but specialists do not exclude application of such solution in case of deep crisis spreading through banking system. The very awareness of such a possibility may lead to significant moral hazard problems.

## Arguments against Creation of the IFC

One of the most frequently repeated reasons not to establish any fiscal body independent from the government is that it would not be right for political and constitutional system in a parliamentary democracy to have independent fiscal policy decisions (The United Kingdom Parliament, 2003; Balls, 2004). Those decisions have to be made by ministers and accountable to parliament. The same argument was raised when concepts of the central bank independence and creation of an independent monetary policy decision-making body like monetary policy council were discussed.

At present in majority of the EU countries that stay outside the eurozone, collegial bodies freed from ministerial governance and not accountable to parliament conduct monetary policy so neither the government nor parliament can shape monetary policy according to their views and needs. The power of this argument is based on assumption that fiscal policy plays quite different role in economic and political dimensions than monetary policy. Fiscal policy is more complex with many details directly important for citizens because leading to decisions about their income and overall welfare (taxes, benefits, pensions, healthcare, etc.). The citizens are the voters so moving basic fiscal powers to the IFC would reduce existing range of democracy.

This philosophy has some weak points if positive answers to questions below are not obvious:

– Do price stability, availability and cost of money significantly less affect the citizens' live in the end than fiscal decisions?

– Has establishment of the independent

monetary bodies turned out so far to be harmful to political and economic condition of society?

– Is present parliamentary democracy system performing well, i.e. does it allow to transform individual needs and choices into public decisions in the name of majority in a proper and just manner?

Otherwise, present political and institutional arrangement of fiscal policy is of no special value of its own.

Above discussed argument is a cornerstone of the IFC critics. The rest of arguments against the IFC are of rather technical nature and counterarguments from experience with funding the independent monetary bodies can offset them. On the other hand, it is natural that the narrower set of the IFC powers the weaker become arguments based on the threat of reduction of democratic accountability of fiscal policymakers.

## The Independent Fiscal Council and Taxation

As mentioned above, the IFC is not constructed as institution dealing with details but rather creating stable framework for government's activities in fiscal policy. Elaborating this approach on a subject of taxation, the IFC job would be to signal necessity of raising or cutting taxes to balance the budget at given level of expenditures but one can assume that reversed assessment i.e. raising or cutting expenditures at given level of revenues is also possible.

What seems to be tricky is that in predominating part of the IFC debate taxes are treated as automatic stabilisers according to the theory of economic cycles. The idea is that the IFC has at its disposal very reliable data reaching into the future, and that it is able to elaborate present proportion between revenues and expenditures, which is the most beneficial at the current phase of the economic cycle and for its further course. However, many researchers and practitioners admit that the economic cycle concept is beautiful but very hazy when it comes to guessing about timing of its phases, which is crucial for active fiscal policy decisions.

In such circumstances, the IFC, if created, should be very careful with pursuing aggressive countercyclical policies and even more careful than the government when is the sole fiscal policy governing and implementing body. It reduces the role of the IFC to keeping fiscal policy stable and the budget possibly balanced what can be supported by credibility of data gathered by the IFC or the independent statistical office and therefore freed from 'creative accountancy' so often practiced nowadays by various governments. In case of taxation, overoptimistic governmental assumptions of tax revenues are one of main reasons of underestimated budget deficit (House of Lords, 2004; Annett, Decresin, Deppler, 2005).

Another problem relates to the fact that taxes and generally budget revenues constitute only a part of public revenues. Various public special off-budget funds, public agencies and other organisational forms of gathering and spending public money apart from the general budget make strategic fiscal decisions less precise.

## Conclusion

This overview of general questions about the independent fiscal council as remedy for profligate and destructive fiscal policies run by many members of the EU is not able to provide incontrovertible answers with vast amount of supporting evidence but anyway suggests some options.

The IFC concept is worth further examination because:

– Many of current domestic fiscal policies of the EU member states require some institutional rearrangement for their own sake and for the EU future as a whole.

– There are many different arrangements of the IFC powers and personal compositions possible and each country can look for solution that fits best into its economic and political structure.

– Discussion over the IFC may contribute to finding another institutional framework for sound fiscal policy.

The IFC problem is not purely economic but also political in terms of its potential effects for democracy therefore interdisciplinary research, at least involving the Public Choice approach, would bring more results applicable in practice.

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**Nepriklausomos fiskalinės tarybos koncepcija**

Santrauka

Šiame straipsnyje apžvelgiami Nepriklausomos fiskalinės tarybos steigimo klausimai. Nepriklausoma fiskalinė taryba galėtų atlikti išlaidžios ir destruktyvios daugelio Europos Sąjungos valstybių narių fiskalinės politikos prevenciją.

Autorius nepateikia nenuginčijamų tiesų ir įrodymų, tačiau siūlo keletą galimų sprendimo būdų. Nepriklausomos fiskalinės tarybos steigimas kaip mokslinių tyrimų sritis yra aktuali dėl keleto priežasčių:

• *Daugumos Europos Sąjungos valstybių narių vykdoma nacionalinė fiskalinė politika reikalauja institucinių pokyčių, būtinų kiekvienai valstybei narei ir visai Europos Sąjungai apskritai.*

• *Galimi keli Nepriklausomos fiskalinės tarybos struktūros modeliai, kiekviena valstybė turi nuspręsti, kurie labiausiai atitinka jų ekonominę ir politinę struktūrą.*

• *Diskusijos dėl Nepriklausomos fiskalinės tarybos steigimo gali nulemti alternatyvių institucijų, gebėsiančių užtikrinti teisėtą fiskalinę politiką, kūrimą.*

*Nepriklausomos fiskalinės tarybos steigimas nėra tik ekonomikos objektas – kaip demokratijos svertas jis svarbus ir valstybės politikai. Taigi Nepriklausomos fiskalinės tarybos steigimo problemos tarpdisciplininis tyrimas, apimantis ir visuomenės pasirinkimo teisę, įgytų ne tik mokslinę, bet ir praktinę reikšmę.*

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Straipsnis įteiktas 2005 m. gruodžio mėn; recenzuotas; parengtas spausdinti 2006 m. kovo mėn.