Do we need a new sheriff in town?

A case for technocrats taking over fiscal policy

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Do we need a new sheriff?

Summary

Public finances in the advanced economies were already deteriorating prior to 2007 and the financial crisis only accelerated this process. The simple reason for this is the existence of deficit bias in most Western countries. Unfortunately, the introduction of fiscal rules and fiscal agencies has failed to adequately address this problem.

By taking stock from the success of independent central banks in dealing with the inflationary bias of monetary policy, we argue that nonpartisan agencies could play a similarly useful role in the fiscal realm by dealing with the deficit bias. By delegating the power over fiscal policy at a macro level to an independent council of experts, governments can ensure public debt sustainability in a less painful way given stronger credibility. What's more, the build-up of fiscal cushions by independent fiscal councils (IFCs) would enable them to respond to adverse shocks in the short-term. The increased flexibility means that countries with already strong fiscal positions will also benefit from introducing IFCs.

We need a new sheriff in town not only for ourselves, but also for the future generations that will need to bear a substantial amount of debt without having any say. With technocrats in charge, we can hopefully return to fiscal sustainability and avoid the massive costs of sovereign debt crises in the future.

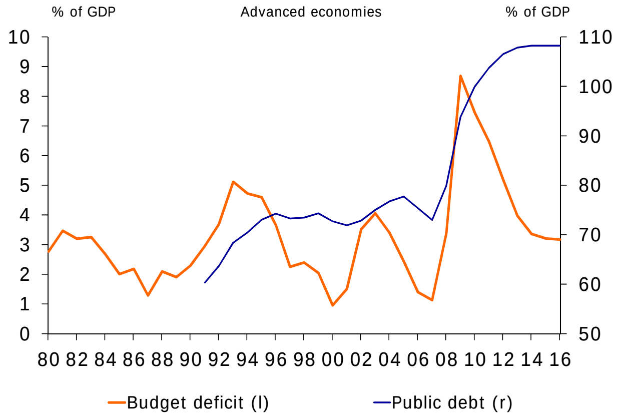
Deficit bias has been with us for so long

Luxembourg's long-serving Prime Minister, Jean-Claude Juncker, once famously proclaimed "*we all know what to do, but we don't know how to get re-elected once we have done it*." This is sadly the ruling dogma of the political class in most of the Western world. Public debt/GDP ratios (hereafter debt ratios) were already rising in most of the advanced economies prior to the crisis and the situation worsened further post-2007 following the measures taken by policymakers to spur economic activity and stave-off a total financial meltdown. According to the IMF data, over the past 30 years, there has not been a single year that advanced countries, on average, posted a surplus on their budget balance (see figure 1). In the meantime, public debt in some countries has risen to unprecedented levels. Of particular concern is the fact that government finances deteriorated ahead of intensifying demographic pressures on entitlement spending (see figure 2).

So the question we need to ask ourselves is the following: why is deficit bias an inherent feature of most democratic systems in the West? There are three reasons we can think of.

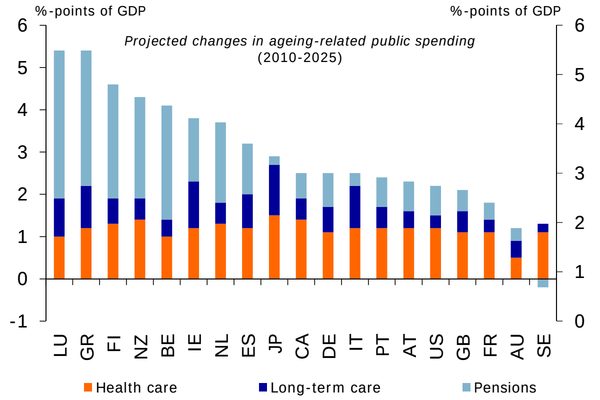
1. Politicians acting in their own interest rather than in the interest of the electorate (the well-known **principle-agent problem**). This is made possible by lack of fiscal transparency and insufficient knowledge of voters on the functioning of the economy and the long-run constraints on fiscal policy. As research on political business cycles shows**,** voters have difficulty evaluating economic outcomes. As such, fiscal policy making often suffers from **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 in order to increase their re-election chances through boosting growth/job creation in the short run. Politicians might also

Figure 1: Public finances



Source: IMF

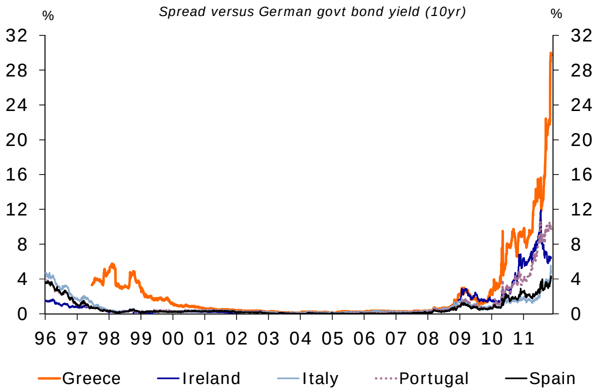
Figure 2: Demographic prospects



Source: Standard and Poor's

undershoot their budget target due to over-optimism concerning growth prospects. The selfishness of politicians, in the sense that too little weight is attached to the long-term benefits of fiscal prudency, means that the preferences of politicians (the agent) are not perfectly aligned with those of the electorate (the principle).

Figure 3: Bond yield spreads vs Germany



Source: Reuters EcoWin

2. There is **insufficient disciplining effect** from the financial markets. In theory, fiscal discipline will increase when interest rates asked by market participants start to rise in view of worsening government finances. In reality, however, markets do not effectively constrain a deficit bias. If anything, the financial markets generally seem to penalise fiscal profligacy only at a very late stage. This is exactly what happened in the Economic and Monetary Union (EMU) as the deterioration of fiscal positions within the region did not translate into higher bond spreads until the global financial crisis made landfall (Boonstra, 2011). In fact, after the introduction of the euro, bond yields converged to the lowest (German) level (see figure 3). It seems that financial markets completely denied the existence of sovereign risk (i.e. suffered from the '*this time is different*' syndrome), and/or denied the no-bail out clause of the Maastricht Treaty. The same story holds for the US, the UK and Japan, where one sees that interest rates are hardly reacting to weakening fiscal positions. So experience suggests that market discipline is certainly not a sufficient deterrent against unsustainable fiscal policies. As a general rule, markets tend to react with some delay but then very strongly.

3. Governments are usually taken hostage by individual groups that lobby for extra spending that is financed out of general taxes or revenue windfall gains (known as **common-pool problems)**. Individual groups have a preference that public spending on their preferred programmes increase given that the budgetary costs are dispersed across the society.

The record of fiscal rules and fiscal agencies

We should note that governments in many countries have taken measures over the years aimed at correcting the distorted incentives in policymaking. One approach favoured by many is the introduction of comprehensive and transparent medium-term **fiscal rules**[1] against which governments can be held accountable.

[1] A fiscal rule is defined as a permanent constraint on fiscal policy through simple numerical limits on budgetary aggregates. Each of the elements in the definition is important: a

In theory, fiscal rules provide a stable anchor for fiscal policy decisions and raise the reputational costs of deviating from the debt sustainability path. Formalising a permanent fiscal rule is also intended to send a signal to the financial markets about the government's commitment to stable public finances. This is why fiscal rules have gained popularity over the past two decades. In 1990, only seven countries worldwide had a fiscal rule according to the IMF (2009); by early 2009, either national or supranational rules were in place in 80 countries (of which 21 in advanced economies[2]). While the crisis has strained existing rules, many countries are adopting new rules or strengthening existing ones to show their commitment to fiscal sustainability. For example, a balanced-budget constitutional amendment, similar to the debt-brake rule of Germany and Switzerland, is being discussed for all euro members.

Fiscal rules are indeed a noble idea on paper, but they have not been very successful to lower debt ratios in some countries (Debrun et al., 2008; European Commission, 2006; Deroose, Moulin, and Wierts, 2006; IMF, 2009). To illustrate this, we have plotted the Fiscal Rules Index[3] (FRI) of the European Commission against public debt ratios of Western European countries that have enacted a fiscal rule in their national law in the previous two decades (i.e. supranational fiscal rules in the form of SGP are excluded). Looking at figure 4, we see that the stronger enforcement of fiscal rules did tend to have a downward effect on debt ratios in Austria, the Netherlands, the UK, Belgium, Denmark, Sweden and Finland. In fact, in nearly half of the 24 successful cases of fiscal consolidation since 1980 identified by the IMF, countries started the austerity measures with national fiscal rules in place – in many cases they had just been introduced specifically with a view to reversing a trend of fiscal deterioration. For example, in Sweden and Finland, the adoption of fiscal rules was a major building block of adjustment efforts that followed the countries' financial crisis of the early 1990s.

But how much credit must fiscal rules get for these successful consolidations? The evidence provided by empirical research is mixed, at best. On the one hand, Guichard et al., 2007 show that in the OECD countries, the size of fiscal consolidations was significantly larger when national or supranational fiscal rules

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rule delineates a numerical target over a long lasting time period with a view to guiding fiscal policy; it specifies a fiscal indicator to which it is applicable; and it is simple so that it can be readily monitored, operationalised and communicated to the public (IMF, 2009). The most frequent fiscal rules stipulate upper limits on the budget balance, or on the debt, or on spending, or lower limits on tax revenues. Combinations of the limits are frequent as well.

[2] Australia, Austria, Canada, Denmark, France, Finland, Germany, Hong Kong, Iceland, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Slovenia, Slovak Rep., Spain, Sweden, Switzerland and the UK.

[3] This index is based on five criteria of national fiscal rules: (i) statutory base of the rule, (ii) nature of the body in charge of monitoring the respect of the rule, (iii) nature in charge of enforcement of the rule, (iv) enforcement mechanisms of the rule and (v) media visibility of the rule based on self-reporting by EU Member States. The index is standardised so that the average over the sample (1990-2009) is zero and the standard deviation is one.

were present. For EU countries, the European Commission (2006) also finds that stronger and wider fiscal rules were associated with a greater likelihood for successful fiscal consolidation. On the other hand, the IMF (2009) postulates that econometric evidence on whether national fiscal rules have contributed to triggering fiscal consolidations in EU countries is not clear-cut. In particular, both fiscal rules and improved fiscal performance could be affected by omitted determinants of fiscal behaviour such as budgetary institutions or processes. Not to mention that in many instances, more favourable debt dynamics (i.e. falling interest rates and pick-up in growth amid strong global demand) may have also assisted countries in their consolidation effort. Larch and Turrini (2008) also find that when estimating the probability of a fiscal retrenchment occurring, the FRI is only weakly significant. Moreover, IMF's analysis for the OECD countries suggests that fiscal rules are not per se credibility enhancing when measured in terms of their impact on market risk premia. Rather, 'credibility rewards' appear to be reaped primarily by countries that had already healthy fiscal track records and macroeconomic conditions.

While most fiscal rules were in place at the outset of consolidation, some were adopted only during large adjustments. Seven countries (out of the total of 24) introduced fiscal rules after their debt ratios had started to decline, according to the IMF (Ireland and Spain's adjustment are depicted in figure 4). This points to reverse causality – improved fiscal performance led to the adoption of fiscal rules in order to 'lock in' gains in consolidation, or to signal authorities' commitment to debt sustainability in the future.

Finally, there are cases that fiscal rules have had absolutely no impact on fiscal sustainability. For example, in France and Portugal, public debt ratios have been on the rise while fiscal rules were supposedly strengthened (according to the FRI). This again shows that the willingness of the government to take painful measures instead of getting creative with statistics is more important than simply introducing a fiscal rule in the national law. Phrased differently, fiscal frameworks not involving formal rules but focused on transparent and credible strategies backed by proper budgetary institutions are a better approach to support fiscal discipline.

There are three important reasons why we do not believe coming up with more (stringent) fiscal rules going forward is desirable. First, fiscal rules entail a **procyclical stance** in bad times as they constrain discretion (and in good times they may not be binding). Put differently, governments may have less of an incentive to run surpluses during years of economic boom but need to drastically cut spending and raise taxes when the economy turns south, further aggravating the situation. This is why rigid rules are often broken when governments convince public opinion that today's circumstances are 'special' and that rules made in the past are standing in the way of serving people's interests. According to

Figure 4: Fiscal rules vs debt ratios

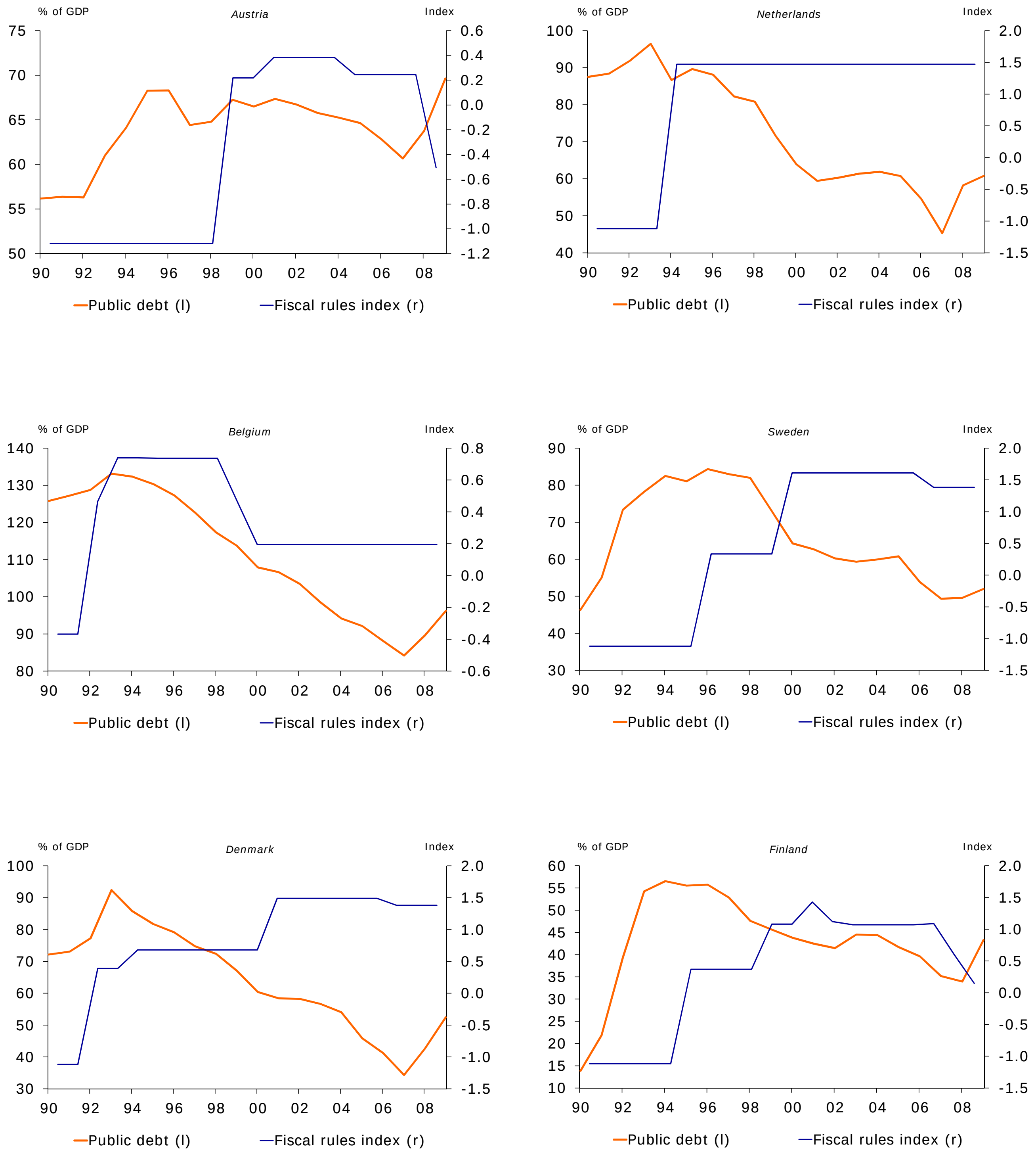
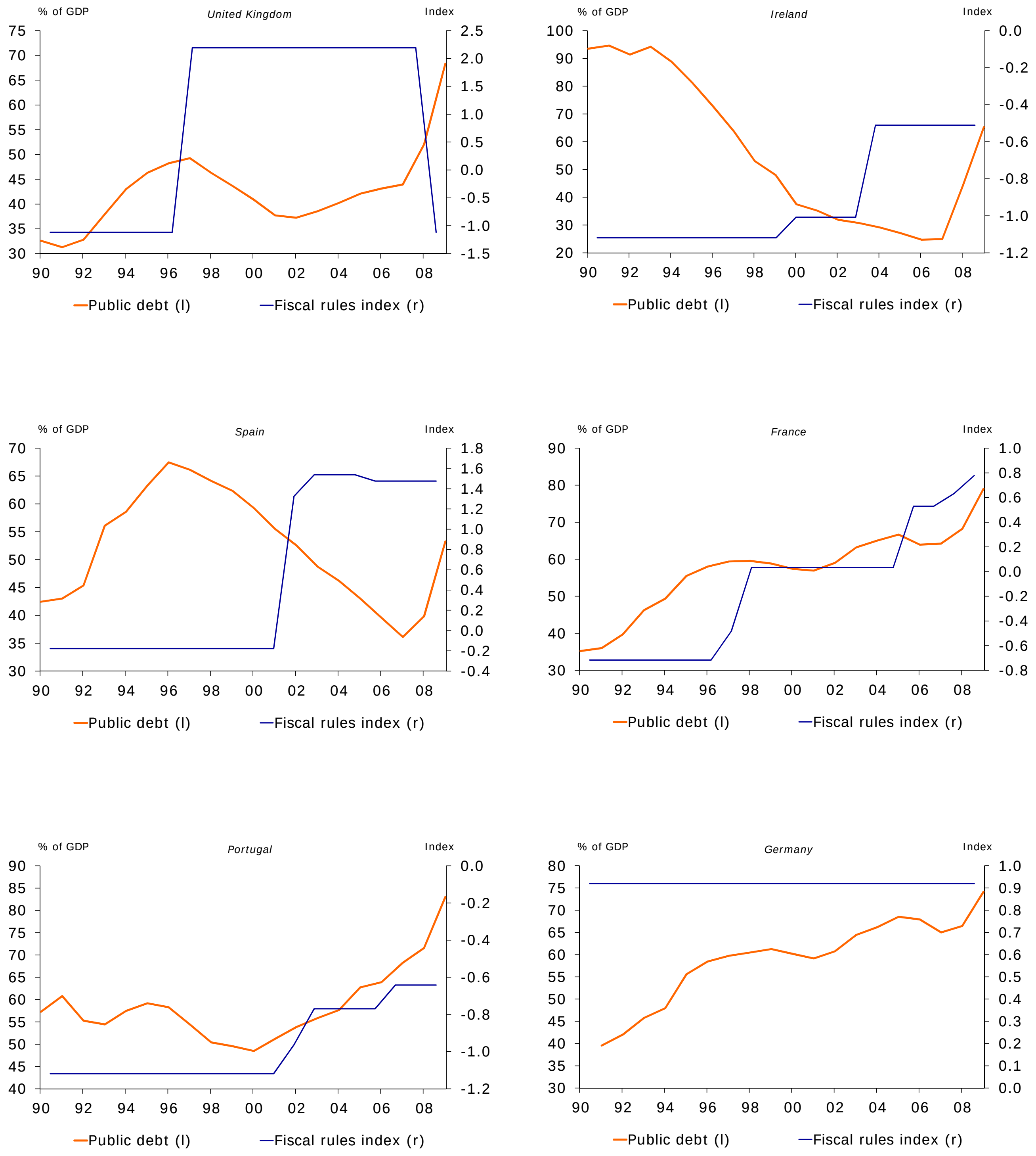


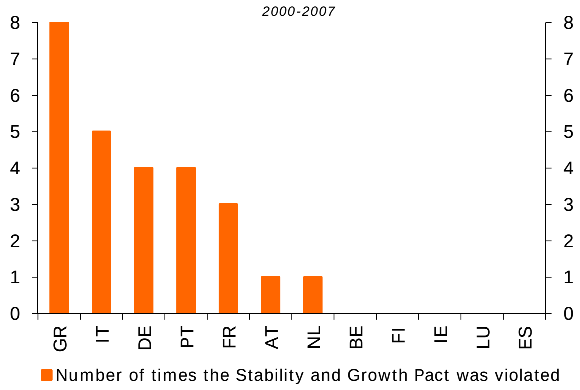
Figure 4: Fiscal rules vs debt ratios



Source: European Commission, Rabobank

the IMF (2009), about a quarter of the countries with national rules modified them or put them into abeyance since the financial crisis. From figure 4, one can see that the FRIs in Austria, Sweden, Denmark, Finland and the UK dropped since the inception of the crisis.

Figure 5: Violation of SGP



Source: Reuters EcoWin, Rabobank

Rules were also changed or ignored even before the crisis. One example was the US Gramm-Rudman-Hollings deficit reduction law of 1985. The annual deficit targets were raised in 1987 when they proved too difficult to meet. Not to mention that the US debt ceiling has been raised more than 70 times since 1962 under both Republicans and Democrats. Another famous example of rules being thrown out of the window was when the eurozone's two largest countries, France and Germany, disobeyed the Stability and Growth Pact (SGP) in 2004 when it was not in their interest to stick to fiscal prudence. In fact, the SGP rule (3% deficit) has been broken on multiple occasions by a variety of member states, including the so-called 'core' countries (see figure 5).

To address the rigidity of fiscal rules, some countries have proposed to consider making a rule based on structural or cyclically adjusted budget balance in order to take account of the economic cycle (e.g. Sweden, Switzerland and Germany). Although, with such a rule in place, governments can allow the automatic stabilisers to operate in full, discretionary fiscal stimulus measures are still out of the question. Besides, making cyclical corrections to the budget balance is more art than science. Given that our ability to compute structural budget balances in real time is quite limited, it is unsure how much merit such a rule will have. Governments can tweak the estimate of the output gap in order to run a budget deficit if they so wish. Since such a cyclically adjusted rule is not simple for the broad public to understand, the fiscal authorities can easily get away with it.

Another reason why rules are undesirable is because they are subject to manipulation. Put differently, rules encourage rosy forecasts, 'creative' accounting and off-budget operations to mask the underlying weakness in the fiscal position. This temptation is likely to be all the greater when the government believes that it is unlikely to meet its debt or deficit target and resorts to 'painless' measures to abide by the rule. Mind you that the notoriously inaccurate statistics in Greece that has in the past years grabbed a lot of headlines in the international press is not a singular event, albeit the most extreme, as significant revisions of fiscal data have been reported in some other European countries (Gordo Mora and Nogueira Martins, 2007; De Castro et al., 2011; Beetsma et al., 2011).

The shortcomings of simple rules have made some countries to opt for creation of **fiscal agencies**[4] tasked with the monitoring and assessment of fiscal developments (e.g. the Central Planning Bureau in the Netherlands, the High Council of Finance in Belgium, the Swedish Fiscal Policy Council and United Kingdom's Office of Budget Responsibility)[5]. Fiscal agencies help in the formulation and implementation of sound fiscal policies while leaving discretion about policy objectives and instruments in the hands of the political representatives. Meanwhile they contribute to greater transparency by raising public awareness concerning inappropriate policy. The reason why fiscal agencies have been less successful to improve debt sustainability in some countries is due to the fact that they do not have discretion over fiscal policy. Since politicians always have the final say, deficit bias may exist even in the presence of fiscal agencies.

A proposal for creating an independent fiscal Council (IFC)

So must we delegate the discretion over fiscal policy to technocrats[6]? Economic theory points to four basic criteria that should dictate whether it is desirable to delegate some or all aspects of policy (Alesina and Tabellini, 2007). First, there must be socially harmful distortions in policy implemented by the elected representatives. If there are no such distortions, there would be no gain from delegation. If that is the case, the other three criteria would not apply. Second, there should be a broad consensus on what constitutes 'sound policy' in any particular domain. It is essential to establish a fixed mandate for which the independent agency can be held accountable. The absence of such a consensus would lead to conflicts among social groups or constituencies. Third, delegated mandates should not be primarily distributive or have major distributive consequences. In democracies, distributional decisions should reflect a popular mandate that can only be exercised legitimately by the elected representatives. Fourth, delegation should not give rise to major (economic) policy coordination problems. If a policy in a particular area or some aspect of it is delegated, it should not create conflicts with policymakers in other areas that are not delegated. Otherwise, the coordination difficulties could outweigh any benefit from delegation.

[4] Calmfors and Wren-Lewis (2011) list eleven independent councils with advisory or non-binding control roles in developed countries. Debrun *et al*. (2009) report that similar councils have been set up in other developed or emerging-market countries (including Japan, Chile, Indonesia, Jordan, Korea, Mexico).

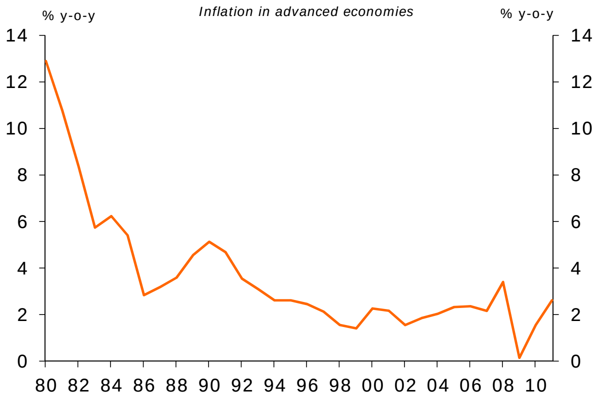
[5] There are three types of fiscal councils:

1. Councils that provide objective analysis of current fiscal developments, and costing of budgetary initiatives.
2. Councils that produce independent projections and forecasts regarding both the fiscal variables as well as the relevant macroeconomic variables.
3. Councils that, in addition to the above tasks, have the mandate to provide normative assessments, including regarding the appropriateness of the fiscal policy stance.

[6] Some academics have proposed this in the past. These include Eichengreen et al., 1999; Calmfors, 2003; and Wyplosz, 2005.

In our view, delegation of fiscal policy at a macro level ticks off all the right boxes: deficit bias and procyclical fiscal policies constitute socially harmful distortions in policymaking; there is broad agreement that sound fiscal policy should not lead to unsustainable debt levels; the overall fiscal balance does not have direct distributional consequences, except across generations; and delegating the setting of the fiscal balance can reduce the problem of macroeconomic policy coordination, especially with monetary policy.

Figure 6: Inflation bias defeated



Source: IMF

Given that there are clear parallels between current discussions of fiscal policy frameworks and earlier ones of monetary policy frameworks (see box 1), will it make sense to depoliticise fiscal policy as well? We certainly think so. The success of independent central banks in dealing with the inflationary bias of monetary policy[7] (see figure 6) is reason enough for us to argue that nonpartisan agencies could play a similarly useful role in the fiscal realm by dealing with the deficit bias. Independent fiscal councils (hereafter IFCs) could obviously have a direct disciplining effect on fiscal policy. A prudent fiscal stance would allow for the build-up of fiscal cushions to enable IFCs to respond to anticipated pressures over the long term, such as implied by population ageing, as well as unanticipated ones in the short-term (e.g. an adverse shock). In the next section we make a proposal for delegating decision-making power over fiscal policy at a macro level to an IFC mandated to deliver socially optimal policy.

Box 1: Taking stock from independence of monetary policy

It is interesting to note that monetary policy was also delegated to independent technocrats because it fulfilled the above mentioned criteria. In the 1980s, the persistence of high inflation prompted an intense debate on the merits of granting central banks complete operational independence from elected officials in pursuing price stability. The basic premise was the perception of politicians' perverse incentive to take monetary policy as hostage whenever faced with high unemployment and/or public indebtedness. This resulted in very high and volatile inflation rates in the past (see the appendix). Formal independence along with some form of inflation targeting were found to be the magic recipe that would provide more short-run flexibility (as opposed to rigid rules such as fixing the exchange rate or the growth of money supply) without jeopardising

[7] Empirical research has found that average inflation was negatively related to measures of central bank independence (Alesina and Summers, 2003). Cukierman (1992) provides an excellent summary of the empirical work; references to the more recent literature can be found in Eijffinger and de Haan (1996) and Walsh (2003).

the long-run price stability objective. Thus, monetary policy changed in the wake of the high inflation rates of the 1970s and the high costs of disinflation in the 1980s and 1990s in the industrialised world. By the end of the 20th century, most major central banks around the world had gained full control over monetary policy in the context of an explicit mandate to deliver low and stable inflation.

Needed institutional arrangment for an IFC

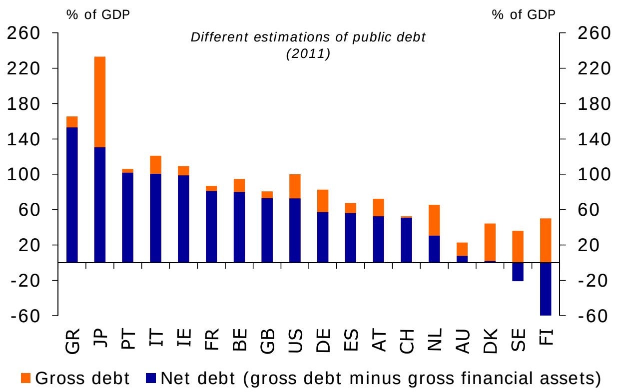
The following institutional arrangements need to be given specific attention if a country is to set an IFC.

Mandate

It is commonly accepted that the most important goal of fiscal policy is to ensure **public debt sustainability**, which, in turn, enables the government to contribute to macroeconomic stabilisation in periods of economic and financial stress. What does this mean in practice? To understand it, we must first begin by defining debt sustainability. The basic requirement for the sustainability of public debt is that governments should not engage in a *Ponzi-finance scheme* – servicing existing debt by issuing additional debt to cover both interest payments and principal repayments (Bohn, 2005). Instead governments should stay within their intertemporal budget constraints (IBC). In highly technical terms, this implies that the discounted value of current and future income plus initial wealth should at least be equal to the discounted value of all current and future non-interest expenditure (van Wijnbergen and Budina, 2008). But it should be reminded that the IBC is considered over an infinite horizon with no implications about when the primary surpluses should be larger or smaller, nor does it imply that the debt should stand at a particular finite value at any given point in time. As such, it could theoretically be satisfied by very high levels of debt and, therefore, very high interest payments, in the short term or at any time horizon, as long as there is reason to believe that sufficiently large primary surpluses will be achieved afterwards. In simpler terminology, we should not worry even if a country's debt ratio is approaching 1000% because one day the government will decide to run enough primary surpluses to bring it down again. This can lead to a nice mathematical formula, but experience shows that this definition is hardly reflecting reality! Hence, it is best to define a finite version of the IBC, by setting a target date and considering whether the target debt level can be achieved given the expected evolution of the economy in the future. Much like central banks foresee inflation at a policy-relevant horizon (around 2-3 years), the fiscal authorities should commit to stabilising the debt at a feasible distance. Of course, the horizon should be long enough to extend beyond the business cycle.

Once the policy relevant horizon is determined, the IFC should consider the debt ratio that is deemed sustainable. This is not a simple exercise since we do not have a theory of the optimum debt level. This should warn us against setting a definitive quantitative target, like Maastricht's 60%, which has absolutely no economic relevance and was an accident of history as it corresponded with the average debt level in Europe on the day the Maastricht Treaty was finalised (Wyplosz, 2005). Caner et al. (2010) use a dataset of 99 countries (1980-2008) and find that when debt ratios rise above 77%, annual GDP growth falls. Reinhart and Rogoff (2010) find in their extensive database of 44 countries and about 200 years of observations that growth rates fall when the debt ratio rises above 90%[8]. More recently, Cecchetti et al. (2011) estimate the threshold to be around 85% of GDP (sample: 18 OECD countries over the period 1980-2010).

Figure 7: Public debt estimations (gross vs net)



Source: IMF

Given that there is no magical number for a debt ratio, the IFC must take a host of factors such as the country's demographic outlook, economic growth prospect, the gross financial assets of the government[9] (see figure 7), the contingent liabilities of the government (in terms of banking sector bailout) and the current and likely future extent of home bias on the part of investors to determine the 'optimal' debt ratio. So settling on a one-size-fits-all approach and aiming for, say, 60% debt ratio makes no sense. For instance, a country with a favourable demographic outlook, a small banking sector and lots of financial assets can simply opt for a relatively higher debt ratio than a country without these characteristics.

Does this mean that the IFC must simply keep the definition of debt sustainability as vague as possible? That is not a good idea, in our view. A quantitative target – with all its known limitations – can serve several useful purposes. The experience of an explicit mandate by central banks (i.e. price stability is often translated into inflation not rising over 2-3%) manages to anchor expectations and provides a clearly understandable policy goal. Furthermore, a simple and transparent mandate facilitates the monitoring of the agency and enhances its accountability. The IFC must be held accountable if, for example, the debt ratio rises above its target. In a similar vein, central bankers are asked to justify their actions whenever inflation overshoots their target. This naturally gives economic policymakers more leeway to stabilise output whenever necessary. Allowing inflation to move away from the target can be an acceptable trade-off as long as long-run price stability is not jeopardised. Equally, a temporary rise in the debt ratio may be warranted if an economy is hit by an unexpected shock. In both cases, flexibility as well as credibility are involved.

[8] Reinhart and Rogoff do not control for causality.
[9] Since governments can always opt to liquidate their assets to meet outstanding liabilities, one needs to consider the asset side of the public sector balance sheet to measure fiscal sustainability.

Instrument

The IFC cannot be held accountable to achieve its mandate without having an instrument. For central banks, the policy rate has been the main instrument for accomplishing price stability over the medium-term. The criteria for choosing the instrument is that it must (i) have a close link to the ultimate objective (i.e., the debt ratio); (ii) be controllable and provide clear operational guidance for fiscal policy; and (iii) be transparent and easy to monitor. **The overall budget balance as a ratio to GDP generally fulfils these operational criteria**. It is in principle the variable that is most closely linked to the debt ratio, although operations that are off-budget or recorded as financing items could weaken this link. It is also easy to monitor and seen to be the key element determining fiscal performance. Finally, the overall budget is easily understandable for voters and politicians alike.

We must stress, however, that the microeconomic role of fiscal policy – tax rates and public sector expenditures – must remain under the control of the elected government. This lies at the core of the **democratic mandate** received from the electorate. The reason is that budgets are redistributive — money is taken from some citizens and given to others — and that such redistribution is a highly political issue that should be decided by elected officials. Of course, the macroeconomic role of fiscal policy (i.e. determining the overall budget balance) is similar to the macroeconomic role of monetary policy (which affects inflation, interest and exchange rates), in that it has limited redistributive effects and its aim is exclusively to affect aggregate variables. The main redistribution effect of the budget balance is between present and future generations. Given that future generations are not electing current officials, the democratic principle does not apply. What's more, the presence of a deficit bias suggests that future generations need to be protected from the failure of current governments to properly discount the future. This is why the remit of IFCs should be strictly limited to the overall budget balance. To put it more concretely, IFCs should not be allowed to express any view on any of the other components of fiscal policy such as the size of public spending, the tax burden, the spending items and the tax structure. All aspects that have a redistributive impact – affect relative prices and incomes – must remain in the hands of politicians.

Owing to our limitations of calculating the cyclically adjusted budget balance, as discussed preciously, it is best to target the overall budget balance while having an eye on the stage of the economic cycle. In addition, IFCs must ensure that the budget is not overly exposed to windfall revenues arising from a specific sector (contained fiscal risk). This means the budget balance should be deep into the black when the country is benefiting from, say, a real-estate boom. Alternatively, IFCs operating in countries that are commodity exporters should take periods of rising commodity prices into account while setting the budget.

Largely in the same way as central banks indicate the interest rate path that they intend to follow, IFCs should focus on defining the most desirable budget balance path. This path must always be such that the debt ratio target is reached at the end of the policy relevant period, barring any unforeseen shocks. An IFC could, for example, be mandated to set a binding deficit target at the beginning of the budget process while the individual revenue and expenditure plans in the budget would continue to be decided through the political process. To ensure that politicians abide by the rule, parliament would only be legally allowed to pass the budget if the target set by the IFC was reached. Note that the final budget law approved by parliament must specify a budget balance that matches the IFC's decision for the most likely interest rate and growth forecast, which is also provided by the IFC itself to help offset tendencies to over-optimism and overconfidence. Should legislation fail to pass, the IFC could be allowed to implement across-the-board cuts in spending and taxes. The appeal of this approach is if no agreement is reached, all parties will stand to lose from failing to reach an agreement. In any case, some sort of sanction must be put in place to make sure that the budget balance desired by the IFC becomes reality. Otherwise, politicians will always find excuses to spend more and/or tax less. Mind you those sanctions need *not* be imposed if the budget deficit increases due to unforeseen circumstances. In such a scenario, the IFC should re-evaluate its desirable budget balance path given new information.

Independence

If an IFC 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. Having discretion over the budget process without being independent renders the whole institution useless.

To safeguard independence, a number of measures must be taken. First, there should be a long-term budget for the council so that it does not have to fear that its resources may be cut whenever it reaches politically unpopular conclusions. This criterion is very important given that IFCs will not be able to earn a profit like central banks. So their entire existence relies on public funding. Second, IFCs must be staffed by non-elected professionals mandated to provide non-partisan decisions on fiscal policy. 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 the government administration, experts from the financial sector and former politicians. In our view, academics must form the majority of the council as they are expected to apply fresh research perspectives. What's more, there would be a high reputational cost in the academic arena for former council members who were seen to be acting in a political way in the IFC rather than making research-based judgements. All in all, the diversity of the IFC will help its credibility and also make it more effective. Third, IFC members must be appointed for a fixed duration, long enough to make them fully independent and to exceed the horizon of the policy target. Non-renewable and long-term appointments are a way of reducing the risk that IFC members become unduly affected by re-appointment concerns. Fourth, an IFC should be an agency under the parliament rather than the government. This emphasises that the council has a more independent standing than an ordinary government agency. Finally, there should be explicit guarantees against political control. This can be achieved by including the IFC's mandate and existence in the country's constitution. This is especially important because everyone must be convinced that the council will not be dismantled whenever the going gets tough. One must overcome situations like in Hungary where a fiscal policy committee was set up in 2008 only to be shut down a few years later when a new government came to power.

Box 2: Will IFCs make a difference?

Thus far, a fiscal policy council with the power to decide on the budget balance has not existed anywhere in the world. But let us just assume for a moment that they were implemented today, how would they help the industrialised countries? It is difficult to know ex ante what decisions IFCs would make. But it is safe to assume that IFCs can help most advanced countries strengthen their public sector balance sheets without chocking the nascent economic recovery. Here we briefly discuss the potential impact of IFCs in the US, Japan and the periphery of the eurozone.

The US: An American IFC would possibly allow the fiscal stance to be at least neutral in the short-term, if not outright stimulative, to allow the recovery to gather steam while putting forward a credible deficit reduction plan in the medium-term to restore order to the public finances. With such strategy in place, both the economy will perform better and the country's public finances will improve. What we have today instead is political foot-dragging, which is endangering the recovery. Insofar as none of the political parties wish to back down from their principles, the country will experience a severe fiscal contraction at the worst possible moment (IMF, 2011). This certainly does not commensurate with sound economic policymaking. Political bickering will force Americans to pay a high price through lower income growth and structurally higher jobless rate that, in turn, hurts long-run economic growth.

Japan: With the world's highest gross debt ratio and a history of two decades of stagnation, Japan will certainly benefit from an IFC. We should stress that Japan does run a tight fiscal ship with one single exception: social benefits. As things now stand, virtually every other part of government – including defence, education, science and economic development – is being starved in order to pay for underfunded social benefits amid an ageing population. This is the result of especially serious common-pool problems, which is built into the electoral system in a way that makes fiscal problems inevitable. Older voters, who are heavily over-represented in the current system of election districting, tend to benefit while the young pay (Eichengreen et al., 2011). This problem will not persist if an IFC were to force the government to start running a budget surplus in order to lower the debt ratio to more sustainable levels. The structural budget deficit over the past 20 years has amounted to 4.8% of potential GDP, on average. The last time the government posted a surplus on its budget balance was 1992!

Eurozone periphery: In solving the sovereign debt crisis in the periphery, European leaders have so far stuck to their ‘muddle through’ approach whereby funding is provided subject to strict conditionality in the hope of going back to business-as-usual in a matter of years. This is not unlikely to succeed nor is it desirable. Pushing countries towards years of painful austerity measures without offering them a chance of higher growth will be self-defeating and risks stoking social unrest. At this moment, some countries are being pushed towards insolvency as sovereign risk is being repriced at a rampant speed. One should note that *any country* may be driven into insolvency when interest rates start to rise against a nervous financial market backdrop. Economists call this ***multiple equilibria***. If investors believe that country X is fundamentally solvent they will buy its government bonds at a sustainable interest rate. In this case debt service will be bearable. But if many investors start having doubts about the solvency of country X, interest rates will shoot up and the country’s banks will be shut out of the capital markets. The economy will then tank, reducing government revenues at exactly the time the government faces higher debt service costs, and the public sector will slowly be pushed towards insolvency. Therefore, solvent countries in the European periphery must make sure that they return to the ‘good’ equilibrium of low and stable interest rates. They might be able to achieve this (i.e. regain market trust) by creating an IFC, which shows how serious they are about debt sustainability. Only having new elections may not do the trick given their poor fiscal track record. Markets will always be suspicious that fiscal profligacy will return regardless of which party is in charge. Of course, for countries that are truly insolvent amid huge debt overhang, default remains the only viable option even if they do introduce an IFC. But there is still merit in introducing an IFC because the defaulting country can potentially return to the markets under more favourable terms given that there is a new sheriff in town in charge of fiscal discipline.

Concluding remarks

Governments never run out of excuses for living beyond their means. Over the decades, public finances in the industrialised world have deteriorated dramatically and the financial crisis has added insult to the injury. To address the inherent deficit bias in the democratic systems of the West, many countries have resorted to fiscal rules and fiscal agencies. But this has only proved successful in countries that already had strong fiscal discipline and willingness to maintain debt sustainability (e.g. the core European and Scandinavian countries). In other cases, political parties show either *unwillingness* to take the necessary measures to restore fiscal sustainability or *inability* to make the changes at the speed demanded by the market.

By taking stock from monetary policy independence in the past two decades, we propose to de-politicise fiscal policy as well. Monetary policy went through a welcome transition that gave us years of low and stable inflation. In a similar vein, by delegating the power over fiscal policy at a macro level to an independent council of experts, governments can ensure public debt sustainability (in a less painful way given stronger credibility) while being able to stabilise economic activity in the short-term. Even countries that already have fiscal discipline and sustainable public finances will benefit, in our view. This is because sticking dogmatically to fiscal rules brings about an unnecessary rigidity in fiscal policy-making that can eventually hurt economic growth. What we have learnt from monetary policy was that having a clear and set objective (price stability) together with political independence can be socially optimal (inflation bias was defeated at no expense to growth). It is high time to achieve the same result for fiscal policy (defeat deficit bias while maintaining flexibility to respond to output shocks).

We need a new sheriff in town not only for ourselves, but also for the future generations that will need to bear a substantial amount of debt without having any say. Technocrats must be called upon to, once and for all, restore order to our public finances.

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Appendix

History of inflation rates in the advanced economies

Countries	Period	Maximum	Minimum	Standard deviation
Australia	1818-1990	57.4	-33.8	10.6
	1990-2010	7.3	0.3	1.6
Austria	1440-1990	2544.3	-69.2	109.9
	1990-2010	3.4	0.4	0.9
Belgium	1462-1990	455.4	-42.7	22.6
	1990-2010	4.5	0.0	1.0
Canada	1868-1990	20.7	-17.7	5.3
	1990-2010	5.6	0.1	1.2
Denmark	1748-1990	77.4	-40.7	13.8
	1990-2010	3.4	1.2	0.5
Finland	1860-1990	242.0	-11.3	24.4
	1990-2010	6.1	0.1	1.4
France	1432-1990	67.4	-38.4	12.2
	1990-2010	3.4	0.1	0.8
Germany	1428-1990	211427400987.8	-200.0	8926471865.9
	1990-2010	5.0	0.2	1.2
Greece	1833-1990	640.0	-26.3	61.1
	1990-2010	20.5	1.4	5.8
Ireland	1922-1990	20.9	-7.2	6.6
	1990-2010	5.3	-1.7	1.7
Italy	1548-1990	344.6	-42.9	22.4
	1990-2010	6.2	0.8	1.6
Japan	1818-1990	975.6	-31.0	77.2
	1990-2010	3.3	-1.4	1.3
Netherlands	1450-1990	65.9	-27.4	10.0
	1990-2010	5.1	1.4	0.9
New Zealand	1857-1990	17.2	-16.0	5.9
	1990-2010	6.1	-0.2	1.3
Norway	1517-1990	152.0	-67.6	13.1
	1990-2010	4.1	0.5	0.9
Portugal	1565-1990	80.9	-100.0	17.1
	1990-2010	13.4	-0.9	3.4
Spain	1500-1990	102.2	-38.5	11.5
	1990-2010	6.7	-0.2	1.6
Sweden	1540-1990	65.8	-86.8	14.4
	1990-2010	10.5	0.5	2.6
Switzerland	1850-1990	25.7	-17.7	6.0
	1990-2010	5.9	-0.5	1.7
UK	1265-1990	41.5	-33.5	9.3
	1990-2010	7.4	0.9	1.7
US	1720-1990	29.7	-19.4	7.0
	1990-2010	5.4	-0.3	1.1

Source: Reinhart and Rogoff (2010), Rabobank

Colophon

The Special is a publication of the Economic Research Department (ERD) of Rabobank Nederland. The view presented in this publication has been based on data from sources we consider to be reliable. Among others, these include EcoWin, Bloomberg, OECD, and IMF.

AU is Australia, AT is Austria, BE is Belgium, CA is Canada, DK is Denmark, FI is Finland, FR is France, DE is Germany, GR is Greece, IS is Iceland, IE is Ireland, IT is Italy, JP is Japan, LU is Luxembourg, NL is the Netherlands, NZ is New Zealand, NO is Norway, PT is Portugal, ES is Spain, SE is Sweden, CH is Switzerland, GB is the United Kingdom and US is the United States.

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