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CAN FISCAL POLICY COUNCILS BE A SOLUTION TO THE CURRENT DEVELOPMENT IN THE EUROZONE?[2]

Introduction

Since the financial crisis and other aspects of the world economy started to intervene negatively into the real economy, the Euro zone has been facing its biggest troubles. But these troubles did not come out of nothing, only the existing, but in good times not that important economic problems, have become a real burden for further existence of single European currency. What we speak about here is the fiscal indiscipline of European governments.

Financial markets have put more pressure on governments of countries that suffer from high fiscal imbalance to present and adopt detailed plans for decreasing the level of debts and deficits in the short- and medium-term. The only (but quite considerable) problem is that this pressure for fiscal improvement is coming not with the best timing. The recovery of the economies is (if even exists) still too weak and many countries, especially those that would need the adjustment in the first place, are still suffering from economic downturn (we can name Greece, Ireland or Spain) or have negative outlook for 2012 and 2013 (Portugal, Italy). Fiscal consolidation in these countries would work as an additional dumper for the domestic economies, which would in turn negatively affect the fiscal situation. Thus the policy makers have to deal with two contradictory issues – to deal with the short-term demand for economic stabilization (in terms of aggregate demand support) and demand for long-term sustainability of public finances. This negative development has put pressure on the project of the single European currency. The responsible authorities of the Union have had to provide external financing in order to save the most hit countries (in terms of fiscal indiscipline and distrust from the financial markets) from going "bankrupt". New mechanisms have been established in order to provide financing for countries that could potentially end up in the same situation as Greece, Ireland or Portugal. But what has to be emphasized is that the

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primary purpose of all those mechanisms is to help countries in troubled economic (fiscal) situation, not to prevent its occurrence.

The aim of this paper is to review two potential scenarios that could deal with the origins of today's development – fiscal indiscipline and long-term unsustainability of public finances. There is a very interesting concept called fiscal policy council (further referred to as FPC). There are several forms in which the FPCs can and do appear (will be explained in detail later). But basically the main purpose of such councils would be the same as in the case of central banks, i.e. to implement some policy independently from the government or other policymakers. In this case, the role of FPCs would be to give either recommendations, or binding constraints (depending on the form of FPC) for fiscal policy. Such an independent body could be the guarantor for long-term sustainability of public finances. Two forms of FPCs will be described in the paper and their possible outcome concerning the fiscal situation will be described using the very simplified non-financial cost-benefit analysis.

Literature overview

There have been published papers that deal with FPCs either on general, theoretical level, or use some existing examples as a case study to prove or disprove the potential of such arrangements. To the first group, Wyplosz (2008) or Calmfors and Wren-Lewis (2011) can be assigned. Especially Wyplosz is providing important information about various forms and potential functioning of FPCs. Other paper, Hedvabny, Schneider and Zapal (2005), concentrates more on the application of the model on the Eurozone, while Eichengreen, Hausmann and von Hagen (1999) take a closer look at the development in Latin America and Bos (2008) at the development in the Netherlands. The views and proposals incorporated in these papers will be discussed in the text of the paper.

Theoretical framework

Before dealing with the definition of a FPC, let's move to a more general debate. This concerns the question, whether an improved fiscal discipline can be better reached by setting up rules or by institutional solution.

Using fiscal rules can be seen as the easiest way how to ensure higher fiscal stability. The strictest way would be to forbid deficits completely. This approach would put a high pressure on governments to behave very responsibly in fiscal terms. On the other hand it does not give the policymakers any chance to adjust their policy when there is a drop in economy's output. That would require further tightening and would probably cause decline in aggregate demand. A slightly modified idea, used for example within the Eurozone as the Stability and Growth Pact (SGP), suggest that deficits should not be banned completely, but there should be set a limit on the deficits. In case of the SGP is this limit set on 3 % of national GDP. The biggest disadvantage of this concept is that it allows deficits even in times of economic upswings. What can be seen as the most important drawback of setting up fiscal rules is that they allow for very low degree of flexibility. Especially when economic slowdown is on, using these rules might result in implementing pro-cyclical fiscal policies. As Wyplosz (2008) is correctly stating, "rules can be contingent, but the contingencies must be precisely described, otherwise they can be used as loopholes that undermine the rule. And it can be quite difficult to think of all possible situations where rules should be suspended" (p. 180).

Since the institutional arrangement in implementation of monetary policy has been so far more than successful, many economists have proposed the same solution also for fiscal policy. But such a system of delegation of powers to some independent authority is quite widespread. We could name for example jurisdiction.

According to Wyplsosz (2008), FPCs should be granted only the macroeconomic role of fiscal policy. Microeconomic aspects (income redistribution, provision of public goods and services, the size of public spending and tax burden) should be excluded and kept in the hands of elected authorities. Important feature of this characteristic is that such a limitation of powers allows for concentration on achieving public debt sustainability, which leaves room for stabilizing the macroeconomy in the short run. The question that remains is how to define public debt sustainability.

Depending on how much should be delegated to FPCs, Wyplosz (2008) distinguishes between two basic forms: soft and hard FPCs.

Soft FPCs have nothing more than 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" (Wyplosz 2008, p. 183).

The other variant, hard FPCs, means, that they "set the budget balance each year, without expressing any view neither 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" (Wyplosz 2008, p. 185).

The Problem
Soft FPCs

The concept of soft FPCs has been applied only in few countries. Bos (2008) and Wyplosz (2008) name Finland, the Netherlands, Sweden, New Zealand, Belgium, Denmark and to some extent the United States. As was stated above, the most important feature of this arrangement is that they only have an advisory role and as Wyplosz (2008, p. 183) is correctly commenting, their effectiveness rests entirely on reputation and public debate.

Soft FPCs might come in different forms. Interesting one is being applied in the Netherlands. As is described in detail in Bos (2008), there exists a trend-based fiscal framework. Its role is not to provide any deficit rules, but expenditure ceilings. According to Bos (2008, p. 11) the main advantages of such arrangement are following:

- Rules setting only a maximum limit on the deficit might encourage countries to run the largest deficits permitted, creating risks of excessive deficits. On the other hand, spending rules could provide better guidance to policy makers independently from the situation of the economy and the budget.
- Deficit based rules provide no incentive for counter-cyclical policy in strong economies and might even impose limits on the operation of automatic stabilizers. On the contrary, spending rules allow the automatic stabilizers to work in any economic conditions.

The expenditure ceilings are set in a process of negotiation of independent institutions like Central Planning Bureau, Statistics Netherlands, National Advisory Group on Budgetary Principles and Dutch Central Bank with the government, all with reference to a target for the fiscal balance based on longer-term budgetary sustainability considerations.

The question is whether the concept of soft FPCs would be applicable to the current institutional arrangement in the Eurozone. With the experience that even binding rules are in some cases not that binding, it would be probably very difficult to establish a trustworthy independent body, which would serve as advisory institution. Or to be more precise, its establishing would be much easier than gaining the needed reputation. Probably the best way how to implement a soft FPC could be to combine the current deficit rule approach (Stability and growth pact) with long-term expenditure ceilings. Such an arrangement would eliminate costs connected with deficit rule. But also this potential solution raises many questions. The most important one concerns management of the whole arrangement. Would there be one centralized FPC for the whole Eurozone (with some dislocated teams in individual member countries) or many different institutional FPCs in member countries. This issue is connected with the question of cooperation and sharing of the same aims. Since there is one rule concerning the deficit and one body (the Council) that is (or at least should be) responsible for its abidance, I think that there should also exist only one FPC (or more precisely one independent organization or institution) that would be present in all member countries and would have the same (advisory) role in fiscal policy framework. This could gain more respect and reputation for the FPC. Negative point could be connected with more difficult implementation of the same structure in different countries, since the fiscal framework and the processes are not the same in the member countries. This problem could be solved by using the second option, i.e. by setting up different FPCs in individual countries. It would probably enhance the implementation process, but this would raise the question of cooperation between these FPCs. But in both variants, the FPCs (maybe in cooperation with other local independent organizations) should focus more on the long-term sustainability of fiscal policy and allow more for flexibility in short term (Calmfors, Wren-Lewis 2011, p. 13).

Costs

- The biggest potential cost of this arrangement could be seen in gaining nonsufficient reputation. This would probably mostly concern the national FPCs rather than one FPC with organizational units in individual member countries. If they had no or low reputation, than they wouldn't be able to participate effectively and influence national fiscal framework. Only strong independent institutions in all member economies could be seen as an effective tool for dealing with the causes of financial difficulties of the Eurozone member countries. But achieving this seems to be presently quite unrealistic, especially with regard to the needed same level of acceptance in individual economies.
- The next problem arises from hard implementation. Establishing of new institutions is generally difficult, especially in a case when these institutions should somehow intervene into the power of government or other elected bodies. At least elementary understanding between the main political parties would have to exist in order to retain the existence and influence of such an institution. This may also be very hard to reach with the view of turbulent political environment in many European countries. It would be also connected with a change in national constitutions.
- Issue of independency is also very important. The functionality of a soft FPC must be primarily based on its independency. There should be no influence from the side of national government or other interest groups.

Benefits

- The main benefit of such an arrangement would be its focus on long-term sustainability of public finances and fiscal policy. Expenditure ceilings agreed on a basis FPC – national government seem to be a good tool for this purpose. Important would be to prepare these ceilings for a period that goes ahead an election period of central government. Thus more than one government would be bound to stick to this plan. Or there is also a second possible approach, applied in the Netherlands, when the government, at the end of its election period prepares (in cooperation with the Central Planning Bureau – the FPC) the spending guidelines for the next government.

- This approach would aim more at the causes of the current crisis, not consequences, as the existing mechanisms do.
- If a good cooperation between not only national FPCs (or unit of a FPC located there), but also between them and EU institutions (especially the Commission and the Council) could be achieved, this would lead to better and more effective coordination of economic policies and hopefully also economic cycles.

Costs vs. benefits

A soft FPC seems to have more balanced costs vs. benefits that the currently applied approach. The largest benefit could be ascribed to the inclusion of long-term perspective, since the current arrangement (Stability and growth pact) focuses more on short- to middle-term perspective. On the other hand, the largest costs could arise from the unsuccessful implementation of such an institution. In this case, when its credibility was low, the potential benefits would be strongly eliminated.

Hard FPCs

The difference between a soft and a hard FPC is characterized above. The "harder" version of an FPC gives binding recommendations on the budget balance each year and the elected bodies of a country have to follow them. Important is that "the FPC does not express any view on the size of the budget itself (spending and revenues) nor on any item in the budget" and "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" (Wyplosz 2008, p. 185).

The hard FPC has not been implemented yet in any country, which makes our analysis, with regard to experience with it, a little bit complicated. Theoretically we could say, that role of the Council during Excess deficit procedure shows some resemblance to the hard FPC. As is written above, the role of the Council is to monitor, whether the member economies apply to the fiscal rule according to the Stability and growth pact or not. If it decides that there is an excessive deficit in one or more member countries, then it gives recommendations that country (or countries) must implement in order to reduce the level of indebtedness and to avoid sanctions. This is how it should be working out, but as was illustrated above, the reality looks sometimes differently. But there are also some features that make this arrangement not a hard FPC. Firstly, this mechanism in not activated continually, but only when countries do not comply with the deficit rule.

This brings us to the second important difference, which is the fact that the specific role of the Council is activated ex post, when there exists a problem, not a priori, i.e. to prevent these problems to occur. The focus is more on short-term improvement of current negative situation, not on long-term sustainability. The member countries present annually stability programs that should mainly focus on the long-term view, but their application by countries is questionable. With regard to these facts we can state that the current role of the Council can't be described as a role of a hard FPC.
But there might exist some way how to implement a hard FPC into the European fiscal framework. We could use the example of a soft FPC, which was mentioned above, as a basis. What would change now in the arrangement, if we transformed it into a hard FPC? The answer is, not much. The most important difference would rest in the binding outcome of the FPC for the governmental decision makers. There would be no discussion about what to implement, but only following the given direction. In such an arrangement would it be counterproductive to combine the hard FPC with the deficit rule in form of the Stability and growth pact. The deficit rule could be better performed by the FPC, since this approach would eliminate the rigidity of the rule and allow for more flexibility. What would have to be dealt with carefully is again the institutional arrangement, i.e. whether to have one central institution with independent organizational units in individual member countries or specific institutions performing the same role in these countries. In this case, the issue of credibility and reputation is also important, but in other way. Since the recommendations of the FPC would be binding, its reputation would not have to be gained for the reason of trustworthiness and cooperation, but for being accepted by the government as a partner that has the same objective – stability of public finances. We can apply the same costs and benefits as in the case of the soft FPC, but some adjustment is needed.
Costs

- Compared to the soft FPC, the issue of nonsufficient reputation is limited since the firm anchorage in national fiscal framework.
- The process of implementation would be probably even harder than in the case of a soft FPC. The role of this institution would have to be precisely stated in national law and some amendments to the constitution would be probably needed because of the shift in powers to this new institution. But once this would be reached and implemented, it could retain for more than one electoral term. The only question is how long this would take to implement in all member economies of the Eurozone.
- Again, issue of independency is also very important. The functionality of a hard FPC must be primarily based on its independency, since it sets binding guidelines. There should be no influence from the side of national government or other interest groups. The issue, which would

have to be solved, is also the system of financing of the FPC. A fiscal council should have a long-term budget, removing a temptation for governments to try and influence the council's work through the size of budget appropriations (Calmfors, Wren-Lewis 2011, p. 16).

- The "new" potential cost concerns accountability and election method of the FPC members. One aspect is indisputable – they all have to be experts in this problem. But who would be entitled to nominate candidates and who would appoint them and for how long period? These issues would have to be very precisely specified and should differ only in details in member countries. Generally speaking, the FPC members must be accountable to elected officials. In European perspective, this role could be played either by national parliaments (in case of national approach to FPC) or by the European parliament (in case of one FPC with national units). There are many ways how to nominate a candidate. This competence could belong to public, interest groups, universities, etc. More important is the process of their election. Members should be elected and appointed by other body than they would be accountable to. At national level, this could be the role of president (who nominates members of central bank in many countries) or other body of national parliament; at EU level, this may be performed either by the Commission or by the Council. Personally, I would intercede for the EU solution due to larger complexity and possible higher simplicity in implementation. And the members should be appointed for a period of time, which would sufficiently exceed a standard electoral term.

Benefits

- The main benefit of this arrangement should be the same as in previous case, i.e. focus on long-term sustainability of public finances and fiscal policy. This should not constitute any problems since the hard FPC sets out the principles and guidelines. This could be done in the of expenditure ceilings (as described in the case of the soft FPC) or by the decision over the maximum permissible change in the government (or public) debt – the debt change limit. The latter proposal, described in detail in Eichengreen, Hausmann and von Hagen (1999), could transform the deficit rule (the Stability and growth pact) into institutional arrangement and thus allow for more flexibility.
- This approach would again aim more at the causes of the current crisis, not consequences, as the current existing mechanisms do.
- Very crucial would be the extent of cooperation between the hard FPC and EU institutions. If it was a close cooperation and there was only one FPC, then this could be perceived as a huge step towards the final completion of the Economic and monetary union (EMU). Effectively coordinated economic and monetary policies could finally lead to a sustainable economic development in a long-term perspective.

- This arrangement, when functioning properly, would also help to enhance (or restore in some countries) the level of credibility for external creditors (Eichengreen, Hausmann and von Hagen 1999, p. 417).

Costs vs. benefits

The implementation of a hard FPC might bring largest benefits of the three described and analyzed approaches. It is not burdened with so many compromises as a soft FPC and concentrates on the essence compared to the current approach. But is still has some costs, especially connected with its implementation, which would be the crucial point concerning success of the whole fiscal policy council concept.

Conclusion

In this paper, very actual topic, financial distress in many European economies, has been introduced and analyzed. Current solution is not sufficient and unless additional steps will be taken in terms of concentration on true causes of the problems, I don't see any bright future for the single European currency in middle- and long-term.

The development may turn into the positive one, if the concept of fiscal policy council was implemented. Even a soft FPC could bring some benefits, although it is connected with some compromises and drawbacks. The best way how to ensure long-term sustainability for the single European currency would be to introduce a hard FPC. At the beginning, this would be probably connected with implementation problems and the question of accountability would have to be solved, but the outcome should bring positive results – long-term sustainability and short-term flexibility (compared with the current situation).

Unfortunately, this concept has not gained much attractiveness among politics yet. The reason can be seen in the fact that fiscal policy is the only remaining true economic power left to politicians, since they transformed the implementation of monetary policy to independent central banks. And fiscal policy is the only way how to "impress" electorate.

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SUMMARY

Current economic and financial situation in the Eurozone is not favorable. Three member countries, Greece, Ireland a Portugal, have been forced to ask for external financing of their liabilities, because financial markets have lost confidence in these economies. After helping Greece, the EU (or more precisely the Eurozone) decided to establish new mechanisms that can be used in similar situations. But this arrangement is only on temporary basis, both mechanisms (the EFSM and EFSF) will be replaced by the mid of 2013 with the new ESM mechanism that will operate as a permanent rescue mechanism. But it still shows the feature of an ex ante approach, not focusing on the true causes of the recent development. Fortunately, there are other approaches, how to tackle the fiscal irresponsibility, which is the main reason for the turbulences we've been witnessing. It is a concept of fiscal policy councils that combine features of rules and discretion, i.e. they focus on long-term sustainability, but also allow for some flexibility in short-term. There are two basic variants of a fiscal policy council, the soft and the hard one. Their possible application in the Eurozone and costs and benefits of them are described in this paper.