



INDEPENDENT FISCAL WATCHDOGS: RATIONALE AND DANISH EXPERIENCE

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AGENDA

- Rationale for independent Fiscal Policy Councils
- The Danish Economic Council: Organization, policy thinking and policy influence
- Evolution of the Danish fiscal strategy
- The role of the Danish Economic Council in public expenditure control

POTENTIAL ROLES FOR FISCAL WATCHDOGS



Fiscal Policy Council: Independent expert body monitoring the public finances. Possible roles:

- *Ex ante* evaluation of whether fiscal policy is likely to meet announced targets
- *Ex post* evaluation of whether fiscal policy has in fact met the targets
- "Objective" macroeconomic forecasts as a basis for budget proposals
- Costing of new government initiatives
- Analysis of the long-run sustainability of fiscal policy
- Recommendations on fiscal policy



CAN FISCAL WATCHDOGS PROMOTE SOUND FISCAL POLICY?

Potentially yes, by

- improving awareness of long-run consequences of fiscal policy
- increasing transparency of fiscal policy (e.g. exposing off-budget items and hidden government liabilities)
- Increasing the reputational political costs of irresponsible fiscal behaviour
- Strengthening the legitimacy of necessary austerity measures in the eyes of voters



CASE STUDY: THE DANISH ECONOMIC COUNCIL

Established by law in 1962 to advise the Danish government and parliament

Mission (according to the law):

- To monitor the business cycle
- To analyse long term perspectives for the Danish economy
- To promote dialogue and consensus among the various economic interest groups

Original focus: incomes policy

Over the years: increasing focus on fiscal policy, long-run fiscal sustainability and structural reforms

INSTITUTIONAL SET-UP FOR THE DANISH ECONOMIC COUNCIL



- Chaired by four academic experts (the “Wise Men”), assisted by a staff of 35-40 people
- Chairmen formally appointed by the government; in practice the government always appoints the persons nominated by the incumbent chairs
- Chairmen cannot hold a seat in Parliament and must be independent of interest groups

INSTITUTIONAL SET-UP FOR THE DANISH ECONOMIC COUNCIL



- Other members of the Council include the leaders of various interest groups, the permanent secretaries of the economic ministries, a central bank governor and three independent academic experts
- The full Council meets twice a year to discuss a report prepared by the chairmen. A summary of the comments by Council members is subsequently published along with the original report which represents the independent opinion of the chairmen
- Following publication, the chairmen present their report in a hearing before the Fiscal Affairs Committee and the Economic Policy Committee of the Danish parliament

TASKS PERFORMED BY THE DANISH ECONOMIC COUNCIL



- Short-term and medium-term macroeconomic forecasts
- Analysis of current fiscal stance
- Analysis of long-run fiscal sustainability
- Analysis of trends in income distribution
- Recommendations on short-term fiscal stabilization policy
- Recommendations on structural policies with an emphasis on labour market policy, tax policy and pension reform



SUCCESSSES OF THE DANISH ECONOMIC COUNCIL...

The Council's main influence goes via the public debate. Recommendations often rejected at first, only to be implemented later. Examples:

- Labour market reform – first recommended in 1988; actual reforms started in 1994; the latest significant reform adopted in 2010
- Earned Income Tax Credit – first recommended in 1998; implemented from 2004
- Retirement reform – recommended since mid-1990s; minor reform in 1998; far-reaching reforms agreed in 2006 and 2012



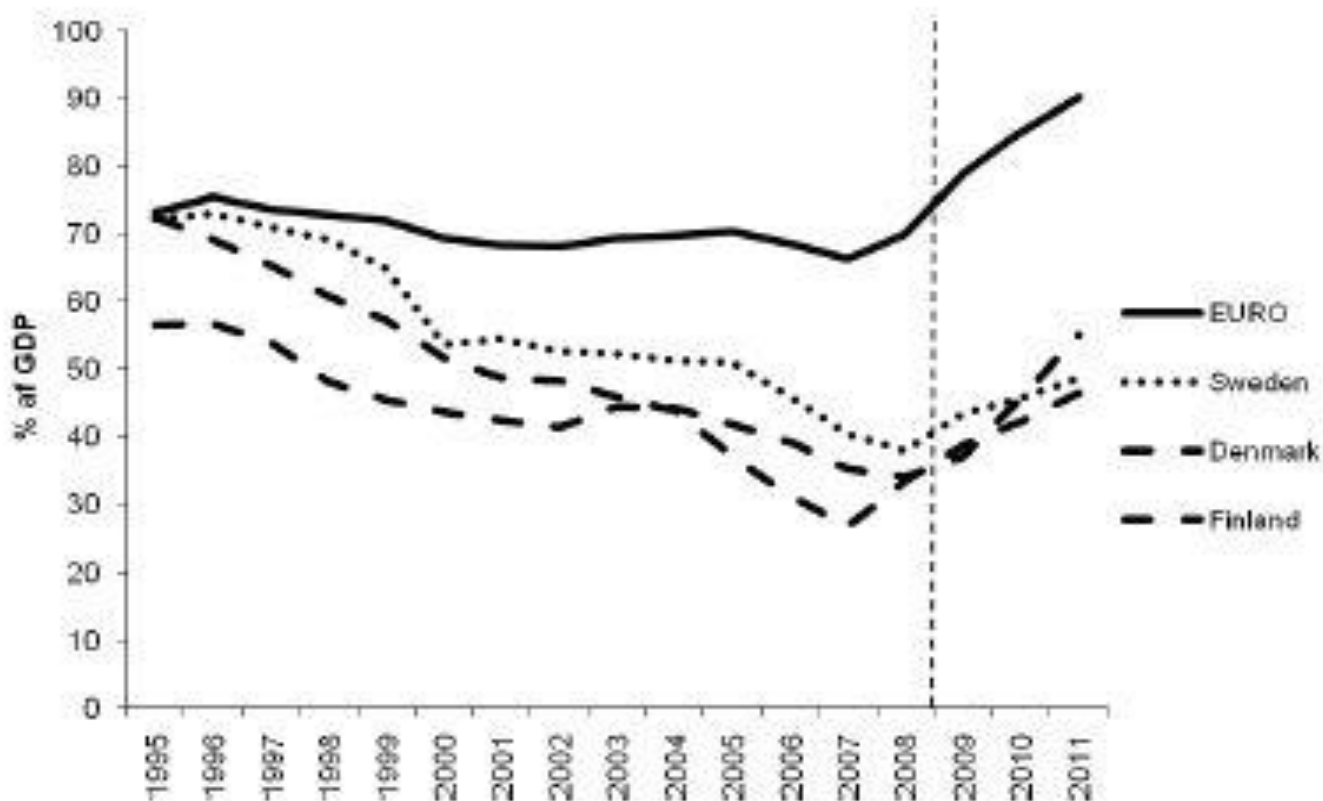
...AND FAILURES

Despite repeated warnings of the chairmen of the Economic Council,

- fiscal policy became procyclical in the mid 2000s
- public expenditure control loosened before the recent crisis
- a nominal freeze on properties taxes contributed to a housing bubble in the run-up to the recent crisis



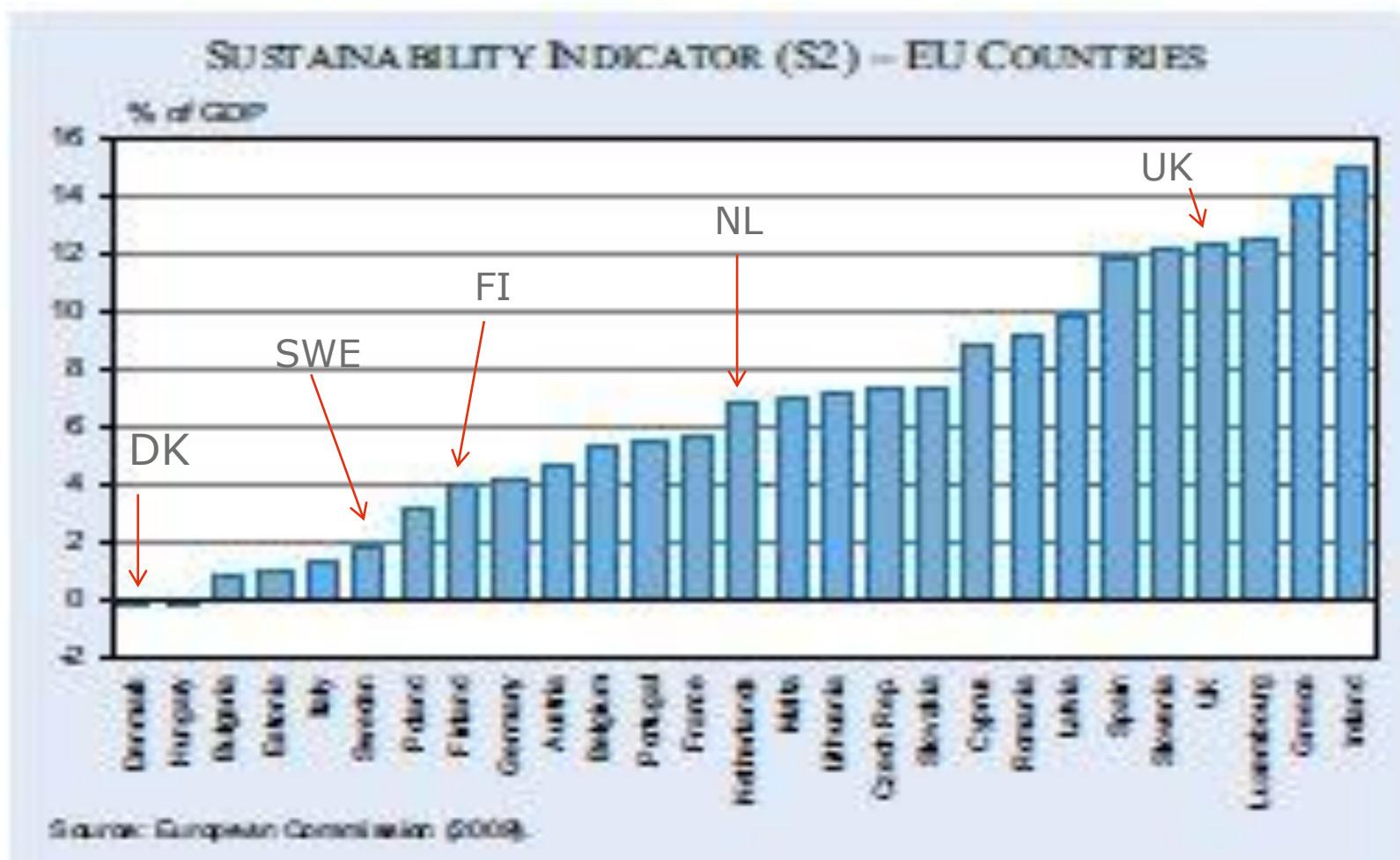
DENMARK VERSUS OTHER COUNTRIES: PUBLIC DEBT (Maastricht definition)



Source: Torben M. Andersen (2010), based on OECD data.



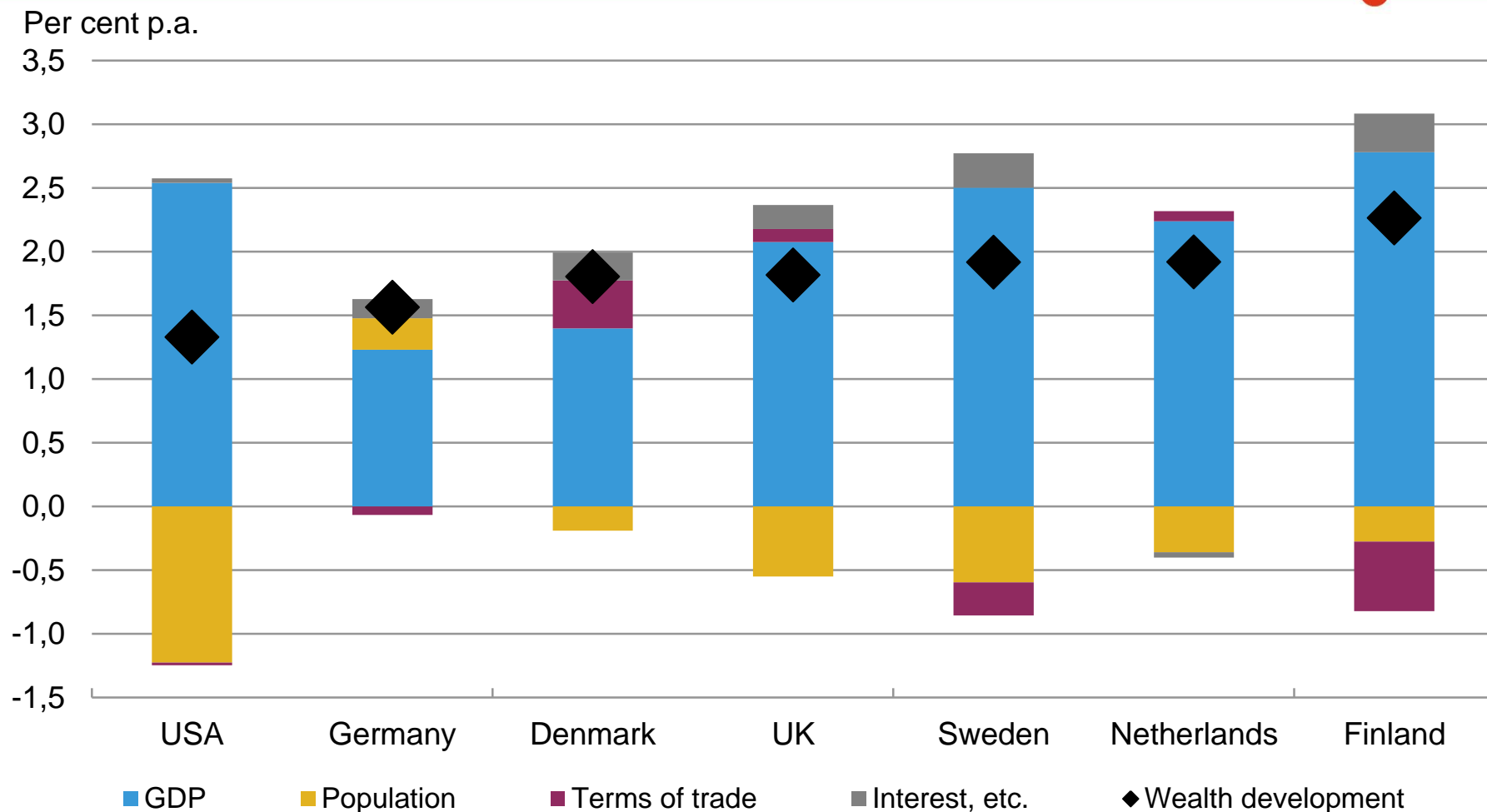
FISCAL SUSTAINABILITY IN THE EU, 2009



Note: The columns indicate the permanent improvement of the structural primary budget balance (in percent of GDP) needed to ensure fiscal sustainability. Source: European Commission.



AVERAGE ANNUAL GROWTH IN REAL INCOME PER CAPITA, 1995-2010



Source: The Danish Central Bank.



DANISH MEDIUM TERM FISCAL PLANS

- **2005 plan** launched in 1998: Targets for net public debt and net foreign debt
- **2010 plan** launched in 2001: Targets for net public debt and the structural budget balance to be achieved through structural reforms and low public spending growth
- **2015 plan** adopted in 2007 and **2020 plan** launched in 2011: updatings of 2010 plan



DANISH FISCAL THINKING AS OF 2011

Thanks in part to the pedagogical efforts of the Economic Council, there is now a broad consensus among Danish policy makers that

- Long-run fiscal sustainability is a *minimum* requirement that does not guarantee credibility
- A *credible* fiscal strategy must ensure that the structural budget deficit and net public debt remain below conservative limits



DANISH FISCAL THINKING AS OF 2011 (CT'ND)

- Within a *medium term* horizon structural budget balance must be achieved through a combination of structural reform and constrained public spending growth (savings strategy)
- In the *long term* the demographic challenge must be handled via recurrent adjustments (adjustment strategy reflected in 2006 Welfare Reform and 2011 Retirement Reform; indexation of retirement age)

FISCAL POLICY TARGETS IN THE NEW GOVERNMENT PROGRAMME



Goals and targets:

- Positive (or at least zero) structural budget balance by 2020
- The indicator of fiscal sustainability must always be positive
- The 1.5 percentage point improvement of the structural budget balance during 2011-13 requested under the EU Stability and Growth Pact must be achieved
- The level of public debt must be kept well below the limit set by the Stability and Growth Pact



A NEW FISCAL POLICY PRINCIPLE

The new Danish government has announced a new

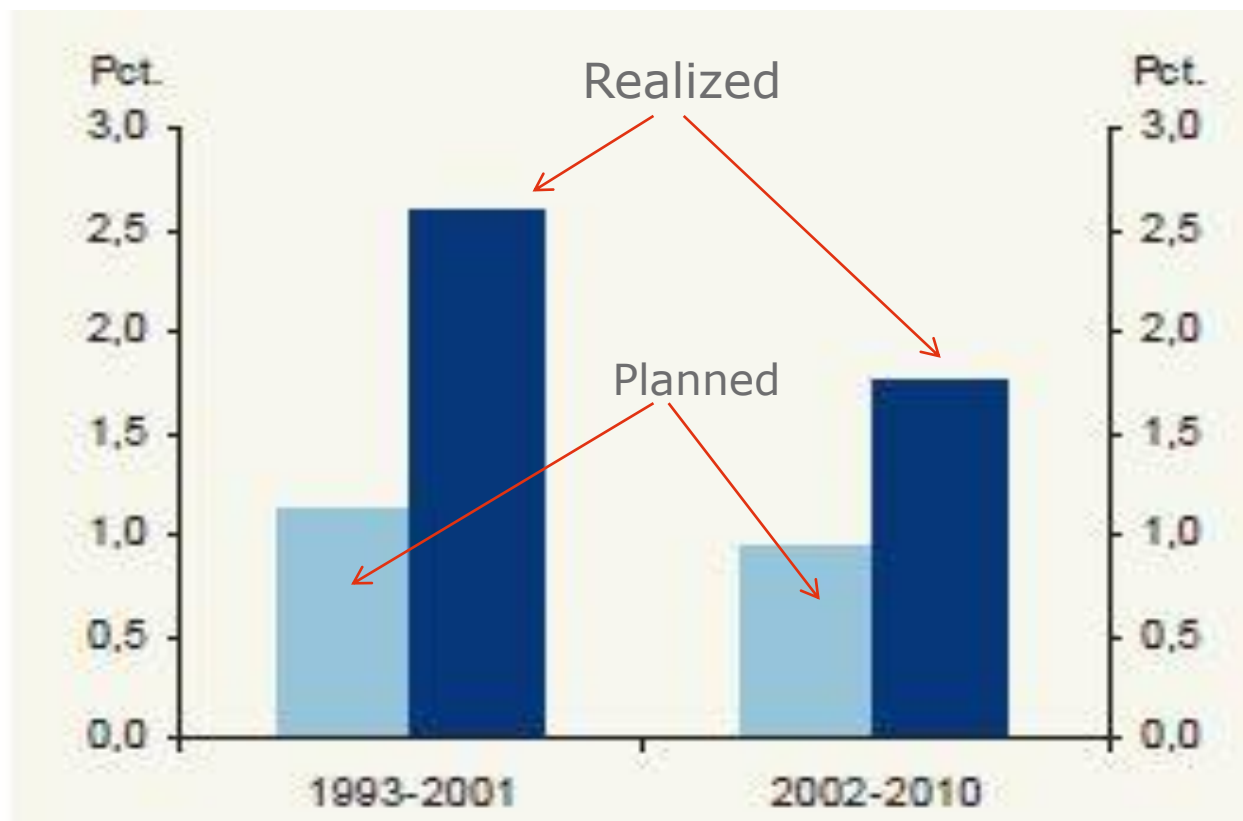
precautionary principle for fiscal policy:

- No new public spending to be legislated until the financing has been secured



THE PROBLEM OF SPENDING CONTROL

Annual growth in real public consumption



Source: Danish Ministry of Finance

POLICY RESPONSE: A NEW BILL ON PUBLIC EXPENDITURE CONTROL



The new government plans to follow up on the previous government's proposal to introduce a new **bill on public expenditure control**. Expected elements:

- Targets for budget balance and public debt
- 4-year (rolling) nominal spending ceilings for all levels of government (spending on unemployment benefits and certain other cyclical expenditure exempted)
- Tougher budget control procedures and sanctions against central government institutions and local governments if they violate their budgets (repayment, lowering of next year's budget etc.)
- The Danish Economic Council will be given additional resources to monitor adherence to announced expenditure policy and fiscal policy



CONCLUDING REMARKS

- Danish experience suggests that a fiscal watchdog can help serious politicians take difficult decisions on fiscal policy and structural reform
- The causality issue: are fiscal watchdogs established because politicians are already responsible, or is responsibility the result of the activities of the watchdog?
- Danish experience suggests it works both ways



Supplementary material



DANISH FISCAL STATUS IN THE FALL OF 2011

Target: Zero structural budget balance by 2020 →

Required improvement of structural budget balance **before** 2011 reforms: **47 billion DKK (2.9% of GDP)**, assuming that the annual growth rate of real public consumption is kept at roughly 0% in 2011-13 and at 0.8% from 2014

Improvements of structural balance due to

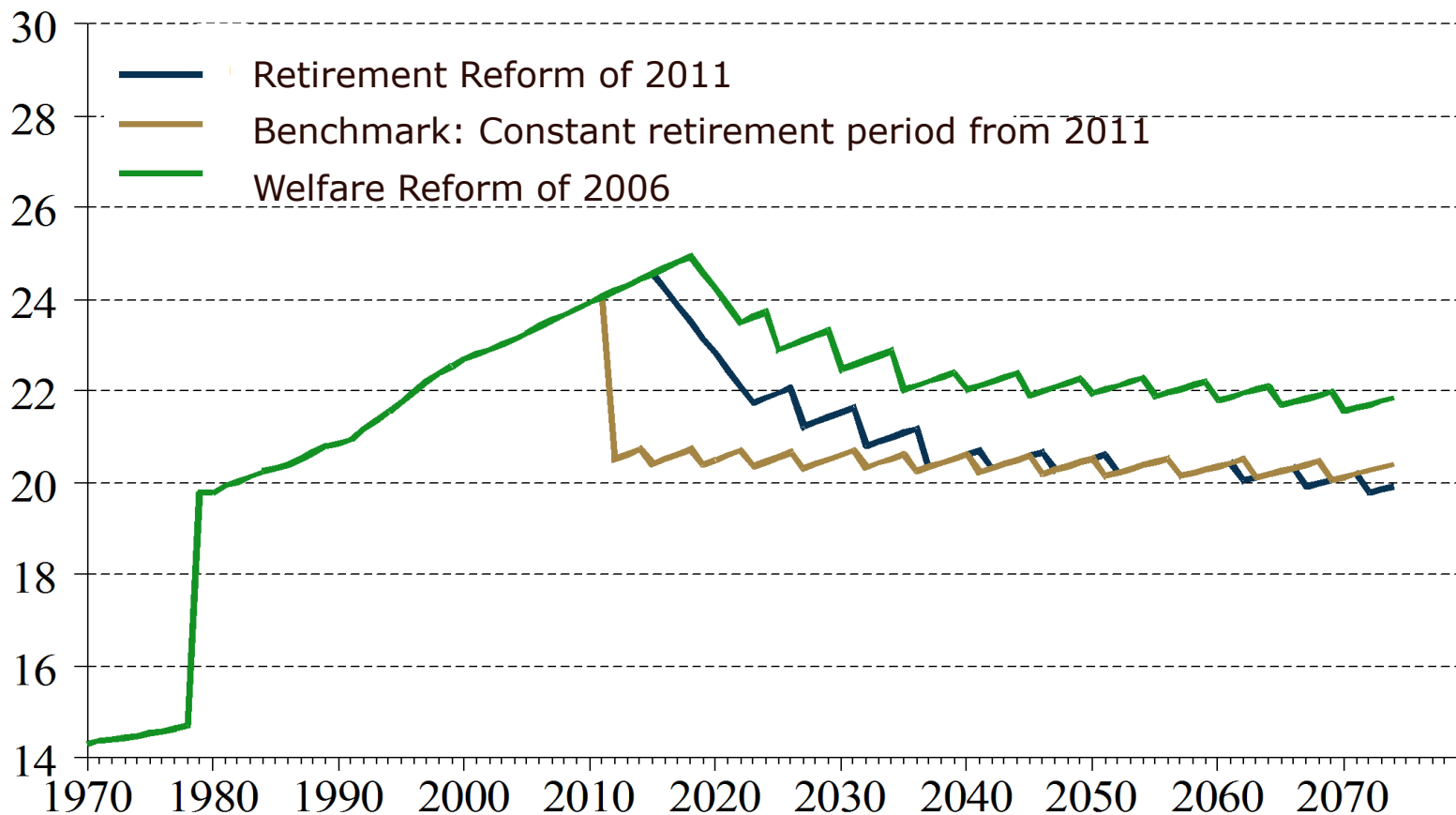
- Consolidation package (incl. reform of unemployment insurance): 24 billion DKK
- Retirement reform: 18 billion DKK
- Cuts in defense spending from 2015: 2 billion DKK

Remaining gap (closed by reforms agreed under previous government but not supported by current government): 3 billion DKK



EFFECTS OF RETIREMENT REFORMS: EXPECTED NUMBER OF YEARS IN RETIREMENT

Years in retirement



Source: The Danish Economic Council.