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Where is the line between independent economic analysis and active policy making? The example of the independent fiscal councils

The question to be raised

The invitation to a conference[1] made me write the exploration below. Fiscal councils independent from governments and political parties have been established in a growing number of countries, Hungary included, and their representatives gathered in Budapest to exchange their experiences. For example the legislation that brought Hungary's Fiscal Council into being specified that it be independent of the government, the governing, and the opposition parties, and stay remote from domestic political struggles. This has been expected by the public. I assume the legal specifications and expectations are similar in other countries.

I have been dwelling on the question of what independence really is. Where is the line between political activity associated with fiscal policy and the work of independent fiscal analysts? Can such a line be drawn at all?

While my thoughts can directly be only related to the roles of a *special* type of independent institution, my more *general* message can also be applied to other independent institutions (with the appropriate adjustments). My intention to reach a wider audience interested in public affairs made me choose this journal, and not a specialized monetary one.

"Big state" or "small state?" Structural transformations

Let me begin by analyzing the questions of essential structural change and radical reform. There is worldwide debate on the weight, size and influence the state should have in the economy. Do we need a "big" state or a "small" state, or something in between? This question was placed on the agenda by some events of great import.

The state had immense weight under the socialist system. The collapse of communism led inevitably to drastic reduction in the state's role in the post-socialist economy. Meanwhile the upkeep of the welfare state has been a cause of chronic fiscal difficulties, mainly in Western and Northern Europe. There began a process of trimming the tasks performed by the state.

While both historic events pointed to a *reduction* in the role of the state, there were also developments inducing an *increase* in it.

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[1] Organized by the Hungarian Fiscal Council, „Independent Fiscal Institutions" held a conference in Budapest, on March 18-19, 2010. The conference was first greeted by President László Sólyom, followed by the lecture, the basis of the above paper.

Many people who have studied the origins of the present economic crisis ascribe it largely to excessive withdrawal of the state from regulating the economy.

Any kind of expansion or contraction of the state's activity has tangible fiscal consequences. So the ratio of government spending to GDP is a reasonable first-approximation indicator of the weight (size) of the state.

Defining the state's role is a *political* decision. In practice, decisions are not made on the "aggregate" weight of the state: that tends rather to feature in political slogans only. But specific decisions may be taken on whether to increase or reduce the share of state-guaranteed pensions financed through the public pension scheme within the total income of the population in old age. Another example would be whether to increase or reduce the share of state-financed health care in total spending on health. These decisions have to be brought through a political process, in line with the constitution and legislation of the country concerned and bearing in mind the traditions in its political process.

Political decisions, if they are principled, rest on *value judgments:* individual liberty and freedom of choice, solidarity with other members of society, compassion for the disadvantaged in need of assistance, the right to welfare compensation for present efforts, or responsibility and sacrifice for the future. Politicians and citizens participating in the political process must choose a position in the conflict between such ultimate values.

I think independent fiscal institutions should keep far away from such decisions. Whatever economists' reasoning may suggest, that is, the attitude instilled in all of us since our student years: they have no right to take a stand on political decisions. But that does not mean they should be silent as these decisions are prepared and made. I would like to emphasize three aspects which they have both a right and a duty to speak out.

1. *Analysis of effects.* The first is analysis of the effects of political decisions. Whichever way financing of the pension system moves, it will affect the budget for many decades in the future. And apart from its fiscal effects, it will influence the distribution of income in certain points in time, and moreover, also the distribution of relative benefits and costs between generations. Those preparing the decision have a duty to prepare and publish these effect analyses. An independent fiscal advisory body must demand they be prepared and published and protest if they are not. And once they are available, it must subject them to careful scrutiny and publish its criticisms. If it feels the need and has the resources to do so, such a body should have experts of its own to conduct background research.

2. *Checking for consistency*. The second aspect to examine is the consistency of the state's intended role. The Republicans in the United States are wont to criticize the policy of the Democratic Party as "Big government, big spending, big taxes." Spending heavily on big government and levying high tax rates is a perfectly legitimate policy. Those who do not like it refrain from supporting it and oppose it on the political battlefield. But an independent fiscal advisory body should not argue either for or against it—that is not its job. Its role is to keep an eagle eye on whether the "big taxes" are sufficient to cover the "big spending."

"Cut taxes!" the US Republicans emphasize. If that is the choice to emerge from the political process, then that is an equally legitimate political decision. No independent fiscal institution should come out for or against it. That is not its job.

But it has a duty to look carefully at whether the cut in total tax revenue is accompanied by an appropriately compensating cut in total spending.

An independent fiscal advisory body should come out firmly against populist economic policy, regardless of where it appears in the political arena. It is cheap and harmful to mouth inconsistent promises even as political slogans, and still more harmful to take inconsistent government action. You cannot at once reduce total state revenue and raise total state spending. That is fraught with grave dangers, and an independent fiscal advisory body can play a crucial role in exposing and combating such a practice.

Now let me say a little about the budget deficit. I do not have time here to explore the relation between the deficit and countercyclical macroeconomic policy, and so I would like to talk only about long-term structural deficit. The fiscal deficit in a given year is affected by numerous factors: the position inherited from last year, fluctuations in activity, recent, on-going economic measures, and so on. But if the trend in the deficit over five or ten years is examined, it will reflect tendencies in the role that state has assumed. If the trend shows a large, persistent deficit, it reveals that governments have been acting inconsistently over the longer period examined. The long-term average fiscal deficit—and still more a rise or even accelerating rise or fall in the trend deficit, or even the speed of that rise or fall—is not just a piece of economic data, it is also an indicator of *political morality*, a yardstick of honesty or duplicity. If politicians want a big state with broad powers, let them take into account the fiscal consequences and levy more state revenue. If they want to increase the sovereignty of citizens and firms over spending decisions, let them narrow the range of state paternalism. A high and rising deficit bias is a warning sign, reflecting that the political sphere is persistently breaking the "pay-go" principle, failing to acknowledge the *joint* consequences of its own policy on both the revenue and expenditure sides.

3. *Transparency.* The third aspect is the transparency of fiscal policy. Independent fiscal institutions must insist that insight into fiscal decisions and their consequences, before political decisions are made, extends beyond the decision-makers and a narrow circle of experts, and should be open to the general public as well. Let them insist that those preparing the budget append aptly designed tables and diagrams that present the main characteristics of the interrelations clearly and can be read by interested citizens who are not trained as economists. Or if they fail to do so, let the independent financial institutions compile the explanations instead. Whichever the case, the jargon of fiscal economists and any evasions of politicians must be translated into clear, plain speaking.

Closely related to this is whether the budget and the fiscal processes in general have been correctly calculated. Is there any trickery in the figures, any "creative accounting"? This might be seen as a problem for the experts, yet these figures are not handled exclusively by economists, accountants and statisticians. Perhaps the political sphere had suggested rearranging the figures in some way, if not to falsify them, at least to give a better impression than warranted. It takes expertise and moral fiber for an independent fiscal organization to stand up against such efforts at distortion.

An “activist state” or “more freedom for the market?” Short-term fiscal policy
Let me turn now to matters of short-term fiscal policy, where it is still harder to say where the province of independent bodies ends and the responsibility of politicians begins. There is a lot of debate these days, among politicians and academic economists, about the causes of the economic recession, how to forestall future crises, and what are the constraints on doing so. It would be self-deceptive to believe this is an expert debate free of politics or values. For behind the conflicting positions and proposals lie not only competing economic theories, but also different political worldviews and value systems.

I have space only for a single example. What should the state (including the central and the local governments) do if some big, significant firm in industry or transport, or some important non-profit organization goes insolvent? Should it be rescued? If the state does not rescue it, if it ceases to function, many people will lose their jobs and spill-over effects will increase unemployment further, not to mention other undesirable social and economic effects. But if the state bails the failed company out, it will have unfavorable influence on managerial thinking. And the more frequent and widespread bail-outs become, the more “moral hazard” sets in and firm managers will expect they can count on a helping hand from the paternalist state if need be. This generates and reinforces the Soft Budget Constraint syndrome. Negative incentives to poor management—the automatic “punishments” that follow losses—will weaken. Softness of the budget constraint is a real encouragement to manage irresponsibly.

The problem is compounded by the many possible causes behind loss—not just bad management but bad luck with the market, or administratively set prices kept artificially low for political reasons, and so on. It is not rare for chronic loss-makers to hold a monopoly, so that the option of *not* rescuing them scarcely arises.

Whatever the case, there are fiscal effects. If loss-makers are state-owned enterprises or organizations, such as providers of public transport, or health-care or educational institutions, the fiscal effect is a direct one. Ultimately the losses are a charge on the state budget. So are the settlement of mounting debts; the vast costs of paying the bills of debt-ridden organizations to assure their survival. The outcome is unfair redistribution, because the rescue costs fall on present and future taxpayers.

Examining the problem makes it plain -- there are intricate value-judgments behind the “rescue or abandon” dilemma. Employment, the right to work, is a value of prime importance. So is fair distribution. Let those who are responsible for the losses pay for it, not the innocent bystanders. This also raises a value choice of how to distribute the costs between “today” and “tomorrow”. Denial to rescue entails problems *today*, but the demoralizing effect of mass-scale rescues and the consequent loosening of financial discipline create problems for *tomorrow*.

Hence, each bail-out calls for a political decision. It is not an independent fiscal advisory body’s task to say which organization should be saved and which left to its fate. It should neither support nor object rescue operations, or relieve decision-makers of their responsibility for deciding on them. The task of independent fiscal advisers is to describe as fully and clearly as possible the various short and long-term consequences of alternative decisions. Above all, they must demand from the governmental organizations preparing the decisions a thorough report on the likely effects. If there is none, the independent fiscal advisory body must draw attention to the omission. If there is, the independent fiscal advisory body must subject it to close scrutiny. The public needs to be informed objectively and reliably on the likely impact of political decisions.

The role of economists

Finally, let me say a few words on the role of academic economists. Economists at this conference who sit on independent advisory bodies or work for such fiscal institutions may retort that I have it easy. I recognize that economists in the academic world are in an enviable, exceptional position. They may, and often do devote one half of their research to objective, positive analysis and the other half to recommendations. Let me add here something less self-evident and less widely applied: it behooves them to declare their value judgments that provide the basis for their proposals. It is superfluous to detail in each article the general system of values that prompt the policy recommendations, but I consider this should be done from time to time, especially in longer, more comprehensive works. There is no such thing as a value-free position on a dilemma requiring a political decision.

The position is different for economists who enter public service, rather than simply write articles and books. I feel that a choice has to be made here between two types of role. They may undertake the task of advising the government or the parties behind it, or a party of the opposition, and as such contribute to the political decision-making process—in other words, they may be *inside politics*. Or they may do what the teams in fiscal councils have undertaken and remain *outside politics*. One or the other. As the great Hungarian poet Attila József wrote, "Smart though the cat may be, she can't catch a mouse indoors and outdoors at once." Certainly there is a fine line between the acceptable field of action for an independent, nonpolitical fiscal analyst and for an economist working within the political realm. Sometimes the line becomes blurred—there is a gray area where the two fields probably overlap. But independent analysts must exert themselves day by day to ensure that the line is observed.