The Creation of the Fiscal Council in Estonia:

Exploring the Explanations of Institutional Design

Authors:

Corresponding author: Ringa Raudla (ringa.raudla@ttu.ee), Professor of Public Finance and Governance, Ragnar Nurkse Department of Innovation and Governance, Tallinn University of Technology, Estonia. Address: Akadeemia 3, Tallinn 12618. Phone no: +3725213990

Kati Keel (kati.keel@ttu.ee), PhD student, Ragnar Nurkse Department of Innovation and Governance, Tallinn University of Technology, Estonia. Address: Akadeemia 3, Tallinn 12618, Estonia.

Mari Pajussaar (mari.pajussaar@ttu.ee), Graduate Student, Ragnar Nurkse Department of Innovation and Governance, Tallinn University of Technology, Estonia. Address: Akadeemia 3, Tallinn 12618, Estonia.

Paper presented at the WINIR conference in Utrecht, 14-17 September 2017.

The Creation of the Fiscal Council in Estonia:

Exploring the Explanations of Institutional Design

Abstract: In this paper, we explore the creation of the fiscal council in Estonia, using the perspectives of different strands of institutionalism on institutional design. Our analysis shows that the institutional design of the fiscal council was influenced, in tandem, by principal-agent considerations, transaction costs, existing institutional configurations, path dependence, and normative concerns of the bureaucratic agents in charge of creating the new body. We conclude that in order to understand and explain the motives and factors involved in institutional design, the explanatory angles provided by rational choice, historical and sociological institutionalism should be viewed as complementary rather than contradictory.

1. Introduction

Fiscal councils (FC) have received growing attention both in the scholarly literature and in practice over the past years, especially after the occurrence of fiscal crises in many countries (Hagemann 2011; von Trapp et al. 2016). In the "rules vs institutions" debate (e.g. Primo 2007; Wyplosz 2005), it has been increasingly argued that fiscal rules alone are sufficient but should be complemented with "fiscal watchdogs" (Debrun and Kinda 2014). In essence, a fiscal council is a "publicly-funded entity staffed by non-elected professionals mandated to provide non-partisan oversight of fiscal performance and/or advice and guidance … on key aspects of fiscal policy" (Hagemann 2011, p. 76). It is expected that having an independent body that monitors a government's fiscal policy can alleviate the informational asymmetries between the government and the electorate, increase the reputational costs to politicians of running deficits, curb the use of forecasts that are deliberately biased in an overly-optimistic manner and, through all that, facilitate commitment to budgetary discipline (Calmfors 2015; Calmfors and Wren-Lewis 2011; Debrun et al. 2013; Hagemann 2011).

In the attempts to address the sovereign debt problems and to promote fiscal discipline in the member states, the European Union (EU) has, in the last years, adopted several reforms of the fiscal framework, including the mandate to create fiscal councils at the national level. Specifically, the two-pack and the Fiscal Compact (or the Treaty on Stability, Coordination and Governance) required all members of the Eurozone to create an independent body that monitors government's compliance with national fiscal rules and produces or endorses macroeconomic projections. While some of these countries already had equivalent institutions (e.g. Belgium, the Netherlands, and Austria), for most it amounted to having to create a new institution (von Trapp et al. 2016).

In this paper we explore how the fiscal council was created in one particular country: Estonia. Analysing the Estonian case, from the point of view of institutional design, is insightful for the following reasons. It allows us to examine a situation where actors *have* to create an institution but they do not see a *need* for it, since the problems such an institutional solution is supposed to address are perceived to not exist. As mentioned above, fiscal councils are regarded as useful for enhancing fiscal discipline. Estonia, however, stands out among the EU countries as a poster-child of fiscal conservatism, reflected, for example, in the lowest level of public debt (10% of GDP) (Eurostat). Thus, in the eyes of the Estonian policy actors, the problem(s) the fiscal council was supposed to address did *not* exist. Furthermore, not only was the creation of a fiscal council considered to be *unnecessary* in the Estonian context, the policy actors were actively *against* it during the negotiations over the EU legislation.

Thus, looking at the creation of the fiscal council in Estonia allows us to explore a situation where policy actors do not see a *need* for an institution, do not *want* it but still *have* to create it. Our research question is: which factors influence institutional design under such circumstances? From the perspective of rational choice (e.g. Shepsle 1989), we would expect that the actors responsible for designing an institution in such a context would go for a "minimizing" alternative – opting for the "easiest" or "cheapest" solution available. In the Estonian context, this would have been to locate the fiscal council within the Ministry of Finance (MoF). The EU mandate did, in fact, allow such a solution. The government, however, decided *not* to adopt the "easiest" alternative. Instead, the new organic budget law, enacted in 2014 foresaw that the fiscal council would be an independent body, supported in its activities by the Bank of Estonia (i.e., the central bank of Estonia). Thus, we are interested in the kinds of motives that led the institutional designers to choose such a solution.

While empirically grounded and starting with a specific empirical puzzle, our paper also seeks to contribute to theoretical discussions on institutional design. Although one would expect the

various streams of institutionalist research (i.e. rational choice institutionalism, historical institutionalism, and sociological institutionalism) to pay extensive attention to the question(s) of institutional design, this issue has attracted only limited attention in the existing literature, which appears to be more concerned about how institutions persist and what the impacts are rather than about how they come about in the first place (Olsen 1997; Peters 1999; Thelen 2009). Furthermore, when existing studies look at institutional design at all, they tend to focus either on a purely *voluntary* creation of a new institution or on a *coerced* imposition (e.g., Olsen 1997). In this paper, we will be focusing on a situation that is "in-between" those two polar opposite cases: where the designers *have* to create an institution but still have considerable *leeway* in how to do it. Given the increasing role played by the EU in the political lives of its member states, understanding institutional design in such circumstances is more important than ever.

The paper is structured as follows. Section 2 gives an overview of different theoretical approaches to institutional design. Section 3 describes how the fiscal council was created in Estonia, followed by the analysis of the factors that influenced its design in section 4. Section 5 concludes.

2. Theoretical approaches for exploring institutional design

Different institutionalist approaches define the term "institution" in different ways. In this paper, we proceed with a relatively straightforward definition, conceptualizing an institution as "a structural feature of the society and/or polity" (Peters 1999, p. 18). We are interested in the creation of a formal body. More specifically, we want to examine the creation of *a watchdog* by actors who will themselves be monitored by this institution in the future, in a situation where they *do not want* to create such a body *but have to*.

On the whole, institutionalist research has been more concerned with how institutions "constrain" behaviour rather than with how actors actually create or design institutions (Olsen 1997; Peters 1999; Thelen 2009). Still, the existing body of institutionalist literature can provide some theoretical insights into how actors might proceed with creating a new institution. The different strands of institutionalism – rational choice institutionalism (RI), historical institutionalism (HI), and sociological institutionalism (SI) – point to various factors that are likely to play a role in designing a new formal institution. The main theoretical arguments used by RI for examining institutional design are principal-agent problems and transaction costs. For HI, the core notion for exploring institutional development is path-dependence, whereas SI focuses on prevailing norms and lesson-drawing. (Peters 1999; Hope and Raudla 2012) In the following, we look at what these different theoretical approaches would predict about a situation where agents have to create their own watchdog, in a situation where they do not in fact see a need for such an institution.

Although RI focuses on the voluntary creation of institutions (Hall and Taylor 1996), its insights can be used for exploring how actors behave when they *have* to create an institution as well. The basic insight of RI is that actors behave instrumentally, are driven by their strategic interests and affected by the expectations of how others behave (Shepsle 1989). Thus, when creating a new institution, the actors would be influenced by the expected value of that institution for them and attempt to choose the form that benefits them the most (Hall and Taylor 1996). More specifically, from the RI perspective, institutional design can be explored through *principal-agent* models and the concept of *transaction* costs (Aspinwall and Schneider 2000; Hall and Taylor 1996; Weimer 1995).

An agency relationship is established when a principal delegates some rights (e.g. rights to utilize foreseen resources) to an agent who is bound by a formal or informal contract to represent the principal's interests (Eggertson 1990). In the public sector context, the elected

officials are usually considered to be the "principals" and bureaucrats their "agents" (Mitnick 1975) but this model can also be used for characterizing a much wider array of relationships: e.g. the voters and politicians, heads of public organizations and their subordinates, ministries and agencies etc (Waterman and Meier 1998). The core problems in the principal-agent (PA) relations are goal conflict and informational asymmetry: the agent's goals may be misaligned with those of the principal and, in the presence of informational asymmetry, agents may engage in opportunistic behaviour, like shirking (Waterman and Meier 1998). In light of these insights, if "agents" are in a position where they can create a "principal" entrusted with the task to monitor them in the future, what would the PA model imply? From the RI perspective, given the agents' opportunism and motives to maximize their self-interest (Dunleavy 1991; Miller and Moe 1983; Primo 2007; Williamson 1985), they would have incentives to create a weak watchdog, with limited powers and constrained opportunities for sanctions. Furthermore, given that agents generally benefit from informational asymmetries (Bendor et al. 1987), they would attempt to create a principal with limited access to information, expanding their opportunities to "shirk".

Another core insight of RI is that when considering, evaluating and comparing different alternatives, institutional designers are likely to pay attention to the *transaction costs* associated with creating each of them (Bartle and Ma 2001; Coase 1937, 1960; Williamson 1985). Transaction costs would refer to how costly it is to set up the body and what costs are associated with its operations (Bartle and Ma 2001; Epstein and O'Halloran 1997; Williamson 1981, 1985). From the perspective of RI, if policy actors *have* to create an institution they don't see a need for, they would be motivated to lower the transaction costs associated with the body (Hall and Taylor 1996; Primo 2007; Shepsle 1989). In addition to the costs of setting up and operations, the designers might be concerned with *political* transaction costs (Bryson and Ring 1990; Twight 1994) and assess how different types of institutional designs might

influence the costs of reaching political agreements in the future. In the public sector context, the actors in charge of creating an institution may, in fact, intentionally seek to *increase* political transaction costs – in order to secure "better" decisions (Bartle and Ma 2001) or to avoid departure from the status quo (Primo 2007).

For the most part, historical institutionalism (HI) is relatively silent on institutional design and the creation of new institutions; it focuses more on how political institutions persist, after they have been formed (Hall and Taylor 1996; Peters 1999). However, it can still provide some useful insights about the potential constraints imposed on institutional designers. HI would emphasize the importance of existing institutions and policy trajectories in the creation of a new body (Hall and Taylor 1996; Steinmo et al. 1992). One of the core concepts of HI is *path dependency*: when a government programme or an organization embarks on a path there is an inertial tendency for those initial policy choices to persist (Hall and Taylor 1996; Pierson 1993, 2000). Previous institutional commitments and policy choices influence subsequent decisions and modes of interactions between the policy actors through lock-in and feedback effects (Hall and Taylor 1996; Peters 1999; Steinmo et al. 1992). Also, institutional choices made at one point in time can influence the power distribution, and through that, reinforce the existing path (Thelen 1999). In Offe's (1996) words, in the modern world "designed" institutions are almost always "successor" institutions and cannot be built on a tabula rasa. Thus, when creating a new institution, the designers would be influenced by the existing configuration of institutions and would try not to depart from the existing policy arrangements too much. In addition, using the insights from Thelen's (2009) work on institutional change, we would expect the institutional designers to "layer" the new structure on existing ones (see also Bick 2016; van de Bovenkamp et al. 2017).

Sociological (or organizational) institutionalism (SI) has pointed to the importance of prevailing norms and values in moulding the behaviour of actors (Peters 1999). It argues that

the “logic of appropriateness” influences behaviour more than the “logic of consequentiality” (March and Olsen 1984, 1989) or the “logic of instrumentality” (Campbell 1998). Although the main focus of SI is on how institutions as norms *constrain* the behaviour of actors, it can offer some insights about institutional design as well. We can expect that the logic of appropriateness limits the range of search for institutional alternatives and shape the design of the new body (Cyert and March 1963; Olsen 1997). Thus, in designing a new formal institution, the actors would not necessarily choose the “most efficient” form in terms of costs or the “weakest” form in terms of power (as RI would postulate). Instead, by following the “logic of appropriateness” and concerns with securing the social legitimacy of the new body, the designers would be influenced by existing norms and values in general and about specific normative expectations about how the particular institution should (or could) look like in particular (Hall and Taylor 1996; Olsen 1997). They can be expected to use an existing template or a prescriptive model of the institution (Peters 1999; Hall and Taylor 1996).

SI has also pointed to how specific institutional forms have diffused *across countries* (Hall and Taylor 1996). From that perspective, institutional designers are likely to analyse similar organizations in other countries, either with the goal of emulating a “normative ideal” or with the goal of (positive or negative) lesson-drawing (Offe 1996; Rose 1991). When searching for and evaluating various alternatives, the experiences of other countries might provide insights about the functioning of a particular institutional solution and whether it can be transferred to one’s own country (Dolowitz and Marsh 1996; Rose 1993). Policy actors engaged in lesson-drawing can opt for copying or creating a hybrid or synthesis (by blending elements of institutions from different countries) (Rose 1993). They may also learn negative lessons about institutional solutions to be avoided (Rose 1991). In addition to “drawing” lessons, using other countries as models can be used for enhancing the legitimacy of a particular institutional solution chosen (Offe 1996).

3. The creation of the fiscal council in Estonia

In this section, we give an overview of the creation of the fiscal council in Estonia in 2013-2014. Section 4 follows with our analysis of the motives and factors that influenced the institutional design. As sources of data for the empirical analysis, we used policy documents, verbatim records of legislative sessions, and semi-structured interviews. We conducted 14 interviews with the main policy actors involved in the creation of the fiscal council during in 2014-2015 (including public officials from the ministry of finance, the Bank of Estonia, and the parliament). The interviews were recorded, transcribed and independently coded by each of the authors.

The Estonian government was against the mandatory requirement to establish fiscal councils in *all* Eurozone countries since they didn't see a need for it in Estonia. As one of the interviewed officials noted, "During the EU negotiations we were the ones saying the loudest that this provision should not be obligatory for all member states." (Interview 12). All the interviewees argued that although many other countries in the EU might benefit from such an institution, it would be redundant in Estonia since the problems a FC is supposed to address (fiscal indiscipline and biased forecasting) did not exist here. First, it was emphasized that Estonia has not violated the fiscal rules of the EU. Second, it was stressed that the Estonian MoF in general (and the fiscal policy department in particular) has always been independent and not politically influenced in making the economic and fiscal forecasts (Interviews 6, 12, 13, 14). It was also noted that the MoF has emphasized openness and transparency: before publishing the prognoses, it contrasts them with those of the other bodies, explicitly includes the comparisons in explanatory notes and if there are differences, explains why (Interview 6). Furthermore, before publishing its forecast, the MoF organizes meetings with other institutions who also do prognoses and asks them for their opinions. Thus, as one of the interviewees put it, "if MoF had a bias towards overly optimistic forecasts, it would come

out." (Interview 12). Third, several interviewees felt that since there are already several external bodies (e.g. the IMF, the OECD, and the EC) monitoring and evaluating the forecasts and the budgetary policy, creating an additional body would be superfluous. In addition to the perception of redundancy, the objections to creating a FC were motivated by the desire not to "create any additional bureaucracy" and also fears of not having enough analytical competencies to man it (Interview 10).

The Estonian government was, however, not successful in pushing for the non-mandatory nature of FCs in the Eurozone. Once it became clear that this requirement would be included in the two-pack and the Fiscal Compact in 2013, the government first considered an option to just "declare" the Bank of Estonia (BoE) to be the "fiscal council", implying that no new separate body would have to be created. Most of the interviewed officials noted that this would have been a good institutional solution, given that the BoE has the best macroeconomic competencies in Estonia, monitors the budgetary policy anyway, and it would not have required the creation of a "new bureaucracy". The MoF and the BoE officials who had devised this plan, could not proceed with it, however, due to the objections from the European Central Bank (ECB). The European Central Bank (2013) noted in its opinion that if the BoE were to become the fiscal council, its monetary policy mandate and independence might become undermined, which is why this would not be an advisable institutional solution. According to several interviewees, however, the claims of the ECB were not really justified. It was argued, for example, that since monetary policy is made by the ECB and not the BoE, there would be no conflict between monetary policy and fiscal policy even if the BoE took over the role of the FC (Interviews 10, 11, 12).

Given the objections from the ECB, the Estonian government had to devise an alternative plan. Instead of "declaring" the Bank of Estonia to be the "fiscal council", the new framework law on budgeting (the State Budget Act) and the amended law on the Bank of Estonia,

adopted in early 2014, foresaw the creation of an independent body, in the form of a working group (or "advisory board"), composed of six members appointed for five years, which meets regularly and is supported in its activities by the BoE. According to the law, the members' "reputation must be unblemished" and they "must possess at least a Master's degree in an economic specialism or an equivalent degree, and the experience required for the performance of the Council's tasks". Formally, the FC is considered to be an *independent* advisory board. The law on the Bank of Estonia emphasizes that "In performing its tasks, the Fiscal Council operates as an independent body which accepts no instructions from the Bank of Estonia, the Government of the Republic or any other private or public body." At the same time, the FC does have strong interlinkages with the BoE, which plays a significant role in its functioning. The members of the Fiscal Council are appointed by the Supervisory Board of the Bank of Estonia at the proposal of the Governor of the Bank of Estonia. The financing of the FC is part of the budget of the BoE. The BoE provides rooms and support staff for the FC. Also, the Charter of the Fiscal Council is approved by the Supervisory Board of the Bank of Estonia. Thus, although formally independent, the solution adopted in Estonia can be categorized as "attaching" the FC to the central bank. From a comparative perspective, "attaching" the fiscal council to a central bank is a relatively unusual approach in designing fiscal councils, though not entirely unique: in Austria, the Central Bank provides staff for the Fiscal Advisory Council and in the Slovak Republic, funding for the Office of Budget Responsibility is provided by the National Bank (von Trapp et al. 2016). The laws governing the work of the FC outline that its tasks are to assess the state macroeconomic and financial forecasts and monitor the compliance with the budgetary rules. If the Government or the MoF disregard the opinions of the FC, they have to justify it publicly. The FC evaluates the economic prognosis in March and August, gives its ex ante opinion about whether the stability programme and the

State Budget Strategy are in compliance with the structural balance rule, and assesses whether the previous year's budget was in structural balance (in June).

4. Factors influencing the institutional design of the fiscal council in Estonia

In this section, our goal is to explore how well the theoretical insights provided by the different types of institutionalism can explain the creation of FC in Estonia. In particular, to what extent can the designers' choices be understood with the help of the notions of principal-agent relationships, transaction costs, path-dependence, institutional layering, existing norms and lesson-drawing?

4.1. Principal-agent perspective

As argued in section 2, from the perspective of RI, if agents are given the task of designing their own "principal" who would observe and monitor their work and evaluate it, they would have incentives to create a weak one. Although the EU rules would have, in principle, allowed the establishment of a fiscal council within the finance ministry, the Estonian policy-makers did not opt for that. Furthermore, they chose to "attach" the FC to an organization that is well-known for its capacities in macroeconomic analysis and forecasting, subjecting themselves to a potentially powerful principal, who has the authority (and also legitimacy) to call into question the macroeconomic forecasts and the chosen course of budgetary policies.

How can we explain the empirical puzzle that the policy-makers in Estonia, in designing their own "watchdog" created a potentially strong body rather than a maximally weak one? In order to explore the *principal-agent* perspective a bit deeper, we would have to take a closer look at which "agents" were in charge of designing the fiscal council and what their motives were. As pointed out in the explanatory note to the new framework law for budgeting and confirmed by all the interviews, the most important role in the institutional design of the FC in

Estonia was played by the *MoF officials*. When designing the provisions pertaining to the fiscal council, they also consulted the Government Office and the BoE. Thus, MoF officials were designing a "principal" for both themselves but also for the elected officials in the government and parliament. Or, putting it another way, they were creating a situation where they would have another "principal" alongside the politicians. As "agents", however, their motives with regard to the design of the FC were significantly more complex than "not wanting a body that would criticize them". For several reasons, the MoF officials had, in fact, incentives to create a relatively strong FC.

First, the generally rather fiscally conservative MoF officials came to regard the FC as a potential ally against future governments that might be fiscally more profligate (Interviews 1, 6, 13). As was noted in one of the interviews, "We came to realize that the situation may change: other parties may come to power and pressure the MoF to be more biased." (Interview 13). In other words, the FC was viewed as an "insurance mechanism" for preventing future politicians from violating the fiscal rules and increasing spending too much. As Waterman and Meier (1998) have pointed out, when faced with multiple and competing principals with diverging goals, the agents would have an incentive to ally themselves with principals who most closely reflect their policy goals. Thus, in the context of designing a new principal for themselves, the Estonian MoF officials took into account in which form the FC would have similar goals to themselves. In other words, by designing the principal for themselves, they sought to "lock in" their current policy preferences. Furthermore, the bureaucratic agents of the MoF also provided the watchdog with an appointment mechanism that would minimize political influence and meddling – by stipulating that the board of the BoE (rather than any elected officials) appoints the FC (Interview 12). Also, the option of attaching the FC to the parliament was not considered desirable because then the body would have been "too closely involved with politics" (Interview 12).

Second, although the potential criticisms from the FC regarding economic forecasts and the compliance with the fiscal rule may put the MoF in the spotlight, the monitoring by the FC would also allow MoF officials to share the blame for mistakes (if they were to occur). This is especially true with regard to the structural balance requirement, the violation of which could be potentially costly in terms of the sanctions from the EU. Thus, according to the interviewed MoF officials, an additional check (by the FC) would help to improve the accuracy of decisions but also help to diffuse blame if the EU assessments vary from the local ones (Interviews 1,2). As one of the interviewees noted, the FC can aid the MoF in their discussions vis-à-vis the EC over diverging assessments of the structural budget position (Interview 9). In sum, while for elected officials, any criticism coming from the FC might be problematic, the MoF officials saw it as potentially helpful and useful and, therefore, designed the FC to be a relatively "strong" principal.

4.2. Transaction costs

As discussed in section 2, in addition to the principal-agent relations, another core concept for RI in analyzing institutional design is *transaction costs.* In the case of creating the FC in Estonia, the motive of optimizing costs (including transaction costs) did play a considerable role in the institutional design. As several interviewees from MoF emphasized, they did not want to incur large costs in relation to the FC. The first reaction to the EU requirement – the idea of just "declaring" the BoE to be the FC – was very much driven by that consideration (it would have entailed no additional costs at all).

Also, the idea of *not* creating a new *stand-alone* institution, which persisted after the initial idea of declaring the BoE to be the Estonian FC had to be abandoned, was driven by the motive to save costs. The model that was opted for – an FC as a working group of experts that meets regularly and is supported by BoE administratively and analytically – achieved that

(Interview 12). This solution meant that the members of the FC would not be full time employees but would fulfil their obligations in addition to their regular jobs. It also allowed the institutional designers to claim that they were not "creating any additional bureaucracy" (which had been a strong motive in objecting to the creation of the FC in the first place). It was also noted that since the FC does not have that many functions, creating a whole new separate body "would not have made much sense" (Interview 13).

The interviewees from the MoF also explained that they did not want to create an organization that would have to start completely from scratch and first have to find rooms and support staff (Interviews 6, 12, 13). Thus, attaching it to an *existing* organization that could provide all those seemed like a better choice in terms of start-up costs. The idea was to allow the FC to "hit the ground running", so that it would be able to provide evaluations as soon as possible (Interviews 10, 12).

Furthermore, several interviewees emphasized that if a new separate and full-time body had been created, the recruitment of members, given the limited pool of macroeconomic competence in Estonia, would have been highly challenging. Thus, the designers regarded finding the appropriate people with necessary skills as entailing significant transaction costs (Seo and Ryu 2012). Indeed, in a small country like Estonia, there are very few people who can do both macroeconomic and fiscal policy analysis (Interview 8). Thus, it was considerably more "expedient" to design the FC in the form of a working group rather than a full-time body. One of the interviewees also noted that if a whole separate body for making economic forecasting had been created, in a small country context it would have entailed staffing it with the people previously in charge of forecasting in the MoF and, thus, substantively nothing would have changed (Interview 12).

As mentioned in section 2, in addition to the costs associated with the setting up and operation of an organization, the institutional designers in the public sector may pay attention to political transaction costs (i.e. the costs of reaching political agreements in the future). In the case of the FC in Estonia, the designers were indeed motivated to increase the political transaction costs associated with reaching certain types of policy agreements in the future. As argued in section 4.1., the fiscally conservative MoF officials viewed it as desirable that the FC might prevent the emergence of overspending in the future (by increasing the costs of deciding to run a budget deficit).

4.3. Existing institutions and path dependence

The *existing configuration of political institutions* and their interlinkages played an important role in influencing the organizational solution of attaching the FC to the Bank of Estonia. As the interviewed officials noted, the MoF has had close cooperation and frequent contacts with the central bank for many years, in the form of joint seminars, meetings, outings, and informal discussions (Interviews 2,3,4,5,7,10). As one of the MoF officials emphasized, among all the existing public sector organizations, when it comes to macroeconomic forecasting and fiscal policy discussions, the MoF cooperates most closely with the BoE (Interview 2). For example, in the past, when making economic forecasts, the MoF officials presented their prognoses to and asked for information and advice from the BoE officials. Thus, when attaching the FC to the BoE, the MoF officials could anticipate the kinds of informal interactions that might unfold in the future. They could expect that the good informal collaboration with BoE would spill over to the FC as well. Also, as one of the BoE officials noted, "Given that the MoF relies a lot on our advice and information in making their forecasts, it might be somewhat difficult for the fiscal council to start criticizing the MoF" (Interview 5).

In addition to the existing informal interlinkages between the MoF and the BoE, the decision to attach the FC to the BoE was also influenced by the *path dependence* of how the capacities of macroeconomic analysis have institutionally evolved in Estonia. Given the institutional choices made in the early 1990s and the economic policy trajectories since then (see e.g., Raudla and Kattel 2011; Hope and Raudla 2012), the BoE has become the organization with the strongest capacities for macro-economic analysis (Interviews 1, 3, 4, 10, 11, 13, 14). As the interviewees put it, "Historically, the BoE has monitored the fiscal policy anyway, so it was a logical choice to attach the FC to the BoE". (Interview 10) and "All other options were quickly eliminated" (Interview 13). For example, it was briefly considered to attach it to the parliament, but that would have also entailed the necessity to hire new analysts who would work for the council, since the parliament itself does not yet have such capacities (Interview 12). There were also some discussions to attach the FC to a university or a commercial bank. These options were ruled out quickly, however, given that the former was viewed as not having enough "practical" experience and the latter lacking in specific knowledge about *the fiscal a*spects of FC's work. In sum, in order to gain high quality analytical input for the work of the FC, its location in the BoE seemed like an "obvious" choice for the institutional designers (Interview 12). All of the interviewees noted that the solution of attaching the FC to the BoE allows for the best utilization of the scarce analytical competences in a small country context where the number of specialists in macroeconomic analysis is limited.

4.4. The existing norms and templates

In addition to the theoretical arguments of RI and HI, the insights of SI can also shed some light on the creation of the FC in Estonia. The "logic of appropriateness" – referring to considerations of the normative expectations about what a FC should look like – clearly played a role in the institutional design of the FC. As emerged from the interviews, even though the MoF officials had initially objected to the requirement to create a FC, once it

became clear that it would be mandatory, they decided to do it "properly" (Interviews 2, 6, 12). As the interviewed MoF officials put it: "It is important that our solution looks correct to those outside." (Interview 12) "If we had attached the fiscal council to the finance ministry, the question would have remained about how independent it really is" (Interview 6). In addition to being concerned with the notions of legitimacy of the new body, the institutional designers of the FC also followed the prevailing norm of "not creating additional bureaucracy". Almost all the interviewees emphasized that this was an important motive in the institutional design of the FC – reflecting, in part, the generally favourable attitude towards curbing public spending and cutting the size of the public sector in Estonia (Raudla and Kattel 2011).

In addition to the formal (and informal) forms of cooperation between the MoF and BoE, our interviews indicate that the MoF and the BoE officials display intellectual and ideological affinity: the officials in both organizations support fiscally conservative policies and tend to take a critical view of public debt (Raudla and Kattel 2011). Thus, when considering the options for the FC, attaching it to the BoE was facilitated by the common values and principles these two organizations share. Hence, the MoF officials who drafted the provisions concerning the FC could hope that, when supported by the BoE, the FC would display fiscal conservatism in its value orientation as well.

At the same time, the international normative discourse on FCs and the examples of other countries had only limited impact on the design of the FC in Estonia. In the international discussions on fiscal councils, arguments are often made for creating "new" separate bodies in order to better ensure their independence (Debrun et al. 2013). It is also argued that in case the government still chooses to attach the fiscal council to an existing institution, the affiliation with the central bank is generally not considered advisable (Calmfors and Wren-Lewis 2011; Debrun et al. 2013). The designers of the FC in Estonia did not follow these general

principles. With regard to drawing lessons from specific countries, given the relative newness of the concept of a FC and the fact that most other countries in the Eurozone designed that institution simultaneously, the opportunities for that were somewhat limited. As one of the interviewees explained, "Since everybody started creating that institution at the same time, there weren't too many examples to draw upon. The countries that have had it for a while, have a much bigger and separate unit, which we did not want – so we didn't have anybody to draw upon as an example" (Interview 12). Thus, the MoF officials (and also counterparts from the BoE) responsible for drafting the legislative provisions on FC did take a look at some other examples but, for the most part, concluded that those were of limited value due to a very different context. Specifically, they looked at the examples of Sweden, Austria, Slovakia, Slovenia, and the Netherlands, where FCs existed already. In Austria and the Slovak Republic, the FCs are also attached to the central banks and, thus, gave the designers in Estonia some further confirmation of the feasibility of their idea. In addition, they examined the ongoing institutional designs in Latvia and Finland, where FCs were created at the same time. Latvia intended to create a whole new body, which was not considered desirable by Estonian policy-makers given their wish to avoid creating "new bureaucracy". In Finland, the FC was attached to the National Audit Office (NAO) but in Estonia, the institutional designers did not view it as having sufficient macroeconomic competencies to undertake that role (Interviews 10, 13). Some specific lessons were learnt from the other examples. From the Swedish case, the designers concluded that the budget of the FC has to be protected from government interference (Interviews 8, 10). All in all, the policy actors considered it necessary to emphasize in the interviews that the overall goal in designing the FC was not to copy a specific model from anybody but to "create an own thing": to design an institution that would most fit the Estonian context. Thus, although according to SI, replicating a model used

by another country (which is seen as a "good" example) might be used to enhance the legitimacy of a chosen solution, this was not the case in Estonia.

5. Concluding discussion

Reviewers of institutionalist research have complained that the existing studies have paid only limited attention to the questions of institutional design and how institutions come about (e.g. Hall and Taylor 1996; Peters 1999; Thelen 2009). Hence, in our paper, we sought to contribute to the discussions of how to use the insights of existing institutionalist approaches to examine the creation of a new institution. More specifically, we focused on the creation of *a watchdog* by actors who will themselves be monitored by this institution in the future, in a situation where they *do not want* to create such a body *but have to*. The creation of the fiscal council in Estonia allowed us to look at how institutional design unfolds under such a scenario. The Estonian case also provided an opportunity to examine a situation where actors were obliged to create an institution but they did not see a *need* for it, since the problems an FC is supposed to address were perceived to not exist.

As our empirical analysis indicates, in order to understand and explain the institutional design of the FC in Estonia, one needs to draw on the explanatory perspectives from different strands of institutionalist research. None of the analytical lenses *alone* would be able to provide a complete explanation; instead, we have to resort to the theoretical arguments in tandem.

The proposition of rational choice institutionalism that transaction costs would play an important role in the creation of a new institution was clearly corroborated in the Estonian case. Not wanting to create a whole new separate institution that would imply significant costs for the state budget was an important motive behind the decision to create the FC in the form of a working group. The prediction of the basic principal-agent model, however, was not borne out: although it would have predicted that the MoF would design the weakest watchdog

possible, this did not take place. Instead, the FC is supported by significant analytical capacities of the BoE and has strong guarantees of independence. In order to understand these design choices, one has to look closer at the various types of principal-agent relationships unfolding in the case of designing a FC and the specific motives that the bureaucratic "agents" who were in charge of creating the FC had in the Estonian context. As our analysis shows, the fiscally conservative bureaucratic agents were concerned that future (left-leaning) governments might be more prone to overspending violating the structural balance rule; hence, having a stronger FC was viewed as a potential ally of the MoF in guarding fiscal discipline and a mechanism of "insurance" against future political principals who might be fiscally profligate.

In order to understand why the FC in Estonia was attached to the Bank of Estonia, rather than any other existing body, the arguments of historical institutionalism – pointing to path dependence and the importance of the existing configurations of political institutions − provide the best explanatory lenses. Given the long-term cooperation between the MoF and BoE in macroeconomic analysis and forecasting, continuing that cooperation was viewed as the most feasible solution. Also, because of the economic policy development trajectories in Estonia, the macroeconomic analytical competence is concentrated in BoE and is very scarce in other organizations. Hence, BoE was viewed as the most appropriate for supporting FC with analytical input.

Finally, reflecting the arguments of SI, the institutional designers in Estonia were concerned about how the solution opted for the FC would appear to the outsiders. They wanted to make sure that the created FC also "looks good" – in order not to damage the reputation of Estonia or to generate domestic discussions about the inherent legitimacy of the new institution. At the same time, it was felt that the opportunities for lesson-drawing were limited in creating the new body given that most other members of the EU were only in the process of creating their

own FC and because of the perceived need to create a home-spun body that would fit the context of Estonia the best.

Thus, we can conclude in future analyses of institutional design, just focusing on one stream of institutionalist analysis is likely to be insufficient. As Ostrom (1990) has emphasized, different institutional approaches should be viewed as complementary. Or, in the words of Peters (1999, p. 2), "Some eclecticism of approach is likely to pay greater intellectual dividends … than a strict adherence to a single approach." As our empirical analysis in this paper shows, different strands can indeed open up different angles for analysis and questions to be asked. They can illuminate different aspects of how institutional design process unfolds and provide complementary explanations. Our empirical study certainly points to arguments to be made for seeking to synthesize the insights of different institutionalisms rather than (over)emphasizing their differences.

Acknowledgments: The research leading to these results has received funding from the Estonian Research Council Grant PUT-1142 and the Norwegian Financial Mechanism 2009–2014 under project No EMP264.

References

Aspinwall, M.D. and Schneider, G. (2000). "Same Menu, Separate Tables: The Institutionalist Turn in Political Science and the Study of European Integration." *European Journal of Political Research* 38(1): 1-36.

Bartle, J.R. and Ma, J. (2001). "Applying Transaction Cost Theory to Public Budgeting and Finance." In Bartle, J.R. (ed.). *Evolving Theories of Public Budgeting*. Emerald Group Publishing.

Bendor, J., Taylor, S. and Van Gaalen, R. (1987). "Politicians, Bureaucrats, and Asymmetric Information." *American Journal of Political Science* 31(4): 796-828.

Bick, E. (2016). "Institutional Layering, Displacement, and Policy Change: The Evolution of Civic Service in Israel." *Public Policy and Administration* 31(4): 342-360.

Bulmer, S., Dolowitz, D., Humphreys, P. and Padgett, S. (2007). *Policy Transfer in European Union Governance. Regulating the Utilities.* Routledge Taylor & Francis Group.

Bryson, J.M. and Ring, P.S. (1990). "A Transaction-Based Approach to Policy Intervention." *Policy Sciences* 23(3): 205-229.

Calmfors, L. (2015). "The Roles of Fiscal Rules, Fiscal Councils and Fiscal Union in EU Integration." IFN Working Paper No. 1076.
Calmfors, L. and Wren-Lewis, S. (2011). "What Should Fiscal Councils Do?" *Economic Policy* 26: 649-695.
Campbell, J.L. (1998). "Institutional Analysis and The Role of Ideas in Political Economy." *Theory and Society* 27(3): 377-409.
Coase, R.H. (1937). "The Nature of the Firm." *Economica* 4(16): 386-405.
Coase, R.H. (1960). "The Problem of Social Cost." *Journal of Law and Economics* 3: 1-44.
Cyert, R.M. and March, J.G. (1963). *A Behavioural Theory of the Firm*. Englewood Cliffs: Prentice Hall.
Debrun, M.X. and Kinda, M.T. (2014). *Strengthening Post-Crisis Fiscal Credibility: Fiscal Councils on the Rise—A New Dataset* (No. 14-58). International Monetary Fund.
Debrun, X., Kinda, T., Curristine, T., Eyraud, L., Harris, J., and Seiwald, J. (2013). "The Functions and Impact of Fiscal Councils." IMF Policy Paper No. 16
Dolowitz, D. and Marsh, D. (1996). "Who Learns what from whom: A Review of the Policy Transfer Literature." *Political Studies* 44(2): 343-357.
Dunleavy, P. (1992). *Democracy, Bureaucracy and Public Choice*. New York: Harvester Wheatsheaf.
Eggertsson, T. (1990). *Economic Behavior and Institutions: Principles of Neoinstitutional Economics*. Cambridge University Press.
Epstein, D., and O'Halloran, S. (1997). *Delegating Powers: A Transaction Cost Politics Approach to Policy Making Under Separate Powers.* Cambridge University Press.
European Central Bank (2013). Opinion on the European Central Bank on Public Finances. CON/2013/91. Accessible at: https://www.ecb.europa.eu/ecb/.../en_con_2013_91_f_sign
Hagemann, R. (2011). "How Can Fiscal Councils Strengthen Fiscal Performance?" *OECD Journal: Economic Studies* 2011(1): 1-24.
Hall, P.A. and Taylor, R.C. (1996). "Political Science and the Three New Institutionalisms." *Political Studies* 44(5): 936-957.
Hope, M. and Raudla, R. (2012). "Discursive Institutionalism and Policy stasis in Simple and Compound Polities: The Cases of Estonian Fiscal Policy and United States Climate Change Policy." *Policy Studies* 33(5): 399-418.
March, J.G. and Olsen, J.P. (1984). "The New Institutionalism: Organizational Factors in Political Life." *American Political Science Review* 78(3): 734-749.
March, J.G. and Olsen, J.P. (1989). *Rediscovering Institutions.* New York: Free Press.
Miller, G.J. and Moe, T.M. (1983). "Bureaucrats, Legislators, and the Size of Government." *American Political Science Review* 77(2): 297-322.
Mitnick, B.M. (1975). "The Theory of Agency." *Public Choice* 24(1): 27-42.
Offe, C. (1996). "Designing Institutions in East European Transitions." In Good, R.E (ed), *The Theory of Institutional Design*. Cambridge University Press.
Olsen, J.P. (1997). "Institutional Design in Democratic Contexts." *Journal of Political Philosophy* 5(3): 203-229.
Peters, B.G. (1999). *Institutional Theory in Political Science: The New Institutionalism*. London and New York: Pinter.
Pierson, P. (2000). "Increasing Returns, Path Dependence, and the Study of Politics." *American Political Science Review* 94(2): 251-267.
Pierson, P. (1993). "When Effect Becomes Cause: Policy Feedback and Political Change." *World Politics* 45(4): 595-628.
Primo, D.M. (2007). *Rules and Restraint: Government Spending and the Design of Institutions*. University of Chicago Press.

Raudla, R. and Kattel, R. (2011). "Why did Estonia Choose Fiscal Retrenchment after the 2008 Crisis?" *Journal of Public Policy 31*(2): 163-186.
Rose, R. (1993). *Lesson-Drawing in Public Policy. A Guide to Learning Across Time and Space.* Chatham, New Jersey: Chatham Hose Publishers, Inc.
Rose, R. (1991). "What is Lesson-Drawing?" *Journal of Public Policy* 11(1): 3-30.
Seo, J.W. and Ryu, S. (2012) "Transaction Behavior in Nonmarket Settings: Revisiting Transaction Cost Economics Theory." *The Korean Journal of Policy Studies* 27(1): 23-40.
Shepsle, K.A. (1989). "Studying Institutions: Some Lessons from the Rational Choice Approach." *Journal of Theoretical Politics* 1(2): 131-147.
Steinmo, S., Thelen, K.A. and Longstreth, F. (1992). *Structuring Politics: Historical Institutionalism in Comparative Analysis*. Cambridge University Press.
Thelen, K. (2009). "Institutional Change in Advanced Political Economies." *British Journal of Industrial Relations* 47(3): 471-498.
Thelen, K. (1999). "Historical Institutionalism in Comparative Politics." *Annual Review of Political Science 2*(1): 369-404.
van de Bovenkamp, H.M., Stoopendaal, A. and Bal, R. (2017). "Working with Layers: The Governance and Regulation of Healthcare Quality in an Institutionally Layered System." *Public Policy and Administration* 32(1): 45-65.
von Trapp, L., Lienert, I. and Wehner, J. (2016). "Principles for Independent Fiscal Institutions and Case Studies." *OECD Journal on Budgeting* 15(2): 9-24.
Waterman, R.W. and Meier, K.J. (1998). "Principal-Agent Models: An Expansion?" *Journal of Public Administration Research and Theory* 8(2): 173-202.
Weimer, D.L. (1995). "Institutional Design: Overview." In Weimer, D.L. (ed) *Institutional Design.* Springer.
Williamson, O.E. (1985). *The Economic Institutions of Capitalism*. Simon and Schuster.
Williamson, O. E. (1981). "The Modern Corporation: Origins, Evolution, Attributes." *Journal of Economic Literature* 19: 1537-1568.
Wyplosz, C. (2005). "Fiscal Policy: Institutions versus Rules." *National Institute Economic Review* 191(1): 64-78.

List of interviews

Interview 1: MoF official, 18.08.2014

Interview 2: MoF official, 09.09.2014

Interview 3: MoF official, 09.09.2014

Interview 4: MoF official, 10.09.2014

Interview 5: BoE official. 24.09.2014

Interview 6: MoF official, 04.02.2015

Interview 7: MoF official, 04.05.2015

Interview 8: BoE official, 08.05.2015

Interview 9: Member of Parliament, 11.05.2015

Interview 10: BoE official, 05.11.2015.

Interview 11: BoE official, 09.11.2015.

Interview 12: MoF official, 11.11.2015

Interview 13: 2 MoF officials, 17.11.2015

Interview 14: FC member, 18.11.2015