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# Independent Fiscal Councils: Watchdogs or lapdogs?

Edited by Roel Beetsma and Xavier Debrun



**A VoxEU.org Book**

CEPR Press

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**CEPR Press**

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Edited by Roel M.W.J. Beetsma and Xavier  
Debrun

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# Foreword

In modern democracies, decisions on government spending are typically influenced by citizens, through their role as the electorate. The recent emergence, therefore, of independent fiscal councils (IFCs), where unelected bodies of experts are given the power to oversee fiscal policy, is of considerable interest. This eBook examines whether fiscal policy can take the same path that monetary policy did, two decades earlier, when it was devolved to independent central banks. Spending from the public purse is inherently a political decision, so the question surrounding IFCs is whether their role will be that of watchdog, directly exerting restraint on fiscal policy and freeing it from overly political control, or whether they inevitably become lapdogs to that same political control.

The essays in this eBook are written by a group of leading macroeconomists, specialising in fiscal policy, public finance and political economy. The authors begin their research with a look at the origins of IFCs, seeking to understand why governments see a need for them on top of their existing fiscal frameworks. This is followed by an investigation into the variety of IFCs currently in practice, comparing the United Kingdom's Office for Budget Responsibility and Swedish Fiscal Policy Council, set up, a priori, to address known gaps in fiscal policy, to fiscal councils in Spain, Portugal and Ireland, which were created under pressure to enhance fiscal credibility after the Global Crisis. The research rounds off with policy lessons for governments looking to adopt IFCs. There is a consensus that balance between rules and independent institutions, structural design and sufficient funding is key to their success.

CEPR is grateful to Professors Roel Beetsma and Xavier Debrun for their joint editorship of this eBook. Our thanks also go to Sophie Roughton and Simran Bola for their excellent handling of its production. CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this important topic.

Tessa Ogden  
Chief Executive Officer, CEPR  
January 2018





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# Introduction: Can independent fiscal councils be useful?

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**Roel M.W.J. Beetsma and Xavier Debrun**

University of Amsterdam and CEPR; IMF <sup>1</sup>

Discretion, that is policymakers' ability to continuously adjust policy levers to serve well-defined objectives, is a mixed blessing. On the one hand, it allows timely responses to unforeseen events; on the other, it voids optimal, yet time-inconsistent, commitments and it lets distorted incentives turn into costly policy biases. The experience with stagflation in the 1970s and early 1980s, as well as numerous other episodes of high inflation, amply demonstrates the potentially disastrous consequences of leaving monetary policy in the hands of politicians without any formal constraint on their decisions. Evidence of excessive government deficits and mounting public debts since the 1970s suggests that unconstrained fiscal discretion can also have harmful consequences for the economy.

These excesses stimulated a large body of academic research showing the potential benefits of constraining discretion over and above conventional democratic controls. In practice, there are three main ways of doing so. One is to impose numerical rules on meaningful macro aggregates, such as limits on the growth of the money supply, and statutory caps on public debt, deficit, or expenditure growth. The second involves setting up independent institutions, aimed at greasing the wheels of democratic accountability mechanisms affecting the conduct of fiscal policy, including official watchdogs mandated to raise public alarm in case of unwelcome policy developments. The third is the delegation of selected policy responsibilities to independent but accountable institutions with a well-defined mandate.

<sup>1</sup> We are grateful to Charles Wyplosz for suggesting the idea of this eBook. The views expressed in this chapter are the authors' own and do not necessarily represent those of the institutions they are affiliated with, including the International Monetary Fund (IMF), the IMF Board and Management.

## **Constraining policy discretion: From rules to institutions**

As rules-based monetary policy quickly failed in the face of financial innovations in the 1980s, academic research provided theoretical foundations for assigning monetary policy decisions to non-elected experts. By the end of the 1990s, independent central banks had been established in most advanced and many emerging economies, contributing to price stability and inflation expectations that were generally well-anchored in official objectives. Formal constraints on fiscal discretion came much later and have almost exclusively taken the form of fiscal rules. Until the early 1990s only a handful of countries subjected fiscal policy to an aggregate numerical constraint of some sort. The ensuing decade witnessed an unprecedented proliferation of fiscal rules, only to slow down somewhat at the beginning of this century. Currently, the IMF considers that about 80 countries conduct fiscal policy within a formal framework comprising one or more fiscal rules (IMF 2017).

Despite mixed experience with rules, the delegation of fiscal policy decisions to unelected bodies has remained a mostly academic curiosity with no real-world manifestation, so far. This is not surprising: fiscal policy usually has substantial distributive effects that place it squarely into the exclusive remit of politicians. In liberal democracies, this is best summarised by the core principle of ‘no taxation without representation’, as per which the People must control the public purse. It remains that, to avoid the most egregious fiscal excesses, the benefits of placing sensible limits on fiscal discretion most likely outweigh the costs.

Frustration with the design and operation of rules-based fiscal frameworks, as well as a perceived urgency to reaffirm commitments to sustainable public finances after the global financial crisis, led a growing number of countries to establish non-partisan fiscal watchdogs, or independent fiscal councils (IFC). Unlike central banks, IFCs do not decide on fiscal matters but provide public analyses, comments or advice that can foster accountability and contribute to better policies. At last count, there are about 40 IFCs in the world. The recent rise in their number results in part from the obligation for most European Union (EU) member states to assign to ‘independent bodies’ the task to monitor compliance with fiscal rules at the national level and to either produce or at least assess macroeconomic and fiscal forecasts underlying the budget.

That said, fiscal councils have emerged in other regions, from Africa to Latin America and to the Asia-Pacific region.

This book gathers a series of essays by academics, policy analysts and practitioners who discuss and review (i) the rationale and first principles of independent fiscal institutions (fiscal councils), (ii) the practical aspects of rebalancing fiscal frameworks away from rules and towards independent institutions, (iii) the role and nature of these institutions, (iv) the lessons from recent experience, and (v) the future of these institutions.

## **Fiscal councils in principle**

A natural question to start with is why governments seem to need IFCs to grease the wheels of democratic accountability? A perennial problem is that even the best-designed procedures to hold politicians accountable are hampered by a variety of imperfections and distortions. Examples include the presence of incomplete information, which the policymaker may be tempted to exploit; the time inconsistency of *ex ante* optimal commitments (for example the promise not to tax inelastic production factors); common-pool problems, leading decentralised actors to push for more spending on specific items financed by contributions from all; and limited government tenure and re-election concerns, driving a wedge between social welfare and the politician's utility.

The chapter by *Mulas-Granados* addresses in detail the sources motivating the emergence of fiscal councils and turns to the question of how to effectively constrain discretion. The answer is tricky because discouraging its misuse also prevents desirable discretionary actions when circumstances call for it. The author argues that the solution is an appropriate mix of rules and independent institutions. The latter increase fiscal transparency and raise the (reputational/political) costs of conducting irresponsible policies. However, the optimal balance between the two differs depending on the policy instrument. Specifically, monetary policy is heavily based on institutions, while fiscal policy tends to rely on rules.

*Wren-Lewis* discusses the 'Consensus Assignment' – according to which monetary policy caters for macroeconomic stability whereas fiscal policy should stabilise public debts – and describes options in designing ways to constrain discretion.

This involves properly designed rules. Ideally, a rule should be simple, flexible and enforceable, hence confronting its designer with a ‘trilemma’ (Debrun and Jonung 2017). More flexibility, linked to economic circumstances or other meaningful contingencies, compromises a rule’s simplicity, rendering it harder to enforce. After all, the more refined a rule, the harder it is to determine whether deviations are justified or not and the more its flexibility can be exploited by politicians. The combined demand for flexibility and enforceability has led to inextricably complex rules in the European Union, suffering from weak compliance. The limitations experienced with fiscal rules and the realisation that they can be complemented by independent fiscal councils, for example when it comes to judging whether deviations from rules are justified, have led to a proliferation of such councils, a recent and mostly European phenomenon with a growing number of offshoots outside Europe and advanced economies. Both *Wren-Lewis* and *Wyplosz* extensively discuss the complementarity between rules and fiscal councils.

If a good design is a natural prerequisite for effective fiscal rules, the same applies to independent fiscal councils. The OECD recently adopted 22 principles codifying best practice for well-designed IFCs (OECD 2014). *Wehner* shows that these principles are well-grounded in the experience of early adopters of IFCs. The Principles cover ways to ensure the independence of councils, what could typically be made part of their mandate, and how much formal power they should be assigned.

## **Fiscal councils in practice**

Do existing fiscal councils make the cut, in terms of best practice? The answer is tricky in light of the considerable heterogeneity documented by *von Trapp* and *Nicol*. They show that IFCs differ in many respects, including size, human and financial resources, remit, visibility and the circumstances in which they were born. However, they also have several important elements in common. They almost invariably have a watchdog role to enrich and clarify the terms of the public debate on fiscal policy and to boost fiscal transparency. *Alt* and *Lassen* argue that this is particularly important when the incumbent government has superior information about the state of the public finances than do other agents in the economy. However, it is also possible that the government itself suffers from a lack of information, a situation that may be ameliorated through high-quality analyses by a fiscal council.

Beyond improving fiscal transparency, a council can also fulfil some additional functions specific to the political system in place. Looking at the cases of Belgium, Germany and Spain, *Escrivá*, *Janeba* and *Langenus* specifically focus on the coordination role IFCs can play in highly decentralised and federal states. Fiscal councils can ameliorate coordination failures in fiscal policymaking between the centre and decentralised entities, or among the latter. Such failures undermine both fiscal stabilisation and debt sustainability. Expanding the discussion to the supranational context, *Ódor* discusses the role that IFCs could play in a more decentralised fiscal governance for the EU. Such a decentralised and depoliticised fiscal framework, based on subsidiarity, would feature hierarchical responsibilities and cooperation among national fiscal councils.

Obviously, when it comes to the impact of independent fiscal councils, the proof of the pudding is in the eating. It is notoriously difficult to identify the impact of institutions on policy outcomes, since many factors can jointly contribute to observed fiscal outcomes as well as the emergence of IFCs themselves. That difficulty is even greater in the case of fiscal councils, which have often been in place for a limited period of time. *Lledó* gathers *prima facie* evidence pointing to positive effects on fiscal transparency and enhanced compliance with fiscal rules. However, jumping from suggestive cross-country associations to causality is not advisable, especially in the face of highly heterogeneous institutions, which is why case studies can be particularly useful.

## Lessons from experience

The effectiveness of IFCs arguably depends on the extent to which the political system truly owns the new balance between rules and institutions. In that regard, it is relevant to contrast the experience in ‘home-grown’ councils with that of councils imposed by external pressure such as a full blown fiscal crisis. The latter can be fragile and suffer from a weak impact in the budget game (*Horvath*). Instead, the home-grown councils of Sweden (discussed by *Jonung*) and the United Kingdom (discussed by *Page*) addressed very specific gaps in the national fiscal framework. The fiscal councils of Ireland, Portugal and Spain, although they emerged at a time of great fiscal stress, were born out of a broad political consensus that they offer a credible way to restore fiscal credibility post-crisis (*Horvath*). While the combination of strong political ownership,

strict independence and skilful communication with the public and stakeholders in the budget process is a clear recipe for success (*Sunshine*), low ownership can directly threaten the council's capacity to perform its role or even its very existence. This is shown by *Kopits*, who also debunks a series of myths about the necessary conditions for an independent fiscal council to operate.

## The way forward

A substantial part of this book is devoted to the history of the origin of existing fiscal councils, their design features and the subsequent experience with them. Equally important is the question as to where we go from here. Is the recent trend in rebalancing fiscal frameworks toward more independent institutions likely to continue? Are the initial apparent successes likely to catalyse a global spread of fiscal councils? Can we expect the emergence of new forms of fiscal councils, such as councils with a more direct influence over policy? Or will fiscal councils disappear or subsist in a diminished form to the point of irrelevance?

The final part of the book addresses some of these questions. *Asatryan and Heinemann* assess the recently established European Fiscal Board against a set of *desiderata* based on the OECD principles for independent fiscal institutions and conclude that the Board needs to be strengthened in various dimensions, including its independence, its communication strategy and its cooperation with national fiscal councils. While *Basso and Costain* suggest that existing fiscal councils could be a first step towards a limited, yet effective delegation of certain policy levers to independent experts, *von Hagen* raises doubts about the capacity of IFCs to prove their relevance and sustain a meaningful role in the budget process. In his view, the new EU fiscal councils that were established following the crisis were created to address the wrong problem. Only a refocus of these councils to effectively target common-pool problems – e.g. by facilitating the role of a strong finance minister in centralising the budget – would raise the chances of their survival.

It needs to be reiterated that this book comes at a time when many councils are in their infancy and experience is necessarily limited. Only a general assessment some years from now can tell us whether the more optimistic or the more pessimistic scenarios will have materialised.

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# I Fiscal councils in principle



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# 1 Policy delegation and the Consensus Assignment

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**Simon Wren-Lewis**

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The ‘Consensus Assignment’ (Kirsanova *et al.* 2009) is the idea that monetary policy is assigned the task of macroeconomic stabilisation, while fiscal policy is about stabilising the government’s deficit or stock of debt. In addition to this assignment, governments increasingly delegated monetary policy to independent central banks, but fiscal decisions remained with governments. One of the advantages of a clear assignment is that it made monetary policy delegation easier: monetary policymakers could ignore the implications of their actions on government debt and governments were encouraged not to interfere with the task of stabilising the economy.

Before the Global Crisis the delegation of monetary policy was thought to be a success. In many countries inflation was low and close to the targets set by either central banks or governments, and real economy volatility had also fallen, although the extent to which this was caused by monetary policy delegation remains unclear. Control of government debt by governments was less successful, and the term ‘deficit bias’ was coined to describe the trend increase in government debt to GDP ratios seen in many (but not all) countries.

The first response to the deficit bias problem was to formulate rules that were designed to constrain governments. However, it became clear that rules alone were insufficient. Governments were, after all, constraining themselves, so the issue became whether breaking the rules lost these governments serious political capital. If the rules were too simple they could quickly become sub-optimal, which would give governments a clear excuse not to follow them. If they were too complex, in an effort to be more optimal, then this gave governments more opportunity to bend the rules, and there was no clear referee to expose this when it happened.

The second response to deficit bias was the establishment of independent fiscal institutions (IFI) or fiscal councils that could complement fiscal rules (Calmfors and Wren-Lewis 2011). They could be the independent referee that could arbitrate when rules were broken. If the IFI said the government was right to break the rule, it would not lose political capital, but if it said it was wrong to do so it would. Equally IFIs could police more complex rules by, for example, checking or even undertaking (as in the UK) fiscal forecasts on which government decisions are based.

These IFIs are very different both from independent central banks and each other. It is instructive to compare the delegation of monetary and fiscal policy, not because of their similarities but to show how different these activities are under the Consensus Assignment. However, once that has been done, it is important to note the implications of two occasions where the Consensus Assignment does not apply: the euro area and after the Global Crisis.

## **Targets, instruments, forecasts and evaluation**

We can think of either monetary or fiscal policy (at the aggregate level) as involving various stages. The targets or goals of policy are established. There is a set of instruments that are varied to meet those targets. Almost inevitably, targets will involve forecasts (inflation of 2% in two years' time, for example), so forecasts must be undertaken to see how instruments need to change to hit the targets. Finally, there should be some form of evaluation of the success and failures of past policies.

Monetary policy can involve the delegation of all four stages, although there is generally some political element of evaluation in most cases. However, in some countries the objectives of policy are set by governments, or between governments and the central bank. The forecasting process, and the ultimate decision of whether to change interest rates, is always delegated to the central bank.

In contrast, the instruments and objectives of fiscal policy remain clearly with governments in most countries that also have IFIs. Typically, targets will involve some number or limit for the deficit, and governments decide how these deficit targets are met.

IFIs may be involved in forecasts (in the UK, the fiscal forecast is completely delegated to the Office of Budget Responsibility (OBR)) and the evaluation (*ex post* or *ex ante*) of policy.

Delegation in the case of monetary and fiscal policy is therefore very different, and the obvious question is why this is. It is tempting to focus on the fact that while there is (in normal times at least) one main monetary policy instrument (a short-term interest rate), there are many types of fiscal instrument: various different types of tax, and even more types of government spending. The balance between different types of taxation and spending (the fiscal mix) is something governments should decide.

A common justification for IFIs is that they help discourage deficit bias, not that they should help decide on the fiscal mix. It would still be possible for an IFI to set a target for the overall deficit that a government should aim for in its budget, and leave how that deficit was achieved entirely in the hands of the government. This would be rather like what the European Commission does for member countries. Alternatively, IFIs could decide when an escape clause in a fiscal rule should be invoked. To understand why delegation involves advice for fiscal policy and control in the case of monetary and fiscal policy, you need to ask what delegation is designed to achieve.

## Reasons for delegation

If you ask an economist, the main reason they will give for monetary policy delegation is time inconsistency. Governments, who may be impatient, will be tempted to promise low inflation, but then, to capitalise on low inflation expectations, to raise output above its natural rate. Agents understand this, and therefore do not believe the government's promise of low inflation. We end up with inflation above any target the government might set.

There are a number of reasons why central banks are thought to be less likely to behave in this way. For example, they may have less to gain in generating increases in output through inflation surprises, or they may be less impatient, and so have an interest in creating a reputation for not deviating from inflation targets.

If correct, these reasons suggest why it may be beneficial to give control of monetary policy instruments to central banks.

There may also be more mundane reasons to take monetary instrument control away from governments. I remember being told of an occasion where the Chancellor agreed that interest rates needed to rise, but said it could not happen until after the party conference. Central banks are less subject to these political pressures.

Could time inconsistency be a reason for delegating fiscal policy decisions? It is tempting to think along these lines, because intuitively impatient governments might be tempted to deviate from any deficit target by raising spending or cutting taxes to get electoral popularity. But for a time-inconsistency story we need some relationship where the private sector makes decisions or forms expectations based on policy promises. In the monetary-policy story that relationship is the New Keynesian Phillips curve. However, Leith and Wren-Lewis (2013) show that this alone will not account for deficit bias, and indeed could produce too rapid debt reduction after a debt-increasing shock.

There are a number of possible reasons for deficit bias besides time inconsistency, and these have been summarised in various places (e.g. Calmfors and Wren-Lewis 2011). Some, such as voters wishing to exploit future generations, will give rise to deficit bias but do not explain why governments would ever set up an IFI to discourage it. Wren-Lewis (2013) discusses three reasons for deficit bias which give a clear role for an IFI: impatience by governments but not voters, the common-pool problem and informational asymmetries.

That there are a number of different reasons for IFIs is an advantage rather than a problem, because this can help explain the variety of types of IFI that we actually see. For example, in the UK the OBR was set up because the 2010 Coalition government felt that the previous Labour government had been exploiting a particular informational asymmetry, by putting pressure on the Treasury to produce overoptimistic fiscal forecasts. As a result, the OBR produces the forecasts on which fiscal policy decisions are based, but it has no other policy evaluation role.

In the case of other IFIs that do have a policy evaluation role, it is not clear from any of the possible reasons for deficit bias why that role is advisory rather than the control we see with central banks. It may simply be that governments feel that allowing an

IFI to dictate what the planned deficit will be would violate the ‘no taxation without representation’ rule. Wren-Lewis (2013) suggests another reason that IFIs are only advisory, based on the criteria set out by Alesina and Tabellini (2007) for successful delegation. These authors argue that successful delegation requires a broad consensus on what constitutes ‘sound policy’.

With monetary policy, at least before the Global Crisis, that consensus seemed to exist. Few people disagreed with the goal of low inflation and stabilising the business cycle, or the means of achieving that goal through varying interest rates. What the goals of aggregate fiscal policy should be are far less clear. Sustainability says nothing about what the appropriate debt level should be. Nor is there a clear consensus on the speed of adjustment towards any target debt level. Basic theory suggests slow adjustment is optimal, but politicians in recent years have often argued for more rapid adjustment. With this lack of clarity, delegating to IFIs the power to set the deficit that politicians should aim for in their budgets may mean the IFI quickly loses public or political support. As we saw in Hungary and are seeing in the US, even an advisory IFI can come under considerable and perhaps fatal pressure.

## **Delegation when the Consensus Assignment does not work**

The Consensus Assignment does not apply to individual euro area countries, because they do not have their own monetary policy. Unfortunately, the architecture of the euro area seems to pretend that it does. The Stability and Growth Pact specified deficit limits, while doing nothing to direct policy to act in a countercyclical manner during booms. That provided no incentive for the periphery countries to counteract unsustainable inflation in the years before the GC.

Before the GC, the concern of policymakers appeared to be that the euro would remove market discipline on fiscal policy, and that, therefore, the emphasis should be on deficit control rather than domestic stabilisation. We now know, as a result of the euro area crisis, that (in the absence of ECB support) market discipline still exists, but in a more dramatic and non-linear way. In addition, we also know the costs of ignoring domestic stabilisation. It is clear, to me at least, that the euro area’s fiscal rules need to be rethought.



A full analysis is beyond the scope of this chapter, but it is important to note that this has a clear implication for policy delegation. For example, suppose domestic fiscal policy is allowed a domestic output stabilisation role as well as a debt stabilisation role (as suggested by Kirsanova *et al.* 2006, for example). Fiscal policy would then be doing the job that monetary policy does in an economy with flexible exchange rates, and as a result the case for giving the IFI some statutory power over deficits becomes much stronger.

For the euro area as a whole, and for economies with flexible exchange rates, the most reliable instrument for stabilising demand and inflation becomes fiscal policy when nominal interest rates hit their Zero Lower Bound (ZLB). This was understood in 2009, with fiscal stimulus in the US, UK and Germany, but since 2010, attempts to revert to the Consensus Assignment have, in my view, proved disastrous. For example, austerity in the euro area as a whole, that monetary policy could not offset, created a second recession. This has been confirmed by numerous simulation studies, but that austerity would have this effect when interest rates were stuck at their lower bound was obvious from simple back-of-the-envelope calculations (Wren-Lewis 2015).

There may be ways of reducing the chances of another ZLB episode. These include raising the inflation target, replacing this target with a target for the level of nominal income, making institutional changes that would allow negative interest rates, and using helicopter money. In the absence of any of these happening, or even if these changes still leave a significant chance that the ZLB would be hit again, the Consensus Assignment needs to be rethought.

One obvious way to proceed is to modify fiscal rules to allow for fiscal stimulus at the ZLB. This is suggested in Portes and Wren-Lewis (2015), and has been adopted by the Labour opposition in the UK. This way of patching up the Consensus Assignment raises issues for both monetary and fiscal policy delegation. In the Portes and Wren-Lewis scheme, the central bank would have to notify the government if it thought there was a likelihood that the ZLB would be hit. It would then cooperate with the IFI and government in devising both an appropriate fiscal package designed to lift interest rates above the ZLB, and advice on how fiscal targets would need to be adapted after this had

been achieved. It seems appropriate that when the Consensus Assignment breaks down, the two delegated institutions – the central bank and IFI – should cooperate in designing the best route out of recession.

Such a scheme could also work in the euro area. The ECB could advise governments of the amount of additional fiscal stimulus it believes would be required across the euro area for it to raise interest rates. IFIs could then suggest to their own governments ways of achieving this stimulus, and what subsequent fiscal consolidation would be needed to return to any fiscal rule or long-term target.

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## About the author

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Academic work has often had a strong policy focus. In 1989 he published, with colleagues at the National Institute, a study suggesting that an entry rate of 1.95 DM/£ into the ERM was too high, which at the time was a minority view. In 2002 he wrote one of the background papers for the Treasury's 2003 assessment of its five economic tests for joining EMU. He was also the principal external advisor to the Bank of England on the development of its core macroeconomic models. A long-time advocate of Fiscal Councils, his 2007 proposal was influential in the formation of the UK's Office of Budget Responsibility. Since starting his blog at the end of 2011, he has written extensively about macroeconomic policy in the UK and the euro area.

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## 2 Fiscal councils in theory: First principles

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**Carlos Mulas-Granados**

International Monetary Fund

The recent proliferation of fiscal councils is the most important institutional innovation in the field of fiscal policy in decades. The number of these institutions has skyrocketed, from only one council in 1960 in the Netherlands, to nearly 40 today, including in emerging and low-income countries (Debrun and Kinda 2014, Beetsma *et al.* 2017). Key factors explaining this expansion have been a growing scholarly consensus around their potential positive impact and an intense advocacy by international organisations of the merit of supplementing fiscal rules with independent fiscal institutions, especially after the debt spikes resulting from the Global Crisis. This consensus is rare in economics and relies on growing empirical evidence and convincing theoretical arguments, which this chapter will summarise in four main principles.

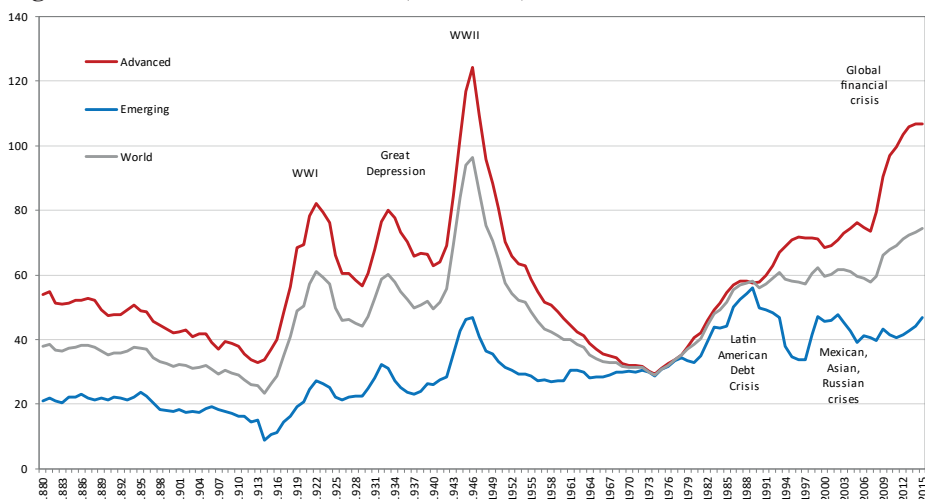
### **First principle: Budgets are rarely balanced**

For close to half a century, public debt has been on a consistent upward trend. At the end of 2015, advanced economies reached average levels of debt close to 106% of GDP, above those during the Great Depression and only slightly below the level registered in the aftermath of WWII (Figure 1). Developing economies have also suffered from increases in public debt since the beginning of the Global Crisis.

Rising debt is typically the result of unbalanced budgets, mostly explained by a deficit bias in the way governments run fiscal policy (Debrun *et al.* 2009). This could occur due to opportunistic fiscal policy, where governments are mostly focused on short-term policies and are time inconsistent, not adhering to initial budget plans.

It could also be the result of piecemeal budgeting to accommodate growing spending requests between line ministries (i.e. the common-pool problem). And it could also be the consequence of uninformed decision-making, which typically takes two forms: on the one hand, information leads the government to underestimate budget costs, rely on overoptimistic growth projections, and not internalise its budget constraints fully; on the other hand, the government also uses its dominant position in the budget process and exploits asymmetric information by sharing insufficient data and background analysis with the legislature and voters (IMF 2013).

**Figure 1.** Public debt, 1880-2015 (% of GDP)



Source: FAD Historical Public Debt Database and IMF Fiscal Monitor.

Note: The chart above uses weighted averages.

## Second principle: Politics explains the deficit bias

Opportunistic planning, piecemeal budgeting and uninformed decision-making are not the result of bad economics but the consequence of bad politics. Economics and politics are profoundly intertwined (Gaspar *et al.* 2017), because politics is “the matter of who gets what, when and how” (Laswell 1936: 19). It is well known that a typical government performs three core functions: allocation, distribution and stabilisation

(Musgrave 1959).<sup>1</sup> The truth is that all of them are intrinsically political. Politics has a direct impact on the provision of public goods and is of particular relevance with regard to stabilisation and redistributive policies. Three sets of political factors have been systematically shown to influence fiscal policies and are behind the most common fiscal illnesses, namely the deficit bias and procyclicality:

- *Electoralism is responsible for opportunistic fiscal policy*: if governments believe that their prospects of getting re-elected will improve in times of economic growth, they may be tempted to launch a fiscal expansion prior to the elections. Such behaviour could generate electoral business cycles.<sup>2</sup> Moreover, if this action is not (fully) compensated for during the incumbent's tenure, it will lead to debt accumulation from one political cycle to the next.<sup>3</sup> A related expression of electoral opportunistic behaviour has to do with the strategic use of debt by the incumbent government. By leaving a sizeable debt, the incumbent government would tie the hands of its successor and oblige it to raise new taxes (which is unpopular) and/or fail on some of its electoral promises (which will cause great disappointment among its supporters).<sup>4</sup> In summary, as elections approach, politicians prefer fiscal policies that accelerate short-term economic growth and therefore maximise their probabilities of getting re-elected. Office-seeking politicians implement tax cuts or spending increases motivated more by selfish political considerations than by aggregate economic needs or fiscal sustainability.
- *Fragmentation is at the root of piecemeal budgeting*: the larger the number of actors with a voice in the fiscal decision-making process, the stronger the pressure for more expenditures financed from the common (and limited) pool of revenues, and thus the greater the exploitation of future tax payers for the benefit of current ones.

1 The stabilisation function is to assure the achievement of high employment and price stability, the redistribution function is to achieve an equitable distribution of income, and the allocation function is to see that resources are used efficiently.

2 See Nordhaus (1975) and Alesina *et al.* (1997).

3 This bias requires two assumptions: fiscal illusion among voters (Buchanan and Wagner 1976), according to which they overestimate the benefits of current expenditures and underestimate the future tax burden that will be needed to finance current expenditure; and voter ignorance, implying that voters find it difficult to fully understand the details of a budget's composition and its long-term impact.

4 See Persson and Svenson (1989) for this concrete example. Also, for a more general overview of the models that analyse the strategic use of debt, see De Wolff (1998) and Franzese (2002).

The more fragmented and polarised the groups are in a country, the longer stabilisation gets delayed, and the smaller the size and duration of subsequent consolidations (Roubini and Sachs 1989, Alesina and Drazen 1991, Perotti and Kontopoulos 2002, Volkerink and De Haan 2001, Illera and Mulas-Granados 2008). The number and strength of political and institutional veto-players also helps explain why spending cuts are so difficult to implement (Tsebelis 1995, 2000, 2002). In summary, minority governments, divided legislatures, coalitions and multiparty cabinets, and a weak coordinating role for the Ministry of Finance, are associated with fiscal profligacy and low productive investment (Hallerberg and Von Hagen 1997, Von Hagen *et al.* 2001, Hallerberg *et al.* 2007).

- *Ideology could lead to uninformed decision-making*: parties in government are motivated by their specific policy agenda following (in part) from their political ideology.<sup>5</sup> This could lead to prejudiced and uninformed fiscal policy, where ideological positions obscure sound policymaking based on purely economic criteria. For example, ideology may influence fiscal policy decisions about macroeconomic stabilisation (Hibbs 1977, 1987) and lead to suboptimal policies, especially if there is uncertainty and imperfect information. In such cases, left-wing cabinets may favour expansionary fiscal policies, convinced that pushing the aggregate demand would always translate into full employment, while right-wing cabinets may instead prefer small and balanced budgets, convinced that market-led equilibria would be better for growth and jobs (Alesina and Rosenthal 1995, Boix 1997).<sup>6</sup> Partisanship may also surface in tax-and-spend redistribution policies (Angelopoulos *et al.* 2012, Boix 2000, Franzese 2002, Notermans 2000, Mulas-Granados 2006).

5 Here I depart from Downs' modelling based on the central assumption that political parties "formulate policies in order to win elections, rather than win elections in order to formulate policies" (Downs 1957: 28). In real life, political parties are guided by both objectives at the same time: the pursuit of policy and the pursuit of office (Muller and Strom 1999).

6 Note that partisanship may play a different role than expected, depending on the degree of development of the underlying welfare states (i.e. in more developed welfare states, ideology is a weaker predictor of government's likely actions) (Starke *et al.* 2014).

### **Third principle: Fiscal rules are not enough**

To date, the main response to reduce the influence of political factors on fiscal policy-making has been the introduction of fiscal rules to restrain the budgetary discretion of politicians. They were introduced in many countries from the 1990s onwards (IMF, 2009). Because political factors could always force sovereign governments to violate fiscal rules, these norms have evolved over time. Today there is ample consensus that in order to constrain budgetary politics fiscal rules should be well-designed (clearly defined, simple, transparent, consistent and flexible), allow effective implementation (by entailing *ex ante* and *ex post* compliance and efficient monitoring) and be enforceable (in terms of decision, amendment and sanctions).<sup>7</sup> But the truth is that, regardless of their design, the capacity of fiscal rules to improve fiscal performance has always depended on how governments perceive the costs of breaching them (Debrun *et al.* 2009). If those costs were perceived as high, rules led to improved performance (IMF 2009, Schaechter *et al.* 2015). Otherwise, governments have always found a way to easily break or modify pre-existing rules (Beetsma *et al.* 2017).

### **Fourth principle: Independent institutions can help...albeit only so much**

On many occasions a durable association between fiscal rules and fiscal performance reflects underlying changes in countries' attitudes toward fiscal rectitude – determining both the improved fiscal performance and the introduction of rules. In such cases, some countries have been willing to take a step forward and consider the option of delegating fiscal policy to an independent fiscal authority (IFA), which, by design, would conduct fiscal policy along technocratic criteria. In such conditions, this IFA would receive a mandate to decide on specific aspects of fiscal policy within a policy framework. So far, no country has developed an institution which perfectly matches the ideal design of an IFA, because these bodies raise issues of democratic legitimacy and accountability, and because politicians have been very reluctant to delegate a significant part of their mandate to a group of unelected technocrats.<sup>8</sup>

7 For a discussion of how fiscal rules should be designed, see Kopits and Symansky (1998).

8 About delegation versus discretion, see the chapter by Wren-Lewis in this book.



A better alternative has been found in Fiscal Councils (FCs). These bodies are more acceptable because they are less intrusive in democratic politics. By becoming watchdogs of fiscal policymaking, they are also more viable than IFAs in promoting the necessary conditions for fiscal discipline.<sup>9</sup> Introducing greater transparency, FCs raise the costs that politicians face for politically-motivated decisions and thus make them more accountable for subsequent fiscal policy failures.<sup>10</sup> To be able to play this watchdog role without being disenfranchised by the executive power, FCs should be independent and non-partisan, but also have a clear mandate and resources (OECD 2014). In most cases, FCs monitor the compliance of public accounts with national and international fiscal rules, but in their role as illuminators of fiscal policy FCs have always relied on the power of increased transparency associated with three key functions (Debrun *et al.* 2009, IMF 2013):

- *Independent forecasting*: by providing independent budget forecasting FCs reduce the temptation for policymakers of using biased economic forecasts for their budget plans. For that purpose, FCs need to enjoy full access to budgetary data, and hire personnel capable of generating budget forecasts on a continuous basis. Revisiting these forecasts to adjust the fiscal stance when needed, FCs help increase the transparency of the budget and improve fiscal performance throughout the year. Ideally, a mandatory use in the budget of the forecasts and assumptions produced by FCs (related to GDP growth, inflation, interest rates, unemployment and tax revenues) could significantly enhance fiscal discipline.
- *Comprehensive analysis*: through objective analysis of budget planning and execution covering the general government, FCs can bring greater transparency and improve fiscal discipline. Analysing complex issues such as fiscal sustainability, intergenerational equity and fiscal risks can help address overspending resulting from the *common-pool* problem between line ministries. In some countries, comprehensive analysis by FCs includes the budgetary costing of specific legislative initiatives (e.g. in the US or Mexico), the regular estimates of tax revenues (e.g. the UK),

9 In a recent study, Beetsma *et al.* (2017) show that the presence of a fiscal council is associated with more accurate budgetary forecasts and greater compliance with fiscal policy rules, two tasks that are expected to enable better fiscal performance.

10 About how FCs can advance fiscal transparency, see the chapter by Alt and Lassen in this book.

the evaluation of national programmes and estimates for bills and forecasts of fiscal trends (e.g. Korea), or the analysis of macroeconomic forecasts by the government (e.g. Sweden).

- *Normative recommendations*: by issuing recommendations that strengthen centralised coordination and avoid soft budget constraints, FCs also contribute to legislative and public debates on fiscal matters. In the US, the FC comments on budget requests and makes proposals for the measures to be taken by the government in the following fiscal year. And in the Netherlands, the FC is a fully independent body that plays a crucial role in helping parties develop the fiscal packages upon which government coalitions are formed. Prior to elections, all political parties submit their policy manifestos to the FC for appropriate independent costing, and, after citizens have gone to the polls, this fully independent institution assesses the compromises negotiated by the different parties that will form the future governing coalition.

In summary, fiscal policy illnesses massively derive from the fact that politics and budgets are almost the same. The proximity of elections, political divisions and partisanship are the key political factors that explain why budgets are often procyclical, rarely balanced, and thus lead to potentially unsustainable fiscal positions. Fiscal rules help constrain policy discretion, but only if truly owned by the countries (citizens and politicians alike) that adopt them. In this context, FCs could end up being a very useful institutional innovation capable of promoting fiscal discipline using simple means: by increasing transparency and by raising the political (and economic) costs of implementing irresponsible policies. At low cost to society, these institutions have the potential to generate important welfare gains, and this is why they are likely to keep proliferating.

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## About the author

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### 3 Fiscal councils and fiscal rules: Complements or substitutes?

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**Charles Wyplosz**

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We have substantial theoretical explanations and empirical evidence that governments naturally tend to run deficits and accumulate debt. Briefly put, public budgets are subject to significant externalities across citizens and sub-central units in any country and in federal systems, both at any moment of time and inter-temporally (von Hagen and Harden 1995, Krogstrup-Wyplosz 2006). There has been some discussion about the possibility of using Pigouvian taxes to deal with these externalities, like taxing ministers, but these ideas are impractical, since there really is no political market in well-behaved democracies. The solution must therefore be a second best.

For a very long time, the solution has been to adopt fiscal rules that tie the hands of governments, or to provide adequate incentives, or both. The classic example is the decision by the US Congress in the 1840s to not bail out individual states, which has led to all but one individual state adopting diverse balanced-budget rules. In this case, the federal-level decision has provided incentives to sub-central governments to effectively tie their own hands, which has worked for more than a century.

As is well understood, the problem with rules is that they cannot be made contingent on all states of the world. It follows that any fiscal rule is bound to occasionally be counter-effective. A good example is the aftermath of the Global Crisis. The G20 agreement to promptly adopt sharply expansionary fiscal policies was correct – this was one lesson from the Great Depression – but it has led to snowballing debts in many countries, which has often prompted premature roll backs. This case well illustrates the limits of rules. It may make sense sometimes to let public indebtedness increase, but how and for how long, and what happens afterwards? It was expeditious to quickly increase public spending, to cut taxes and to provide transfers to households and corporations,



but borrowing to finance unproductive spending magnifies the debt burden, which is in fact what happened as public investment was soon curtailed (Giavazzi and Spaventa 2011), although recent research suggests that well-timed deficits do not lead to higher debt levels (Auerbach and Gorodnichenko 2017). At any rate, in 2009 the conditions for closing the deficits were never spelled out and there was no discussion of whether and how public debts would be brought back down afterwards.

This example illustrates the extreme difficulties of allowing for discretion through escape clauses – the standard solution to the adoption of non-contingent rules. Discretion means the possibility to occasionally untie the government's hands, with the full knowledge that this provides incentives for reverting to fiscal indiscipline. Even if this is done temporarily, it leaves a debt legacy that, in the best case, seriously hampers future government discretion and, in the worst case, leads to a debt crisis. The inescapable conclusion is that you do not want to lend your house key to a well-known thief, ever.

This is where independent fiscal councils enter the picture (Beetsma and Debrun 2017).<sup>1</sup> The theory is that these councils can act as honest neighbours who will take good care of the house while you are away. Benevolent (and competent) experts may recommend that escape clauses are applied and the rule adapted, if they consider that it is warranted by the prevailing economic conditions. One can go even further and entrust fiscal councils with permanent control. A number of serious objections immediately arise. First, fiscal policy is eminently redistributive so that it can only be carried out by elected officials. Second, the unelected council must be subjected to democratic oversight. Where to draw the line between independence and democratic accountability? Third, independent councils can be disbanded as easily as they can be instated, as we saw in Hungary.

There are some answers to these objections. First, the councils should only deal with the budget balance, not the choice and levels of expenditures and taxes. This would take away much of the contemporaneous income redistribution aspects of fiscal policy, while protecting future generations. Indeed, imbalances are mildly redistributive and any redistribution would be temporary and reversed if the budget is balanced over time.

1 Fiscal councils often carry out wider tasks such as verifying macroeconomic forecasts or monitoring budget execution.

Second, fiscal councils must be given very specific and verifiable mandates, with a view to making accounting a precise and systematic exercise. Finally, rules and councils must be established in constitutional law, thus reducing the risk of suppression when they stand in the way of political expediency.

A first implication of the foregoing discussion is that rules can never be complete and that there always will be times when they must be reinterpreted. The required discretion is likely to be complex and to vary from case to case. One day, maybe, artificial intelligence will have progressed to the point where such contingencies can be automated. For the time being, budgetary decisions seem more complex than driving a car in heavy traffic and discretion will have to be exercised by human brains. Because the essence of fiscal rules is that governments should never have a free hand, independent fiscal councils emerge as the best locus for discretionary decisions.

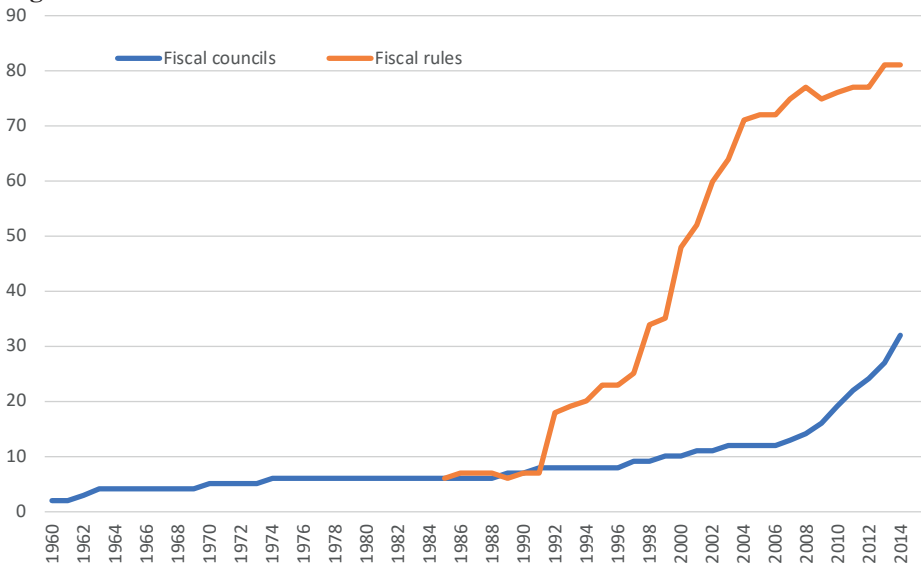
The role of fiscal councils is not limited to exceptional times when discretion is needed. Even in normal times, the rules have to be interpreted. The main reason is that fiscal policy is not, or should not be, a year-by-year exercise, even though it is implemented through annual legislation. The succession of surpluses and deficits must be related to the conjuncture over a business cycle. Not only are business cycles never alike in size, shape and duration, but their evolution must be forecasted. A sad aspect of current practice is that forecasts are produced as expected means, with little or no attention paid to the standard errors. This opens the door to mistakes, which are sometimes intentional. A key role for fiscal councils is to catch these errors before budgets are approved and executed, as well as to factor in the unavoidable uncertainty of forecasts.

Another implication is that independent fiscal councils, as unelected bodies, must be held accountable in that they act according to their mandates. This, in turn, calls for a precise mandate. Given the inherently political nature of the tasks, accountability must not be used as a backdoor to influence or undermine the councils, be it by elected officials or the media. A desirable feature of the mandate, therefore, is that the mandate be simple, even though its technical nature may easily lead to complexity. A clear fiscal rule thus appears to be a desired complement to fiscal councils. This may be challenging. Old rules, like balanced budget rules, are simple enough but fail to recognise the intertemporal nature of fiscal policy and the occasional need for discretion.

Designing simple, yet better rules is a major challenge, which goes beyond this contribution. Suffice it to mention that the ‘debt brake’ rule adopted in Switzerland and then in Germany provides a good departure point. However, these rules can be improved upon. In Switzerland, the rule has been applied rigidly (as written down) in the absence of a fiscal council. This has also been the case in Germany where the fiscal council has limited powers. Both rules could be made more flexible if a council were given the right to interpret them in view of existing circumstances.

The upshot is that fiscal rules and fiscal councils are strongly complementary. This, indeed, is shown by what has happened in the past. Figure 1, borrowed from Beetsma and Debrun (2017), shows two waves: first a wave of adoption of fiscal rules, second a wave of creation of fiscal councils. The fact that most councils have been adopted in countries that already operate a rule supports the complementarity view. Rules require discretion and councils must operate under a clear mandate, pretty much as independent central banks are tasked with delivering a clear mandate. Beyond that, a number of thorny issues emerge. The first one concerns the scope of both rules and councils. One might argue that there is some substitutability between the tightness of the rule and the authority of the council, because the tighter the rule, the less the need for interpretation, and conversely. This is a misleading view. A tight rule is certain to bind quite often and a powerful council operating under lax rules will likely be open to criticism. The second issue concerns the mandate of the council. In many ways, the ideal would be for the fiscal council to be able to decide alone on the budget balance. This would take politics, and the associated deficit bias, (almost) completely out of a mostly technical aspect of fiscal policy (see also Basso and Costain in this volume). The experience, until now, is that no country has gone that far. One reason is that policymakers generally are unwilling to relinquish this power. It is also the case that ‘government by experts’ is open to serious criticism. The usual response is to have advisory councils with a strong voice, a solution that some countries have adopted. A third, related, issue is that the assignment of tasks between the government and the council should be taken a step further. In some countries (the Netherlands and the UK, for instance), the forecasts are now produced by the fiscal council, no longer by the Treasury. This is highly desirable because it is a purely technical task within the budgetary process, which can easily be monitored.

**Figure 1. Numbers of countries with fiscal rules and fiscal councils**



Source: Beetsma and Debrun (2017).

In conclusion, fiscal rules and fiscal councils go hand in hand; this is the case when they are set up. Importantly, combining rules and councils is also likely to lead to improvements over time. Good councils will learn how to better interpret the rules and to suggest improvements. Good rules will make the task of councils easier to perform and less controversial than poorly designed or weak rules. The complementarity goes even further as it also concerns design. Rules and councils ought to be fully compatible lest both are undermined. A poorly designed rule stands to unduly constrain the council if it is required to support inadequate policies. Conversely, councils need to have as complete information as the government does about the state of the economy, if they are to be able to evaluate policy decisions and, when needed, to call for the application of an escape clause. Consequently, the rules must be designed so as to make it feasible for councils to determine whether the rule has been obeyed and whether invoking an escape clause is justified.

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## 4 Promoting good practices: The OECD Principles and beyond

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**Joachim Wehner**

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The spectacular spread of Independent Fiscal Institutions (IFIs) – principally fiscal councils and parliamentary budget offices (PBOs) – has given rise to the development of international norms and principles. Such principles are an attempt to distil, from a variety of experiences, those fundamental features for which there is broad consensus that they are desirable for IFIs in many countries. An important contribution to this debate was the adoption of 22 principles for IFIs by the Organization for Economic Cooperation and Development (OECD 2014). This article highlights aspects of the OECD [Recommendation on Principles for Independent Fiscal Institutions](#) (OECD 2014) that relate to the independence, mandate, and formal powers of IFIs, and reflects on their role in an overall accountability architecture for government budgeting. In discussing these elements, the article draws on global audit norms developed earlier as a comparative benchmark.

### 1. From SAIs to IFIs

It is worth noting that the principles put forward by the OECD have antecedents and complements. A rich public finance literature, dating back to the 19<sup>th</sup> century, has helped to entrench a set of norms and standards for good budgeting, such as the well-known principles of unity, universality, and annuality (Sundelson 1935). These later came to underpin another set of international principles and best practices, on [budget transparency](#)<sup>1</sup>, including the Code of Good Practices on Fiscal Transparency

1 <http://www.imf.org/external/np/fad/trans/>

by the International Monetary Fund (IMF 1998, 2014), the OECD's Best Practices for Budget Transparency (2002), and the [High-Level Principles on Fiscal Transparency](#)<sup>2</sup> (GIFT 2012) developed by the Global Initiative for Fiscal Transparency (GIFT). More recent are related initiatives to establish principles for public participation in budgeting (for a review, see de Renzio and Wehner 2017). Particularly relevant here is another contribution; in 1977, the International Organization of Supreme Audit Institutions (INTOSAI) adopted the [Lima Declaration](#)<sup>3</sup>, a set of international norms and principles for Supreme Audit Institutions (SAIs).

There are important parallels between SAIs and IFIs. Both are meant to be independent bodies with high standards of professionalism and integrity that serve to promote sound use of public resources and sustainable government finances. Like IFIs, audit bodies come in different forms that affect their linkages to other institutions, especially legislatures. For instance, audit courts are independent of both the legislature and the executive and part of the judiciary, such as the French *cour des comptes*<sup>4</sup> set up by Napoleon in 1807. In contrast, audit offices, headed by an auditor general, report directly to parliament and have no judicial function. In the UK, the Exchequer and Audit Departments Act of 1866 required annual appropriation accounts to be investigated by the [Comptroller and Auditor General](#)<sup>5</sup>, who is an officer of the House of Commons. One difference is that SAIs are mostly (but not always exclusively) tasked with *ex post* control functions, while IFIs typically play a role in budget formulation and approval (but again not necessarily exclusively). IFIs are also much younger and smaller and, despite their impressive spread in recent years, still far from universal.

## 2. Independence, mandate, and powers

How to ensure independence? The OECD Principles emphasise the importance of the independence of an IFI, and dedicate six principles to this heading (more than any other).

2 <http://www.fiscaltransparency.net/giftprinciples/>

3 <https://www.internationalbudget.org/publications/united-nations-intosai%E2%80%99s-lima-declaration-of-guidelines-on-auditing-precepts/>

4 <https://www.ccomptes.fr/en>

5 <https://www.nao.org.uk/about-us/>

These include that IFIs should be non-partisan; led by a person with proven technical competence and appointed for a clearly specified term; and have autonomy to choose staff based on merit and technical competence. Under a separate heading, the OECD calls for IFIs to have sufficient resources to fulfil their mandate “in a credible manner”. These principles have close parallels in the [Lima Declaration](#), which was, after all, chiefly aimed at promoting the independence of audit. They should not be controversial, and it is useful for the OECD to spell out strong expectations of independence to help protect vulnerable IFIs from the type of political interference seen, for example, in [Hungary](#)<sup>6</sup>.

What should be the mandate of IFIs? The OECD Principles are less prescriptive in terms of the specific functions that make up the mandate of an IFI. The OECD calls for a mandate that is clearly defined in high-level statute, and for autonomy in producing outputs and determining a work programme consistent with the mandate. It mentions “typical tasks” such as economic and fiscal forecasts, baseline forecasts, assessing compliance with fiscal rules, and costing of policy proposals, for example. However, it does not prescribe any specific tasks, or combination of tasks, and acknowledges that its list is not exhaustive.

In practice, an OECD assessment of 18 IFIs in its member countries (von Trapp *et al.* 2016: Table 2) identified the most common functions to be the analysis of long-term fiscal sustainability (16), monitoring compliance with fiscal rules (12), policy costings (9), and forecasting. While only two IFIs prepare the official macroeconomic and/or fiscal forecasts underpinning the budget, five prepare alternative ones, and eight prepare assessments of the forecasts produced by the government. Not surprisingly, given their direct link to the legislature, PBOs typically support the legislature with budget analysis. In Australia and the Netherlands, the IFIs have a role in costing the election platforms of political parties. The 2017 vintage of the [IMF Fiscal Council Dataset](#)<sup>7</sup> covers 39 IFIs from a wider group of countries (Debrun *et al.* 2017). The most common functions identified are the assessment of government budgetary and fiscal performance in relation to fiscal objectives and strategic priorities (31),

6 <https://www.ft.com/content/69d5e212-00d0-11e0-aa29-00144fcab49a>

7 <http://www.imf.org/external/np/fad/council/>



forecast assessment (30), monitoring of fiscal rules (28), performing normative analysis or providing recommendations (27), and assessing long-term sustainability (25). Less common are the costing of policy measures (16) and forecast preparation (17).

Again, there are certain parallels with INTOSAI's Lima Declaration, which notes different approaches in terms of financial and performance audit as well as pre- and post-audit functions. But here the comparison between SAIs and IFIs is more limited in relation to independence and resources. Auditors are there to audit, which they can do in different ways, while IFIs have a diverse set of possible functions that respond to specific needs (Debrun *et al.* 2013, von Trapp *et al.* 2016). I see no reason for being more prescriptive in this regard. If we take local ownership as a starting point, as in the OECD Principles, then the specific functions of an IFI should align with the demands of the relevant political context. For example, the creation of the Congressional Budget Office in the United States was part of a set of reforms that followed tense legislative-executive relations during the Nixon administration, a period of divided government, and designed by Congress to counter a shift towards executive dominance since the introduction of the executive budget process half a century earlier (Joyce 2011). One lesson from the literature on fiscal institutions is that, even in a context of common rules, domestic politics plays a crucial role in shaping the quality of the budget process and its performance (Hallerberg *et al.* 2009, Alt *et al.* 2014). Hence, it remains to be seen whether the various IFIs created in the European Union, following the adoption of the Fiscal Compact in 2012, will develop as powerful a voice as some of those that have emerged for reasons arguably more strongly grounded in domestic political dynamics.

How much formal power should IFIs have? Past decades have seen a push towards central bank independence that entails the delegation of monetary policy (Cukierman 1992). IFIs have not acquired a similar degree of policy-setting authority, despite some theoretical arguments in favour of such an approach (Debrun *et al.* 2009). Taking fiscal authority away from elected politicians would seem much more threatening to democratic fundamentals than delegating the setting of interest rates. Instead, IFIs have the potential to exercise a budgetary version of 'soft power', primarily through the production of high-quality information and analysis, so that political debates can focus on policy decisions in cognisance of their fiscal implications. IFIs should have the powers necessary to fulfil their specific mandate, such as autonomy in organising their work and the right to access all relevant information, which the OECD Principles cover.

However, there seems little or no desire to transfer policymaking authority itself. As with central banks, it is possible that, with time, there is increased acceptance of the idea that IFIs may acquire a policy role, such as setting a budget balance each year without expressing any view on the size or composition of the budget (Wyplosz 2008).

### **3. Towards an accountability architecture**

Of course, adherence to the OECD Principles cannot guarantee the independence and effectiveness of IFIs. A government that is determined to sideline a fiscal council will always find ways of doing so. However, the OECD Principles raise the cost of such actions. They represent widely accepted standards developed in discussion with the IFIs that participate in the OECD's [Network of Parliamentary Budget Officials and Independent Fiscal Institutions](#)<sup>8</sup> and they were officially agreed by participating countries in the OECD Council. This provides some ammunition for fighting off government interference when it occurs. In addition, the OECD Principles establish an essential reference point in reform debates.

More broadly, the OECD Principles are part of a widening trend to strengthen accountability. A century ago, much energy went into strengthening the executive budget process – as in the United States with the Budget and Accounting Act of 1921. Recent decades have seen a growing realisation that unfettered executive dominance and discretion may be undesirable. The Lima Declaration and the OECD Principles promote effective checks and balances at different points in the budget cycle, from formulation to audit and evaluation. GIFT has also devised [Principles of Public Participation in Fiscal Policy](#) (GIFT 2016).<sup>9</sup> Missing from the mix, thus far, are similar standards for legislative budgeting, which the OECD is working on. Together with the now well-established IMF and OECD norms on fiscal transparency, these contributions cover the core elements of an accountability architecture.

What is required now is a more holistic approach to how the above add up to a coherent package of norms that can inform institutional design. One recent effort, the [OECD](#)

8 <http://www.oecd.org/gov/budgeting/oecdnetworkofparliamentarybudgetofficialspbo.htm>

9 <http://www.fiscaltransparency.net/giftprinciples/>

[Budget Transparency Toolkit](#) (OECD 2017)<sup>10</sup>, attempts to bring together existing norms in an accessible and integrated way. This is a step in the right direction. In the coming years, one challenge is to better understand how SAIs, IFIs, legislatures, transparency, and public participation can work together to promote accountability and better fiscal policy.

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## About the author

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## II Fiscal councils in practice



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## 5 Measuring IFI independence: A first pass using the OECD IFI database

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**Lisa von Trapp and Scherie Nicol**

OECD<sup>1</sup>

*Countries across the OECD have established independent fiscal institutions (IFIs) to promote sound fiscal policy and sustainable public finances. As their name suggests, IFIs are expected to act independently, providing objective analysis free from political influence. The OECD Principles for Independent Fiscal Institutions (2014) offer guidance on issues to consider in the design and governance of IFIs, including key measures to safeguard independence. This chapter presents a preliminary measure of IFI independence using a set of variables drawn from the OECD Principles and new data from the OECD IFI Database (2017) of 26 IFIs in OECD Member countries. It shows that, despite the heterogeneity of these institutions, OECD IFIs exhibit high levels of independence across the board, particularly in the areas of legal independence, leadership independence, and transparency. There is some room for improvement in financial independence, operational independence and access to information. The chapter concludes with a brief discussion of whether there is a link to be made between an IFI's independence and its impact.*

1 Senior Policy Analyst and Policy Analyst, Budgeting and Public Expenditures Division, Directorate for Public Governance, OECD. The information and views set out in this article are those of the authors and do not necessarily reflect the official views of the OECD. The authors would like to thank Jón Blöndal, Ronnie Downes, George Kopits, Michal Horvath and Joachim Wehner for their comments on earlier drafts.



## Introduction

By providing an independent, non-partisan and objective assessment of fiscal policy and performance, Independent Fiscal Institutions (IFIs) serve to promote sound fiscal decision-making and sustainable public finances. They reduce information asymmetries and promote greater transparency of the public finances, thus raising reputational and electoral costs for governments that pursue imprudent policies or break key commitments. Consequently, they can help to address biases towards spending and deficits.

IFIs within the OECD are highly heterogeneous – there is no one size fits all model. The characteristics of this diverse group of institutions are informed by country-specific circumstances and, in the case of European IFIs, by supranational commitments leading to variations in terms of their institutional models, mandates, tasks, governance provisions and resources. Despite these differences, there is broad agreement on factors critical for ensuring the independence and good functioning of IFIs, as outlined in the *OECD Principles for Independent Fiscal Institutions* (OECD 2014), and in line with the rich literature on independence for other independent institutions such as central banks and supreme audit institutions.

This chapter is the first attempt to build an index capturing these critical factors. It encompasses aspects such as leadership arrangements, operational autonomy, and resources. Recognising that access to information<sup>2</sup> and transparency are essential to the good functioning of IFIs, the index also takes these two aspects into account. The data underlying the index is drawn from the OECD IFI Database (2017) which currently covers 26 institutions.<sup>3</sup>

2 Access to information is also one of the eight pillars defining the independence of supreme audit institutions (INTOSAI 2012).

3 This database is regularly updated to include new institutions. Several institutions are in the process of being added and may be included in future versions of this index. It should also be noted that where the categories are the same, the [OECD IFI Database](#) and [IMF Fiscal Council Dataset](#) have been aligned.

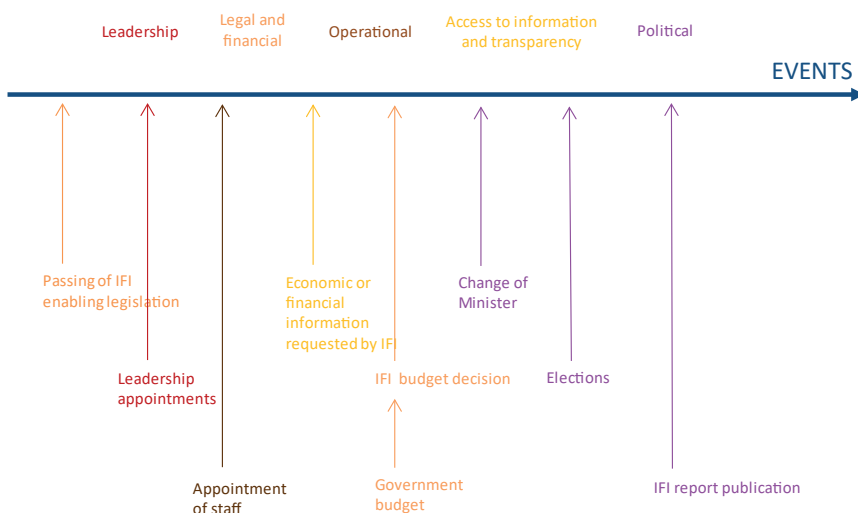
## Establishing IFI independence

Independence and non-partisanship refer to the ability of an IFI to undertake its duties free from political pressure or influence. An IFI that is not independent may struggle to present a critical view of government plans and policy choices when it is most needed. Similarly, an IFI that attempts to take on board bi-partisan or multi-partisan views, rather than being strictly non-partisan, risks coming under political influence or moderating legitimate evidence-based expert criticisms in favour of cross-party consensus. Given that the influence of IFIs in fiscal policymaking is persuasive – rather than coercive by means of legal sanctions or other punitive measures – their reputation is among their most valuable assets. Even the perception that an IFI is not independent can seriously undermine an IFI's reputation and credibility as a politically neutral arbiter of the numbers.

An IFI's independence may come under stress at given 'pinch points' where there is potential for greater undue influence to be exerted (see Figure 1). For example, where there have been conflicts between the government (or the legislature, which may have a strong government majority in place) and the IFI, there are cases of politicians attempting to curtail the independence of an IFI by restricting access to information, cutting or threatening to cut the IFI's resources (e.g. Canada, Sweden) and exerting control over its work programme. In the case of Hungary, not only were resources sharply curtailed and staff eliminated, but its mandate was changed.<sup>4</sup>

The extent to which independence is fostered within an IFI is significantly influenced by the legislation that establishes and governs the institution. Legislation gives the institution legal separation from the executive (and other public institutions) and typically contains provisions relating to the leadership appointment and dismissal process, the institution's resources, and rights to access information, among other things.

4 For discussion of individual country cases see IMF (2013), and von Trapp *et al.* (2016). For an in-depth discussion of the Hungarian case see Kopits (2011).

**Figure 1.** Pinch points: potential entry points for undue influence

It is important to note, however, that *de jure* independence does not always translate into *de facto* independence and may not capture the relationship culture of the IFI, government and other public institutions. Moreover, most IFIs work to gain *de facto* independence over time through their actions and analysis. For example, the decision by the United States Congressional Budget Office not to provide normative advice, while it was not prohibited from doing so in legislation, has arguably reinforced its *de facto* independence. Another of the oldest and most renowned IFIs, the Netherlands Bureau for Economic Policy Analysis (CPB), technically sits within the executive,<sup>5</sup> but in practice it acts with complete autonomy and its independence is respected by all. The CPB also does not have access to information underpinned by legislation but in practice does not experience difficulties accessing the information it needs. Others such as the Canadian Parliamentary Budget Office (PBO) and the Spanish Independent Authority for Fiscal Responsibility (AIReF) have legal underpinning for access to information but have experienced substantial difficulties leading both to bring their case before the courts. *De facto* independence is more difficult to capture in an index such as this one, although certain variables have been included in an attempt to capture both. Nevertheless, as with any index, the results should be interpreted with caution.

<sup>5</sup> Indeed the CPB's *de facto* role as the institution responsible for macroeconomic projections was only recently formalised under the 2013 Sustainable Public Finances Act, which embedded new European requirements in Dutch law.

## Measuring IFI independence

The multi-dimensional nature of independence means that it can best be measured by a set of indicators that are simultaneously appropriate (they capture the relevant aspects of independence), accurate (they measure those aspects correctly) and reliable (the set of appropriate indicators remains stable over time).

As noted earlier, there is broad agreement on critical factors to ensure the independence and good functioning of IFIs, as outlined in OECD (2014), and in literature defining independence for other independent institutions. The OECD IFI Database (OECD, 2017) makes available new information on the key characteristics of IFIs across OECD member countries. Over 40 variables provide information on their context for establishment, legal basis, institutional model, relationship with the legislature, independence, leadership,<sup>6</sup> resources, mandate and functions, publications, access to information, transparency, advisory support and evaluation arrangements. This data has allowed the OECD to build a fairly comprehensive measure of IFI independence.

**Table 1.** Index of IFI Independence and key related OECD Principles

Index Pillar	Key related OECD Principles
Leadership independence	Principles 2.2, 2.3 - selection on basis of merit and technical competence; defined term length different from political cycle; defined criteria for dismissal
Legal and Financial independence	Principles 3.1, 4.1 - established in higher level legislation; published and treated in the same manner as the budgets of other independent bodies; multi-annual funding commitment
Operational independence	Principles 2.1, 2.5, 3.2 – no normative policy-making responsibilities; full freedom over hiring process for staff; set own work programme and scope to produce reports and analysis at own initiative
Access to information and Transparency	Principles 6.1, 6.2, 7.1, 7.2 – access to information (and any restrictions) in legislation and underpinned by MoU; full transparency in work and operations; reports, analysis and methodologies published

6 Including whether it is collegial or individual, the appointment process, etc.

The proposed index of IFI independence covers 16 variables under four broad pillars: leadership independence, legal and financial independence, operational independence, and access to information and transparency (see Annex 1).<sup>7</sup> In the interest of objectivity and transparency, the pillars and variables have been given equal weights.<sup>8</sup>

The index does not include variables related to specific functions (e.g. the role in the provision or assessment of official forecasts or the monitoring of fiscal policy rules). There are other potential variables, for example whether the institution's resources are commensurate to its mandate which were also not included as they were deemed to involve too much judgement without a clear evidence-base at this time.<sup>9</sup>

### Leadership independence

The leadership of an IFI ultimately takes the decisions for which the institution will be held accountable, and can be exposed to greater pressures than professional staff. The variables in this pillar include whether leadership appointments are made on the basis of merit and technical competence; there are clearly defined term limits that are delinked from the political cycle; there are clearly defined criteria for dismissal of the leadership; and whether the institution has experienced dismissal of leadership not for cause.

### Legal and financial independence

This pillar refers to the grounding of an IFI's independence in higher level legislation and to protections for its financial resources.<sup>10</sup> Working independently requires predictable financial resources free from interference, e.g. the government should not have the

7 Early research supports certain of these variables as important to effective IFIs (see for example, Debrun and Kinda 2014, Debrun and Beetsma 2017, Jankoviks and Sherwood 2017).

8 Institutions are given a full score where they fully comply with a variable in the index, and a half score where they partially comply. The selection of indicators and weighting is based primarily on expert judgement. Correlation analysis was conducted and showed no signs of redundancy/collinearity among variables selected.

9 Inclusion of this variable could, for example, impact the place of the German Independent Advisory Board which meets the measures on financial independence but is one of the least resourced IFIs within the OECD.

10 In broad terms financial independence refers to the legal and practical arrangements identifying the finances of an IFI and the extent to which the IFI is subject to outside influence in this regard.

discretion to alter the budget of the institution. The variables in this pillar include whether the IFI is established in constitutional or primary law; has a separate budget line; has a multiannual funding commitment; and whether the IFI has experienced an imposed budget cut.

#### Operational independence

This pillar captures aspects of an IFI's autonomy over its operations. It also considers whether or not the IFI makes normative recommendations, which, according to the OECD Principles, poses a risk to their non-partisan reputation. For many institutions, not making normative recommendations has been an operational choice rather than a legal restriction. The variables in this pillar include whether the IFI can set its own work programme within the bounds of its mandate; is able to undertake research and analysis at its own initiative; makes policy recommendations; has its own staff; and has its own website. The latter is taken as an indicator of operational control over its communications.

#### Access to information and transparency

On the one hand IFIs require full access to information in order to fulfil their mandate effectively and independently. On the other they have a special duty to provide information and to act in as transparent a manner as possible. Full transparency in their work and operations both demonstrates IFI independence and provides the greatest protection of that same independence. The variables in this pillar include whether the IFI has access to information secured through legislation or a Memorandum of Understanding (MoU); the institution's work plan or other operational documents are published; all reports are published; and underlying methodologies are published.

## Results of the Index of IFI Independence

Figure 2 shows the results of the Index of IFI Independence in 2017 for the 26 institutions currently included in the OECD IFI Database.<sup>11</sup> Several messages emerge:

- Most IFIs exhibit a high level of independence, with 19 of the 26 institutions receiving an independence score of 75% or more, and eight institutions scoring 90% or more, meaning that they generally fall down in relation to just one or two of the 16 variables.
- IFIs consistently score very highly in relation to leadership independence, with 16 out of the 26 institutions exhibiting all the measures of independence in this area. Where institutions do fall short, it is most often because they do not have clearly defined criteria for dismissal of leadership (Austria, Belgium, Germany, Greece, Iceland, Korea, Luxembourg, and Sweden). In the Korean case, changes in leadership are also linked to the political cycle as there is a tradition that the Chief submits his resignation when the Speaker of the National Assembly changes every two years.
- IFIs also scored relatively highly in the access to information and transparency pillar, with over half of the 26 institutions exhibiting all four measures of independence in this area. However, this masks some variation between the indicators relating to transparency and those relating to access to information. While institutions tend to score very highly in relation to transparency, fewer score full points in the area of access to information. Three of the 26 institutions only have access to information secured through a MoU (Australia, Belgium and Ireland) and five institutions do not have access to information secured through any means at all (Austria, Denmark, Germany, Netherlands and Sweden). However, as previously mentioned, access to information in practice often depends on good relations between the IFI and institutions within government rather than legal rights.

11 For a full list of institutions currently included in the database see Annex 2. The data for Canada reflects new legislation adopted in 2017 which has yet to be tested in practice. Similarly, the new Slovenian Council has only just started operations. While the index shows the strength of its legislation it cannot capture its *de facto* independence with any certainty at this time. Its place in the ranking should be interpreted with this caveat.

- There are mixed results for the pillar on operational independence. Just ten institutions meet all measures of independence in this area. Seven IFIs do not have their own staff (e.g. seconded from the central bank), or hire staff that are part of another institution's service.<sup>12</sup> It should be noted that, provided that the IFI has full hiring and firing powers, in some cases, particularly for very small institutions, there may be useful efficiencies to having staff linked to another institutions' service. A number of institutions also provide normative advice. However, in the case of OECD IFIs, normative advice is usually strictly limited in scope and relates to providing recommendations to ensure compliance with fiscal policy objectives.<sup>13</sup>
- IFIs score lowest in relation to the legal and financial independence pillar. While all of the institutions, except one (Sweden), are established in constitutional or primary legislation, only three out of 26 obtain full scores in relation to financial independence (United Kingdom, Australia and Germany). Just 54% of institutions have their own budget line, and only 38% benefit from some kind of multi-annual funding commitment.

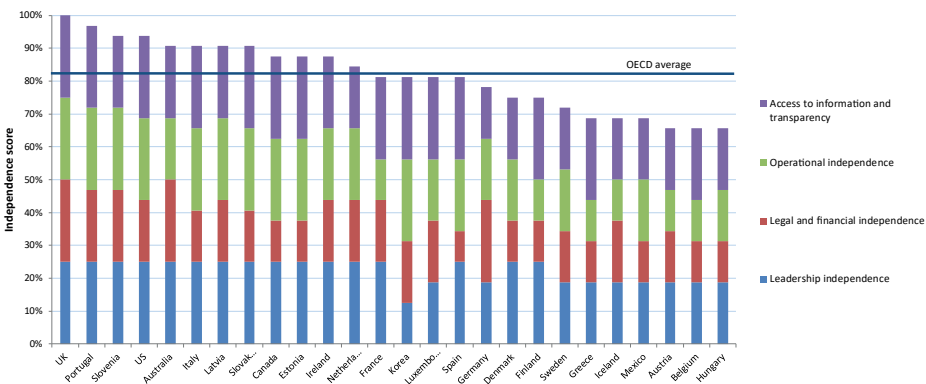
There are three main institutional models for IFIs observed across the OECD: Parliamentary Budget Offices (PBOs), Fiscal Councils, and IFIs that sit within supreme audit institutions. The average independence score is relatively similar for IFIs that are either PBOs or Fiscal Councils. The independence of IFIs within Audit Institutions, however, is slightly below the OECD average due to integration into their host institution. This should be interpreted with some caution. Placing an IFI within the supreme audit institution arguably allows it to benefit from the independence of its host; this was the argument in the case of France for example where the Court of Audit has a strong reputation for independence. Nevertheless, there are risks that the IFI could be too integrated into its host institution creating confusion around their respective mandates and functions (IMF 2013).

12 Interestingly, while not captured in this measure, an independent review of the UK Office for Budget Responsibility found that it was ultimately "dependent on approximately 125 full-time equivalent (FTE) employees from other government agencies to produce its core reports." (Page 2014)

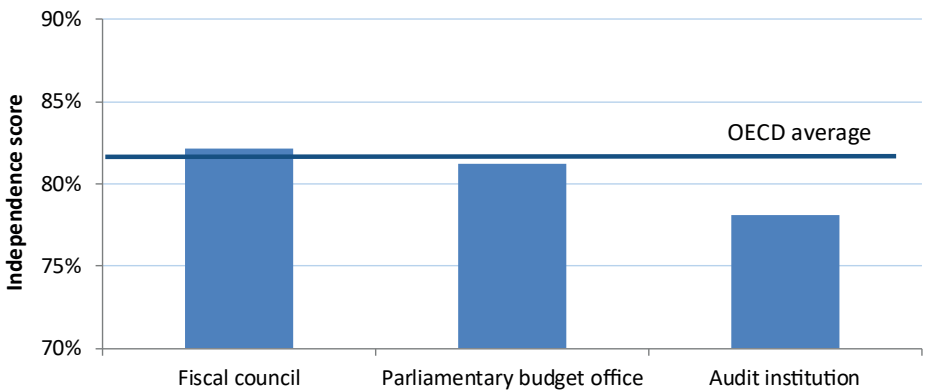
13 Where institutions provide only very limited normative advice, their score was adjusted to reflect this.



**Figure 2.** Index of IFI Independence



**Figure 3.** Independence by Institutional Model



## Independence and the impact of IFIs

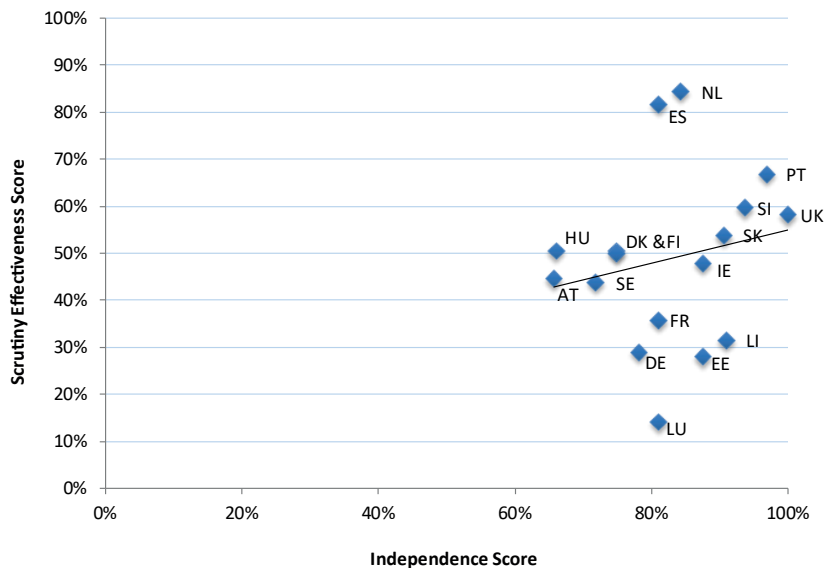
The mere existence of an IFI does not automatically generate better fiscal policy. Observers have noted the difficulties in quantifying the impact of IFIs due to several factors. Most of these institutions are relatively new and their considerable heterogeneity complicates any empirical assessment. Moreover, as Jankovics and Sherwood (2017) note, it is difficult to disentangle the influence of IFIs from other elements in national fiscal frameworks. The individual country context in which they operate is also important.

Any investigation of an IFI's impact needs to take into account sources of deficit bias in the country (Calmfors 2015) or whether governments have traditionally shown a preference or strong commitment to sound public finances.

Direct influence is also difficult to assess as, unlike central banks, IFIs do not have a direct lever on fiscal policy. Their main channel of influence is public debate, typically through media or discussions in parliament. As such, their influence may be measured not only by whether they have been shown to push governments towards adopting more prudent fiscal policies but also by whether their analysis is at the forefront of any timely debate on fiscal policy. One of the worst fates for an IFI is to be ignored. Early analysis undertaken by the IMF suggests that countries where IFIs have a higher media impact tend to exhibit better fiscal outcomes. Interestingly they also found evidence that the credibility of the independence of the IFI is an important pre-condition for its views to be reflected in the public debate (IMF 2013).

Further research has shown that countries with IFIs, either with legal guarantees of independence through legislation, or with operational guarantees through adequate human resources, have, on average, better fiscal outcomes (Debrun and Kinda 2014). Based on a stylised model showing how a fiscal council can effectively promote fiscal discipline, Beetsma and Debrun (2017) found evidence that a strong majority of fiscal councils exhibit the independence required to send the necessary signals on fiscal policy but that a number of institutions would benefit from stronger guarantees of independence, including through increased and secure resources and guaranteed access to information.

Horvath (2017) has developed a first indicator of EU IFIs' aggregate scrutiny effectiveness, which measures how well a given IFI is equipped to carry out their scrutiny role. Comparing his results with those in this article (Figure 4) suggests that, in general, higher protections of independence are associated with higher potential scrutiny effectiveness. However, there are a number of outliers, reflecting once again the importance of country-specific circumstances in which IFIs operate.

**Figure 4.** Comparing independence and effectiveness scores for EU IFIs

## Conclusions

Using IFIs to promote prudent fiscal policymaking and sound public finances is an idea that is enjoying considerable popularity. The preliminary index of IFI independence in this article seeks to further the debate on IFI independence. It shows that the majority of OECD IFIs have been designed to be highly independent and that most score particularly well on variables related to leadership independence and transparency. However, local context remains an important factor when discussing IFI independence. Even where they have been well designed from a legal standpoint, IFIs may lack the necessary information and resources they need and be hampered from carrying out their functions freely. Indeed, institutions tended to score less well on variables related to access to information, financial independence and operational independence.

The index is subject to two important limitations. As discussed, it cannot fully capture *de facto* or effective independence that distinguishes IFIs with a track record of evidence-based active engagement with the government (as is the case of the US CBO, Canada's PBO, the Netherlands' CPB, Sweden's FPC), from IFIs that seem to pander to the government. Second, it should be acknowledged that the index refers to a current

situation that might be rather volatile, insofar as IFIs are, to a greater or lesser extent, fragile institutions when exposed to threats by a government, especially one with a populist orientation (Beetsma *et al.* 2017). This index helps to further pinpoint potential risks to independence should a government seek to put pressure, particularly at one of the ‘pinch points’ discussed earlier.

The importance of independence is highlighted in the theory and early analysis of IFI performance. Despite good indications, further work is needed to more explicitly link independence to IFIs good performance.

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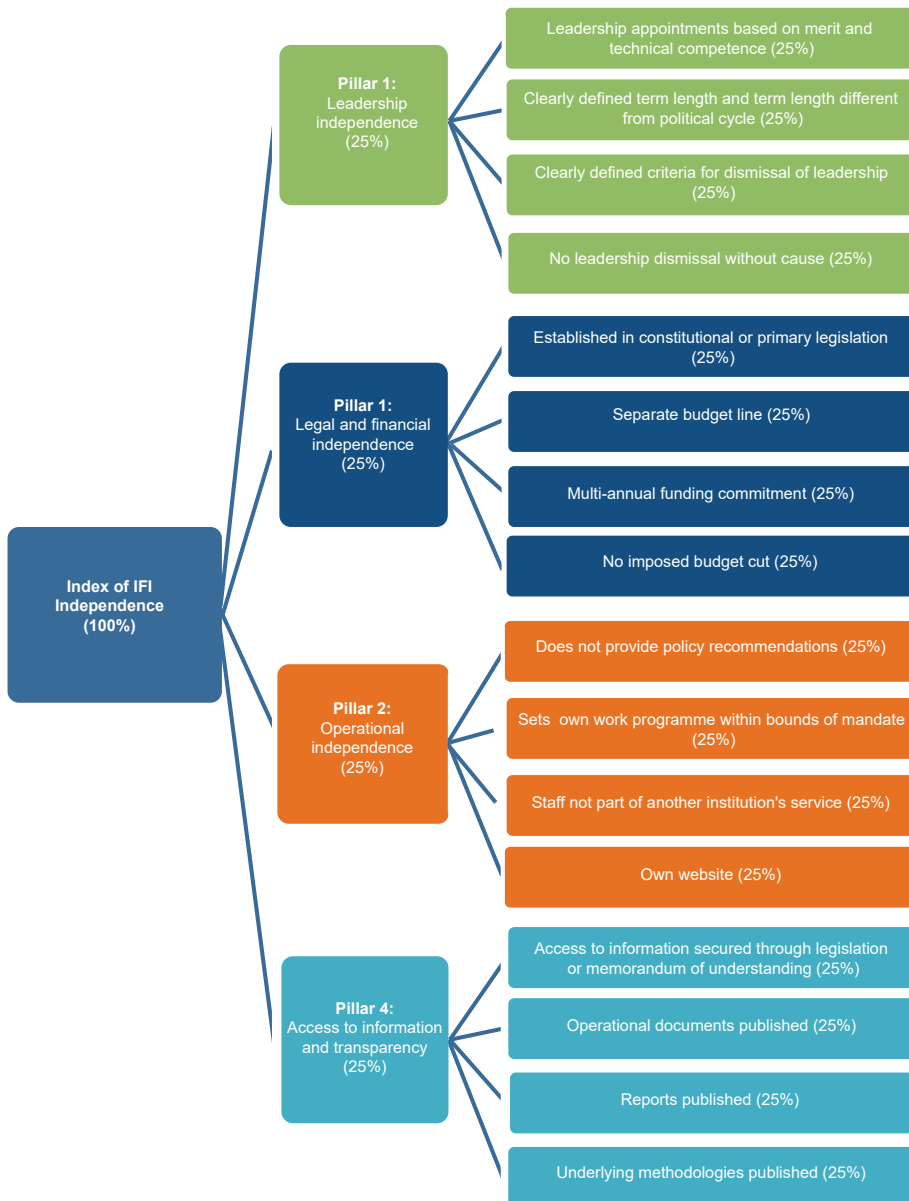
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## Annex 1 Index of IFI Independence and its component indicators



**Annex 2:** Institutions included in OECD IFI Database

Country	Institution name	Acronym
Australia	Parliamentary Budget Office	PBO
Austria	Fiscal Advisory Council	FISK
Belgium	High Council of Finance	HCF
Canada	Parliamentary Budget Office	PBO
Denmark	Danish Economic Council	EC
Estonia	Fiscal Council	FC
Finland	National Audit Office of Finland – Fiscal Policy Evaluation	NAO - FPC
France	High Council for Public Finances	HCFP
Germany	Independent Advisory Board to the Stability Council	IAB
Greece	Parliamentary Budget Office	PBO
Hungary	Fiscal Council	FC
Iceland	Icelandic Fiscal Council	FC
Ireland	Irish Fiscal Advisory Council	IFAC
Italy	Parliamentary Budget Office	PBO
Korea	National Assembly Budget Office	NABO
Latvia	Fiscal Discipline Council	FDC
Luxembourg	National Council of Public Finances	CNFP
Mexico	Center for Public Finance Studies	CEPF
Netherlands	Netherlands Bureau for Economic Policy Analysis	CPB
Portugal	Public Finance Council	CFP
Slovak Republic	Council for Budget Responsibility	CBR
Slovenia	Fiscal Council	FC
Spain	Independent Authority for Fiscal Responsibility	AIReF
Sweden	Swedish Fiscal Policy Council	FPC
United Kingdom	Office for Budget Responsibility	OBR
United States	Congressional Budget Office	CBO





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## 6 The effectiveness of fiscal councils: Emerging international evidence

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**Victor Duarte Lledó**

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*This chapter explores the emerging evidence about the effectiveness of fiscal councils: Are fiscal councils really living up to expectations? And if so, under what conditions? Despite severe data limitations and limited experience with fiscal councils in most countries, different approaches have tried to address these questions. This chapter discusses the accumulating international evidence.<sup>1</sup>*

### **What makes a fiscal council effective?**

Unlike independent central banks, which have complete discretion to set delegated policy instruments to achieve their goals, fiscal watchdogs cannot bite: they have no explicit mandate or instrument that can directly influence fiscal policy. It is how loud and fast the fiscal watchdog barks that matters for its effectiveness.

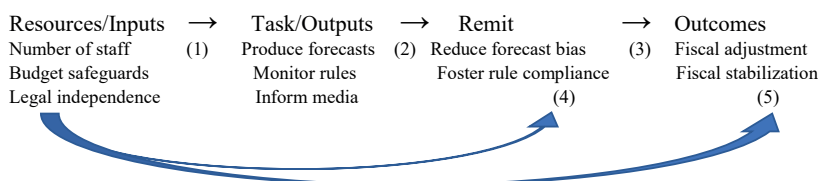
As such, fiscal council effectiveness lies in their ability to persuade policymakers to opt for sound fiscal policies (Beetsma *et al.* 2017). They do so by (i) fostering transparency over the political cycle to improve democratic accountability and discourage opportunistic shifts in fiscal policy and (ii) raising public awareness about the consequences of certain policy paths. And they must do all that in time to prevent fiscal misbehaviour.

1 See Debrun *et al.* (2009), Hageman (2011) and IMF (2013) for previous literature reviews.

In practice, to be effective a fiscal council needs to perform specific tasks and deliver well-defined outputs with the quality and timeliness necessary to observe its mandate. Such tasks include fiscal policy analysis, recommendations, assessments, and forecasts, which are usually delivered through public reports, press conferences, and parliamentary hearings.

To put it simply, effective fiscal councils are endowed with adequate *resources* or *inputs*, allowing them to perform specific *tasks* and deliver certain *outputs* to support their *remits*, conducive to improving fiscal policy *outcomes*. It is the focus on individual segments of this *production chain*, depicted in Figure 1, that differentiates among alternative approaches to assessing fiscal council effectiveness. Before turning to these approaches and to further understand how they differ, we look at some of the challenges in identifying fiscal council effectiveness.

**Figure 1.** Fiscal Council Production Chain



## Identifying fiscal council effectiveness

Identifying the effectiveness of fiscal councils is particularly challenging for several reasons:

- (i.) *The criteria over which effectiveness must be assessed vary depending on the nature of the fiscal council work and design.* Unlike central banks, which have fairly uniform goals and instruments, fiscal councils' remit, tasks, output and resources vary greatly across countries. Country-specific context, therefore, matters and must be considered carefully when assessing fiscal council effectiveness (see von Trapp and Nichols 2018, in this volume).

- (ii.) *Fiscal council effectiveness is not easily measurable.* As illustrated in Figure 1, fiscal councils do not exert a direct impact on commonly reported fiscal aggregates such as budget balances. Their impact is subtler and manifests in ways for which metrics are either not readily available (e.g. quality of the public debate on fiscal policy, including in parliament) or directly observable (e.g. informal interactions with stakeholders in the budget process).
- (iii.) *Fiscal councils are one of several institutions created to promote sound fiscal policies.* Fiscal councils are not the only fiscal institution created to improve fiscal transparency, promote accountability, and encourage sound fiscal policies. They are part of a family of fiscal institutions including fiscal rules and medium-term budget frameworks, that serve similar objectives. Disentangling the impact of fiscal councils from that of fiscal rules is not straightforward given that, in some cases, they have been created contemporaneously and to achieve similar fiscal objectives.
- (iv.) *Fiscal councils could reflect intrinsic preferences for fiscal discipline rather than be an instrument of it.* For instance, governments may choose to introduce fiscal councils to break away from bouts of fiscal indiscipline or to signal their preference for fiscal discipline. As fiscal discipline and the adoption of a council might result from the same shift in preferences, it is difficult to establish the role that the fiscal council can play in enhancing discipline.

## **Alternative approaches: Pros and cons**

A growing literature using alternative approaches is looking at the effectiveness of fiscal councils. The literature is split between case studies and statistical analysis, mostly panel data regressions. Both approaches try to determine whether fiscal councils are effective or not. They complement each other when it comes to determine how, by how much, and in which circumstances fiscal councils are effective.

- *Case studies.* The context-specific approach of case-studies usually allows for a closer look at each individual segment of the production chain. In doing so, a case study is more suitable to explain how specific fiscal council's building blocks may impact the quality of the fiscal policy. It may also offer more precise yardsticks by

which to assess the effectiveness of fiscal councils which, in turn, allows for a better identification of the impact of fiscal councils against that of other fiscal institutions. The context-specific nature of case studies is more limited when it comes to more quantitative, counterfactual analysis, trying to answer by how much and under what conditions fiscal councils with distinct resources and outputs would be more effective.

- *Statistical analyses.* With the support of new datasets disseminated by the [European Commission](#), the [IMF](#) and the [OECD](#), statistical analyses of the effectiveness of fiscal councils have recently caught up with case studies. By exploiting variations in resources and outputs across countries and over time and how they correlate with fiscal policy objectives and outcomes, statistical analyses are better suited to quantify the effect of fiscal councils on relevant metrics, such as their media presence, the quality of forecasts (both in terms of reduced bias and improved accuracy) underlying budget preparation, or even broad-based measures of fiscal performance. Their major drawback is that correlations between the presence of a fiscal council and these indicators do not, *per se*, establish a causality, and cannot inform on the features of fiscal councils that could be particularly conducive to their effectiveness.

## Case studies

Case studies have looked at the effectiveness of fiscal councils from narrative and analytical angles. Initial case studies attempted to gauge the effectiveness of individual fiscal councils for different segments of the production chain in a more narrative and descriptive way without resorting to a specific analytical framework. Recent studies have started to follow a more analytical approach that relies, among other things, on event studies and surveys to assess fiscal council effectiveness for different segments of the fiscal council production chain.

- *Narrative studies.* Calmfors and Wren-Lewis (2011) review the experience with the fiscal councils in Sweden and the UK. Both assessments are comprehensive, covering resources, outputs, remit, and outcomes. The study does not provide any specific conclusion about how effective each of these fiscal councils were, but stresses that effectiveness depends very much on how independent fiscal councils are perceived to be and how much of a direct influence they have on the budget.

IMF (2013) looks at the fiscal councils in Canada, Hungary, Korea, Netherlands, Sweden, and the US to determine how the interlinkages between a fiscal council's resources, outputs, and remit play out to generate good fiscal outcomes. They argue that effectiveness depends very much on the quality and quantity of a fiscal council's resources, including legal independence and staff size relative to mandate, but also on how well they perform their task of communicating to the media and public. Von Trapp *et al.* (2016) is one of the most comprehensive narrative studies to date. It conducts a detailed analysis of fiscal councils in 18 OECD countries. Effectiveness is assessed based on the recently published OECD IFI database, which draws from the OECD IFI principles.<sup>2</sup>

- *Analytical studies.* IMF (2013) and Debrun *et al.* (2017) reiterate the point of an effective media communication strategy in 'forensic' case studies that look at how well-timed, received, and consequential the media interactions conducted by the Netherlands Bureau for Economic Policy Analysis (CPB) and the Belgium High Council of Finance have been. They follow an event-study approach that identifies the impact of fiscal councils' public interventions at times when fiscal policy significantly deviates from plans on the media and, ultimately, on fiscal outcomes. They find evidence that well-timed and clear public interventions are well-received by the media, while the ability of such interventions to elicit policy corrections was less clear cut and possibly detectable only in specific budget inputs rather than the aggregate fiscal stance. Page (2014, and 2018, this volume) provides a comprehensive and methodologically well-defined framework, originally applied to assess the effectiveness of the UK Office of Budget Responsibility (OBR). The proposed framework systematically evaluates the effectiveness of the OBR at each segment of its production chain through 'user surveys' (e.g. member of Parliament, media, general public). The evaluation found that the OBR had succeeded in reducing perceptions of bias in fiscal and economic forecasting and has increased fiscal transparency. That said, the evaluation highlighted that OBR credibility was mainly ascribed to its senior leadership team, calling for long-term succession planning to be undertaken.

2 They cover: local ownership; independence and non-partisanship (including ways to enhance independence and non-partisanship through the appointment process for leadership and staff); mandate; resources; relationship with the legislature; access to information; transparency; communications; and external evaluation.

## Statistical analysis

Statistical analyses range from simple benchmarking exercises, focusing on inputs to gauge the potential (*de jure*) effectiveness of fiscal councils, to econometric analysis, examining the correlation between inputs and outputs to assess the actual (*de facto*) effectiveness of these monitoring bodies.

- *Benchmarking exercises.* Beetsma and Debrun (2016) map the main policy implications of a model they develop into a set of core criteria such as the breadth of the fiscal council mandate, its media impact and independence, that are documented by the IMF fiscal council database. These criteria are scored and aggregated into an index that measures the likelihood that a council will effectively improve voters' ability to assess the competence of the government. They find that a strong majority of fiscal councils exhibit features – political independence and tasks – that allow them to clarify existing signals about fiscal policy. A number of institutions would nevertheless benefit from stronger guarantees of independence to join the group of potentially highly effective councils, including through increased and secure resources and guaranteed access to information. Horvath (2017) constructs indices based on surveys of the inputs available to different European Union (EU) fiscal councils to deliver the outputs and observe the remits as provisioned under the Treaty on Stability, Coordination and Governance (TSCG, or commonly known as the Fiscal Compact) in 2013. Such indices capture the effectiveness of different operational dimensions and are used to rank EU fiscal councils across these dimensions. He finds that, while most EU fiscal councils have the resources and an institutional setting that allows them to fulfil their mandates effectively, in several cases there are critical resource constraints, particularly in the area of access to information.
- *Econometric analyses.* Because of the relatively short time series available, existing studies rely on panel data regression models to look at the impact of inputs and outputs on remits and outcomes.<sup>3</sup> Using data from the European Commission

3 European Commission (2006) was one of the first empirical exercises to look at simple correlations between fiscal council inputs and fiscal performance. The study shows that fiscal performance improved in the years following the introduction of a fiscal council.

on the context, legal status, mandate, independence, and other *de jure* resource characteristics of EU fiscal councils, Debrun and Kumar (2008) create indices along these dimensions to assess their impact on fiscal balances. Their results indicate that fiscal councils, particularly those with formal guarantees of independence, are associated with stronger budget balances. The evidence also points to a causal effect running from transparency to the adoption of a fiscal council, as countries where the budget process was deemed less transparent were also those that seemed more likely to introduce a fiscal council. Using the IMF fiscal council dataset, Debrun and Kinda (2014), explore the impact of fiscal council resources and other features on fiscal outcomes and budgetary forecast quality. The above-mentioned studies also examine the complementarity between fiscal council and rules. Overall, they find that the adoption of fiscal councils is conducive to stronger fiscal balances only to the extent that they are *de jure* independent, tasked with monitoring fiscal rules and producing or assessing fiscal forecasts, and have a stronger media impact. Debrun and Kinda (2014) also find well-resourced fiscal councils to be associated with more accurate and less biased fiscal forecasts. Beetsma *et al.* (2017) extend these two papers using the 2016 vintage of the IMF dataset. They aim at identifying more robustly the impact of fiscal councils on the quality of fiscal forecasts and the compliance with fiscal rules, the two most common remits among existing fiscal councils. Although causality remains an open question, their results largely confirm early evidence about fiscal councils' effectiveness: the optimistic bias in budgetary forecasts is reduced, the accuracy of these forecasts is improved, and compliance with fiscal rules also appears to improve when a fiscal council is active.

## Summing up

Alternative empirical approaches have suggested that well-designed fiscal councils appear to promote sound fiscal policies. In particular, councils tasked with assessing fiscal forecasts and monitoring fiscal rules are on average successful in delivering better forecasts and stronger compliance. Certain features seem to contribute to the effectiveness of fiscal councils: appropriate resources, independence from politics, guaranteed access to information, and media visibility.



Future work should continue to develop metrics that capture fiscal council outputs and remits more closely, disentangle fiscal council effects from those of other fiscal institutions, such as fiscal rules, and address endogeneity issues.

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## 7 Fiscal councils and fiscal transparency

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**James E. Alt, David Dreyer Lassen**

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### Introduction

Fiscal transparency “is defined ... as openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities...so that the electorate and financial markets can accurately assess the government’s financial position and the true costs and benefits of government activities, including their present and future economic and social implications” (Kopits and Craig 1998, p.1 ). This IMF definition, from one of the early, key policy papers on fiscal transparency, continues to capture the key ideas of fiscal transparency, but remains largely silent on how this is to be achieved in practice.

Enter fiscal councils? Fiscal councils are, by institutionalising and codifying the state’s intent towards improving the informational basis for fiscal policy, often argued to increase, or at least stabilise, fiscal transparency.<sup>1</sup> Here, we briefly present arguments for why fiscal councils may or may not be associated with fiscal transparency, why it is difficult to assess in depth, and how they are related in practice. Finally, we comment on the newly established European Fiscal Board (EFB).

<sup>1</sup> Informational problems are, of course, but one argument for fiscal councils and watchdogs; see Calmfors and Wren-Lewis (2011) for an exhaustive list of arguments.

Many, if not most, theoretical accounts of fiscal transparency centre on problems that arise when policymakers or incumbent governments know more about the state of the economy and of current and future public finances than do opposition parties, the media and voters. In this view, efforts to improve fiscal transparency will be met with resistance from those currently in power, as transparency will limit their informational advantages that could be used for political gain.<sup>2</sup>

However, it is also possible that efforts and commitments to improve fiscal transparency could benefit the government in power. If the executive's information about fiscal affairs is not perfect, as is otherwise sometimes implicitly assumed, better or more complete information about current and future fiscal conditions and balances can improve the informational basis for policymaking more generally. Empirically, it is very difficult to determine the relative importance of these effects.

### **Are fiscal councils necessary for fiscal transparency – or a reflection of it?**

The surge in the introduction and use of fiscal rules across OECD countries, initiated in part by the fiscal rules underlying the Maastricht Treaty and the accompanying political and economic challenges of policing compliance with such rules, transformed public finance statistics from being reports on the state of the government purse into actual policy goals, and, as a side effect, made clear(er) the risk of creative accounting (Koen and van der Noord 2005) and the accompanying need for independent input into and verification of government numbers (Savage 2005, Alt *et al.* 2014).

When do we see improvements in fiscal transparency? Fiscal transparency, and fiscal frameworks more generally, are more likely to improve after fiscal crises (Alt *et al.* 2006), and transparency is generally found to be higher in more politically competitive environments (Alt and Lassen 2006, Wehner and de Renzio 2013); the more frequent power-sharing in competitive environments means that incumbents – realising that they could soon be opposition – have stronger incentives to improve fiscal transparency and share fiscal information with outsiders.

2 Beetsma *et al.* (2017) show theoretically that incumbents may prefer transparency over opacity if the challengers have an electoral advantage prior to elections.

If the establishment of a fiscal council is driven by the same underlying factors that cause improvements in fiscal transparency throughout government, assessing the independent effect of fiscal councils on fiscal transparency will be difficult, if not impossible (see below). An additional challenge is the fact that, while fiscal councils in name were not established until the early 2000s, institutional arrangements that were similar in spirit have been around for quite some time.

As an example, consider the Danish Economic Council, an independent and public economic watchdog. The establishment of the Danish Economic Council in the 1960s was in part driven by the idea of challenging the monopoly on fiscal policy analysis held by the Ministry of Finance. This led, among other things, to the independent development of the short-term macroeconomic forecasting model, which to this day still serves as an independent check on the main forecasting model used by the Ministry of Finance. Only in 2012 was the Danish economic council formally tasked with monitoring fiscal policy, as part of the Budget Law Act, but in practice it had done so since its conception.

While the merits of fiscal rules continue to be debated, there is little doubt that fiscal rules without any kind of independent information on and verification of compliance with such rules would leave too much to the discretion of budget-pressured policymakers. Fiscal rules based on complex, calculated statistics including output gaps and structural deficits (Wyplosz 2005), as introduced in an EU-context recently, require additional (untestable) assumptions and made this need even more pertinent (e.g Alt *et al.* 2014).

Every country already has an independent statistical agency; one interpretation behind the establishment of independent fiscal councils is that they (also) do economic analysis, while statistical agencies typically are focused on collecting and reporting economic data; another argument for the division of labour could be that fiscal policy statistics, in particular involving projections and calculated or inferred quantities, are (more) politically contentious than most statistical reporting because of the direct link to public finances and the government budget and, as such, more at risk of political controversy. By placing the role of informational arbiter in an independent agency or institution, the risk that political conflict or controversy surrounding fiscal policy could damage statistical agencies is thus contained.

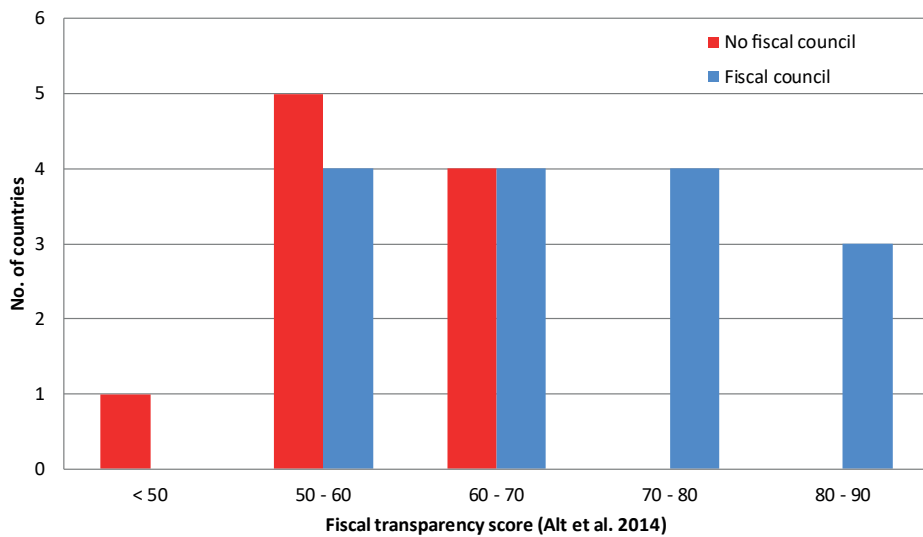
Fiscal councils can contribute to improving the public finance discourse beyond the institutionalisation of information production. It often involves full-time academics who are not beholden to a political or administrative logic or to the prospect of career advancements in such places; such ‘judges’ can provide, but are not a guarantee of, an independent and impartial counterweight to economic ministries and politicians. Fiscal councils’ contribution to the public debate is also well served when the Council can determine the terms of employment of its technical staff. While a revolving door with the administration (e.g. in the form of ‘secondment’ arrangements) has the potential to improve knowledge exchange, it can, on the other hand, cause staff at fiscal councils to conform with political or ministerial demands, in which case the evaluations and analysis of fiscal councils could result in false comfort.

### **Fiscal councils and fiscal transparency: What do the data say?**

Do fiscal councils lead to fiscal transparency? As noted above, the establishment of a fiscal council may reflect, rather than cause, an increased focus on institutional fiscal frameworks. At the same time, high transparency countries may see less of a need for additional fiscal institutions

In an early assessment, Debrun and Kumar (2008) find that less transparent countries “seem to favor more active non-partisan bodies in their budgetary process.” They argue that this could mean that fiscal councils, the prime example of non-partisan budgetary bodies, do not serve a discipline-enhancing function but are essentially smokescreens, or, alternatively, that fiscal councils proved too intrusive once implemented, triggering an adverse response in terms of transparency. However, yet another alternative is that fiscal councils, and fiscal transparency more generally, are substitutes: in countries with existing fiscal councils or close approximations thereof, the marginal effects of such potentially politically costly institutional inventions would be smaller and, hence, the case for separate *de jure* increases in fiscal transparency less clear. Combining recent data on fiscal councils from the IMF (2013) with data on fiscal transparency from Alt *et al.* (2014) shows that there are countries without fiscal councils that are reasonably transparent and, at the same time, countries with fiscal councils that are not. Figure 1 shows the presence of fiscal councils by fiscal transparency score.

**Figure 1.** Fiscal councils and fiscal transparency



*Note:* Data on the presence of fiscal councils from IMF (2013, p.13); data on fiscal transparency based on interpolated fiscal transparency score from Alt *et al.* (2014, SI). Countries: EU-27 minus Luxembourg and Malta.

The overall pattern is clear; moreover, there are fiscal councils in the 11 most transparent countries and no fiscal councils in the bottom five: Latvia, Greece, Lithuania, Cyprus, and Luxembourg.

In a comprehensive analysis, the IMF (2013) notes that having a fiscal council is not enough for achieving improvements in fiscal performance. A key element of any fiscal council is its legal and operational independence. With that in hand, the main fiscal council attributes that are statistically associated with improved fiscal outcomes all have elements of fiscal transparency: monitoring compliance with fiscal rules; assessing or producing forecasts; and a strong media presence. The case studies carried out by the IMF support this and add that some key functions, including rule adherence and the costing or scoring of policy proposals require significant staff, in order to be a credible input into the policymaking process. If, conversely, there is little or no independence, or weak or no direct communication to actors outside government, fiscal councils can become instruments of control rather than of information.

Most recently, Beetsma and Debrun (2016) focus specifically on countries with fiscal councils and examine a measure of what they term the “signal-enhancement capacity” of such councils, which is meant to capture councils’ ability “to ensure that all public



information about the budget is a clear signal of politicians' genuine intent and actions"; in essence, fiscal transparency. This measure, echoing the findings from the IMF study, includes whether the council has a broad mandate, the ability to communicate (freely) with the public, the possibility to directly interact with participants in the budget process, and independence from politics. They note that there is significant heterogeneity among fiscal councils in their ability to provide clear and unbiased information on fiscal policy parameters; in total, between one half and two thirds of all cases can be characterised as well-functioning, while a quarter have little political independence and limited signal-enhancing capacity. In turn, this confirms that independence and transparency move together.

Fiscal councils have a high public profile, can serve as focal points for media, interest groups and think tanks and provide an institutionalisation of independent commentary on fiscal policy. This is a task that one or a string of separate outside observers, such as university-based academic economists, can have a hard time carrying out or committing to on their own. While information about the fiscal process, its components and moving parts may in principle be available, committing resources to validating and/or acting upon such information may – given the number of pages in an average government budget – be all but impossible without a specialised agency tasked to carry this out.

## **Conclusion and fiscal transparency perspectives on the EFB**

Fiscal councils and fiscal transparency are closely related. Many of the arguments and rationales pertaining to fiscal councils are rooted in ideas about access to more, and more precise, information about fiscal priorities and fiscal policy consequences. As such, fiscal councils are about institutionalising and codifying key components of fiscal transparency and, as a result, the presence of fiscal councils is correlated with measures of fiscal transparency.

The establishment of national fiscal councils has implications also for supranational institutional arrangements. In the case of the EU, the establishment of national fiscal councils has, if indirectly, improved national fiscal governance across the Union. However, until recently there has been no equivalent to national fiscal councils at the

EU-level. The establishment of the European Fiscal Board, considered elsewhere in detail, has the potential to fulfil this role at the European level, but, so far, its role and remits, *vis-à-vis* the European Commission and national fiscal councils, is less clear. In particular, a key ingredient for fiscal councils is credibility.

In all likelihood, assessments of the EFB will occasionally differ from those of national fiscal councils. We conjecture that the EFB will have credibility when its views conflict with those of the national councils and that it will help where there are no councils – but many of those cases are non-transparent in other important ways. If its recommendations conflict with national recommendations, one or the other loses credibility. If it adopts a policy of not criticising national councils, both will lose credibility, which can adversely affect the real effects of fiscal transparency.

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## 8 Fiscal councils in federal or decentralised countries: Belgium, Germany and Spain

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**José Luis Escrivá, Eckhard Janeba, and Geert Langenus**

AIReF; University of Mannheim; National Bank of Belgium

Designing and implementing fiscal policies consistent with macroeconomic stability and long-term public debt sustainability raises specific challenges in highly decentralised or federal states. These pertain to potential coordination failures between the centre and the subnational entities, or among the latter, which can undermine fiscal stabilisation and debt sustainability. This chapter collects three short case studies which show how the fiscal council's institutional design and operations are shaped much more by country specificities, notably regarding the role of the centre in intergovernmental relations, than by the nature of the coordination problems they are expected to mitigate.

### **I Belgium: the High Council of Finance<sup>1</sup>**

The Belgian High Council of Finance dates back to 1936. Political interference and institutional instability undermined the Council's effectiveness at first but it was revived by the gradual transformation of Belgium into a federal state. In 1989, following the significant transfer of spending prerogatives to the Regions, a sub-committee was created within the Council so as to avoid fiscal slippage at the regional level that could jeopardise the fiscal sustainability of the general government.

<sup>1</sup> This section was prepared by Geert Langenus. This contribution reflects the views of the author and not necessarily those of the National Bank of Belgium and the High Council of Finance. Helpful discussions with and/or comments by Barbara Coppens, Jan Smets and Bert Ydiers are gratefully acknowledged.

After a review of the institutional background and the Council's current mandate and composition, we assess the functioning of the Council, pointing to a number of issues that may weigh on its effectiveness.

#### A. Institutional background

In Belgium, different institutions perform tasks commonly assigned to a fiscal council. The macroeconomic projections underlying budget preparation are elaborated by the Federal Planning Bureau, under the auspices of the National Accounts Institute. The costing of electoral platforms is yet to be started, but would also be carried out by the Bureau. However, fiscal surveillance is entrusted to the High Council of Finance.

The Council consists of three sub-committees. Whilst one of those advises on taxation issues (including social contributions), the mandates of the other two relate to budget preparation and analysis. The Study Group on Ageing prepares long-run macroeconomic and budgetary projections and assesses the social consequences of ageing. The Public Sector Borrowing Requirements (PSBR) section is typically considered as the key 'Belgian fiscal council' as, in accordance with its mandate, it evaluates past fiscal policy (including the implementation of budgetary plans) and provides detailed budget recommendations.

The PSBR was established against a backdrop of concerns that greater spending devolution would increase fiscal risks, as there is no constitutional hierarchy between the federal government and the regional entities (called Regions and Communities in Belgium). One of the specific tasks of the PSBR is to advise, either on its own initiative or at the request of the federal Minister of Finance, on the appropriateness of limiting the borrowing capacity of a government entity in the face of severe budgetary problems. However, this control mechanism has never been used and, in practice, federal restrictions on the borrowing autonomy of a subnational entity seem politically unfeasible in the Belgian political context.

The PSBR publishes its assessment of fiscal policy in regular reports. It focuses on the implementation of the 'stability programme' endorsed by the European Union. Unlike most fiscal councils, the PSBR also issues detailed operational recommendations on budget targets, taking into account the EU governance framework.

These recommendations are determined for the general government and broken down into (structural and nominal) targets for the federal government (including social security) and each individual regional entity, as well as an aggregate for local entities.

There are 12 Council members appointed for renewable five-year terms. Half of them are proposed by federal institutions (three among these by the National Bank of Belgium) with the other half proposed by the Regions and Communities. The current Chairman is the Governor of the National Bank of Belgium. The Council cannot hire its own staff, but is supported by a small secretariat. Initially limited to experts of the federal Ministry of Finance, the secretariat has now been broadened, with a view to also including staff from regional institutions.

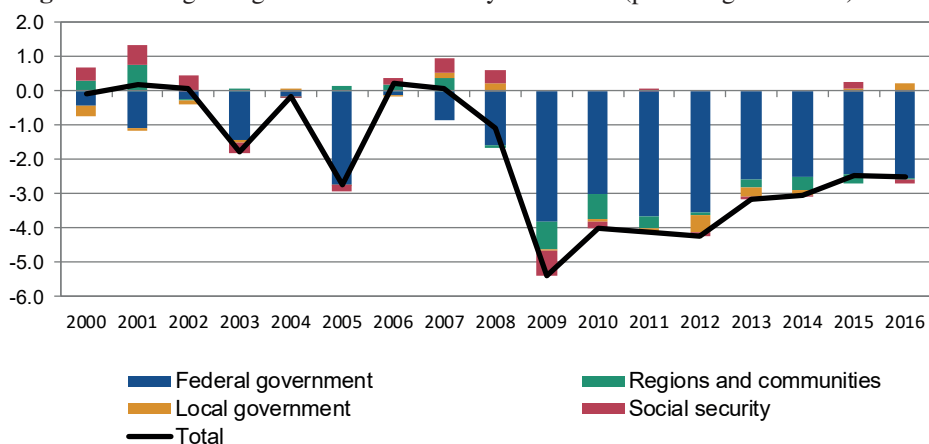
#### B. Functioning of the PSBR and assessment

Since its creation, the PSBR has been an important voice in the Belgian budgetary process. Apart from the aforementioned unrealistic control mechanism for fiscal profligacy at the regional level, it did not have a formal role in the budget cycle until recently. However, the Council has an important moral authority and is a key forum for intergovernmental fiscal co-ordination in Belgium (Spahn 2007). The 2013 intergovernmental Cooperation Agreement that transposes the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union into Belgian law formalises the role of the PSBR in providing advice on the coordination of budget targets.

Overall, budget deficits at the subnational level have been small in Belgium since 1989, despite further devolution. At the same time, the central government has continued to record deficits, despite the PSBR's continued calls to build up surpluses in the face of rising ageing costs (see Figure 1).

While it is difficult to assess the actual impact of the PSBR recommendations, Coene and Langenus (2011) show evidence that the PSBR seems to have influenced fiscal policy. However, its impact has waned following the adoption of the euro, with the PSBR often seen as constrained by pre-existing political views. In light of this experience, addressing several challenges could foster the PSBR's capacity to contribute to sound fiscal policies in Belgium.



**Figure 1.** Belgium: government balance by sub-sector (percentages of GDP)

Source(s): National Account Institute.

### Strengthen budget coordination

Belgium relies on a consensual/contractual approach to fiscal coordination, enshrined in ‘Cooperation Agreements’ between the federal and regional governments. No binding rule governs fiscal performance of the various government levels (except for a form of golden rule at the local level). The 2013 Cooperation Agreement sets out the general principle of the approach. First, budget targets must be anchored in the Medium-Term Objective (or the adjustment path towards it) of the EU Stability and Growth Pact. Second, general government targets must be translated into operational objectives for the federal/central government and each regional entity, as well as the local governments, on the basis of PSBR recommendations, with the PSBR also tasked to monitor deviations from the fiscal targets.

One problem, however, is the lack of ownership of the general government fiscal targets across government levels. The stability programme is elaborated centrally by the federal government. Until 2013, these targets were ratified via specific intergovernmental Cooperation Agreements, but no such agreements have been concluded since then. This hiatus reflects a broader weakness of rules-based fiscal policy in Belgium. The recent strains on the consensual/contractual approach could then further weaken the incentives for fiscal discipline. The lack of numerical benchmarks approved by all

government levels clearly complicates the monitoring role of the PSBR since there is, strictly speaking, no legal basis to establish deviations from those targets.

#### Better alignment with the EU fiscal framework

The 2013 Cooperation Agreement also specifies that the analytical framework to assess budgetary developments is the ‘EC method’ for the calculation of structural budget balances. However, applying the EC cyclical adjustment method to regional public finances raises many challenges. For instance, own regional revenue may depend on other tax bases (such as those related to property taxes) than those considered in the EC method, or may have different elasticities than those used for general government. Although the PSBR has proposed a subnational breakdown of structural targets for general government, it remains a rough approximation (e.g. it ignores cyclicity in own regional revenue) and is not routinely used in the budget processes of Regions and Communities.

More generally, the increased complexity of the EU governance framework – with intertwined and mutually inconsistent fiscal rules – has not helped the transposition of EU objectives to federal countries where fiscal coordination issues are more challenging. Such complexity effectively gives extensive powers to the EC for judgment and interpretations, making the application of the framework less predictable. In particular, excessive leniency at the European level could undermine the influence of the PSBR, especially when it comes to recommendations for budget targets.

#### Foster independence

The High Council of Finance comes across more as a multi-partisan rather than a truly non-partisan institution. Compared to fiscal councils elsewhere, not having its own staff and the specific appointment procedures have raised doubts about its functional independence (see Burret and Schnellenbach 2013). The EC (2017) argues that this weakens the PSBR’s ability ‘to act as an autonomous entity providing independent, unbiased monitoring’. Even though the PSBR impact on political preferences shaping fiscal policy remains difficult to gauge, the PSBR has demonstrated a clear sensitivity to political feasibility constraints.

Outspoken criticism of fiscal policy and of the consistent loosening of budget targets throughout the years has, in particular, become a relatively rare feature in its reports. The PSBR seems to have increasingly focused on providing technical support to political consensus-building or on translating political consensus into operational targets, rather than assuming a genuine fiscal watchdog role. This ‘multi-partisan’ approach partly reflects the broader institutional context in Belgium but leaves the PSBR vulnerable to situations where it is more difficult to achieve political consensus or where the consensus deviates from sound fiscal policy.

In that regard, the sense of urgency to reduce public debt and balance the budget has clearly not increased in Belgian political debate. The current strains on the ‘consensual’ approach may increase the need for a truly nonpartisan arbiter that could focus more on increasing the cost of irresponsible fiscal behaviour. Such an institution should at least have its own staff and a large(r) media impact. A move towards a fully nonpartisan fiscal council could also be reflected in membership and appointment procedures.

## **II Spain: The Independent Authority for Fiscal Responsibility (AIReF)<sup>2</sup>**

### **A. Institutional background**

The existence in Spain of two levels of sub-national governments, including 17 Autonomous Regions and more than 8,000 municipalities, managing 43% of the overall public spending, makes the individual monitoring of sub-national public finances particularly challenging for an independent fiscal institution (IFI). This notwithstanding, the Independent Authority for Fiscal Responsibility of Spain (AIReF, Spanish acronym) benefits from a strong legal basis to perform this task.

Established by an Organic Law, the AIReF is mandated to monitor all public administrations, including sub-national governments, which have to pay a fiscal supervision fee to fund the Authority. The Law states that:

<sup>2</sup> This section was prepared by José Luis Escrivá.

- AIRcF's goal is to guarantee the effective compliance by all the Public Administrations with the principle of budgetary stability enshrined in the Constitution.
- AIRcF will carry out its functions for all the Spanish territory with exclusivity and as regards every public-sector entity.
- Regions and municipalities (except those with budgets below €200 million) are subject to the fiscal supervision fee. They contribute to about a third of the total revenue from supervision fee (average 2015-2017).
- AIRcF can request from any individual public administration the information deemed necessary to perform its supervisory functions.

The Law provides that AIRcF prepares reports covering all phases of the budgetary cycle: setting of numerical rules, budgetary planning, budget execution and compliance with the rules.

As regards the *setting of rules*, AIRcF must assess the central government's proposal for the individual targets of each Autonomous Region, prior to approval by the Fiscal and Financial Policy Council, the body in charge of policy coordination between the central government and regions. Due to the diversity of starting fiscal positions and outlooks for the various regions, AIRcF did not support the central government's proposal of equal targets for all the regions in 2015 and 2016. It proposed instead a fiscal effort metric conducive to setting region-specific targets deemed feasible and credible.

In the *budgetary planning* phase, AIRcF evaluates the accuracy of macroeconomic forecasts underlying the regional draft budgets, if these forecasts do not coincide with those of the national government, something that has happened each year since 2015 in at least eight regions. AIRcF publicly reports on the extent to which the regional and local draft and approved budgets are likely to comply with the Spanish fiscal rules and targets.

There is a permanent monitoring of *budget execution* by AIRcF. The Law states that at least on the occasion of the release of the Quarterly National Public Accounts, a specific report by AIRcF be produced including early warnings. Likewise, before every July 15, AIRcF needs to inform about the risk of non-compliance of individual subnational public administrations with respect to the fiscal targets of the on-going year.

For these reports on budgetary planning and execution, AIREF conducts a thorough analysis of each of the 17 Autonomous Regions and has progressively increased the scope of its assessments of Local Corporations. It started by assessing six Local Governments (provincial capitals with more than half a million inhabitants); in 2016, this figure rose to 16 Local Governments and five Provincial Governments; and this year, one of the AIREF's novelties has been to identify the Local Governments with a particularly problematic fiscal situation (32).

Finally, on *rules' enforcement*, the AIREF can promote the activation of preventive and corrective legal measures. Specifically, AIREF formally brings cases before supervisory institutions (the Ministry of Finance for the 17 Autonomous Regions and the Autonomous Regions themselves for most Municipalities), requesting the activation of legal provisions. It is required that the two-year rebalancing plans that regions missing fiscal targets must submit be informed by AIREF prior to the approval by the Fiscal and Financial Policy Council.

#### B. Functioning of AIREF and assessment

While AIREF's role in subnational entities' budget planning and execution has not met with major hurdles and has had tangible results, the activation and implementation of preventive and corrective measures at regional level has been more challenging. Although the AIREF has recommended the activation of preventive measures whenever deemed appropriate – including the stepping up in legal measures following serious non-compliance – the Ministry of Finance did not act on these recommendations.

Various factors help in understanding this. First, repeated national elections led to extended periods with a caretaker central government of limited powers. Second, regular modifications to the stability targets agreed with the European institutions in the context of the Excessive Deficit Procedure have greatly complicated their enforcement at the subnational level. Third, fairness issues hinder the implementation of corrective measures because some of the non-compliant regions are widely recognised as structurally under-financed. This has weakened somewhat the moral case for enforcing the rules. Finally, some sanctions – such as the inability of the region to resort to

extraordinary funding mechanisms available to overcome borrowing constraints – were excessively tough.

Against this background, the AIREF has been asking for clarifications over the fiscal framework applicable to regions and the causes and consequences of not applying the measures foreseen by law, and it has emphasised the need for a comprehensive approach to subnational public-finances analysis. Such analysis must be linked to the aggregate state of public finances. Interconnections among different levels of government cannot be ignored, especially after a financial crisis that has reinforced dependency on Central Government funding and in a context where structural problems in the regional financing system complicate compliance with fiscal targets for certain regions. Hence, beyond calling for more consistent and more enforceable fiscal rules, the AIREF has been insisting on a review of the institutional setting for subnational administrations, including a reconsideration of the regional financial system, the extraordinary financing mechanisms, the regional debt legacy, and the need to facilitate a smooth return to the financial markets.

AIREF has faced challenges when undertaking the granular analyses required at the subnational level. Two of them are common to all IFIs with an ambitious subnational scope: information access and adequate analytical tools.

Regarding information access, the Spanish Ministry of Finance set up a one-stop shop to facilitate AIREF's access. Initially, however, the information was often incomplete, submitted late, or even denied. Hence, the Authority had to directly request information from subnational governments which responded diligently and in a timely manner. Information problems remain at the municipal level, reflecting mostly the challenges inherent to the sheer volume of data rather than a lack of cooperation. To address this problem, the AIREF developed indicators and screening tools to identify those municipalities with a more worrisome public finances situation. The upcoming challenge is how to perform an in-depth analysis for this higher number of smaller entities.

On macroeconomic and fiscal analysis, the AIREF rapidly emerged as a reference. Milestones include: quarterly GDP estimates for Autonomous Regions; forecasting models for regional GDP and employment, including information on regional economic

indicators; models for the main expenditure items managed by the Autonomous Regions, such as health-care and education; specific indicators to assess the feasibility and fairness of the individual regional targets; or the analysis of regional public debt by creating an observatory as well as an interactive platform accessible to the public and including debt projections for each region.

AIReF can also claim success in having established a smooth dialogue with sub national governments. This success has been supported by growing confidence in its analytical capacities and independence. Special studies requested from AIReF by regions and municipalities – under the advisory function envisioned by the law – are a telling example of such confidence. For instance, two regions have requested studies to be completed this year. Both are aimed at improving the management of the public sector (state owned enterprises and toll motorways respectively). At the national level, the AIReF was asked to conduct a comprehensive spending review that, in its first phase, will be devoted to grants and will also assess policies managed by subnational governments. Venturing that far in more advisory and normative tasks is rare for IFIs, and could be a life-changer. The challenge is to manage the coexistence in a single institution of positive and normative tasks, the former stemming from the objective and fact-based analyses of the spending reviews and similar studies, and the latter from the fiscal watchdog role common to all IFIs.

### **III Germany: the Stability Council and its Independent Advisory Board<sup>3</sup>**

Times look good in Germany: stable growth, substantial budget surpluses, falling debt-to-GDP ratio, and full compliance with European and national fiscal rules. However, fiscal policy and institutions are tested only in bad times. And it is not clear whether Germany's institutional setup will be able to weather a storm because the conduct of fiscal policy and its supervision within the context of European and national fiscal rules – including the independent fiscal council – is special. After briefly characterising the institutions underpinning fiscal surveillance, we identify strengths and weaknesses of Germany's fiscal council – the Stability Council and its Independent Advisory Board – to draw lessons for other federal countries.

3 This section was prepared by Eckhard Janeba.

## A. Institutional background

Germany is highly decentralised politically and economically. Three government layers consist of the federal level (*Bund*), 16 states (*Länder*), and about 11,000 municipalities (*Gemeinden*). On top of those comes an extensive social insurance system (health, pension, unemployment, long-term care) that alone accounts for 19% of GDP in government expenditure. The Constitution (Art. 109) puts fiscal policy in the hands of *Bund* and *Länder*, giving social insurances and municipalities a junior role. The *Bund* and the 16 *Länder* are autonomous, but share the main tax sources (income tax, value added tax; Art. 106) and the responsibility for obligations resulting from violations of European rules such as the Stability and Growth Pact.

### Debt brake and Stability Council

The federal and states' budgets are monitored by the Stability Council and constrained by a national fiscal rule: the debt brake. Both the debt brake and the Stability Council were introduced into the Constitution as part of the 2009 federalism reform (*Föderalismusreform II*).

The *Stability Council* consists of the two federal ministers of finance and the economy and the 16 state finance ministers. This setup reflects the importance of Germany's decentralised structure and, in particular, its *Länder*. The Stability Council performs some of the functions typically assigned to a fiscal council, as one of its obligations is to monitor the budgetary situation of the federal government and the 16 states in order to avoid budgetary emergencies. A budgetary emergency is identified on the basis of indicators such as the structural deficit and the debt-to-GDP ratio, among others. In an emergency, the Stability Council imposes a fiscal consolidation programme (*Sanierungsverfahren*) on the affected government, which has to report to the Council on its consolidation progress twice a year. The Stability Council is not independent from the executive, however, and it cannot be considered as an independent fiscal institution *per se*.

After seeing public debt rising stepwise as a fraction of GDP since the 1970s, the debt brake's (*Schuldenbremse*) intent is to curb the public debt trajectory through a balanced budget rule. From 2016 onwards, the federal government can run a maximum structural



deficit of 0.35% of GDP, while the *Länder* must avoid structural deficits from 2020 onwards. The federal government has complied with this rule since 2016. Most *Länder* are expected to comply with the structural balanced-budget requirement in 2020, not least because of very low interest rates and buoyant tax revenues over recent years. However, the two smallest states (Bremen and Saarland) currently have substantial structural deficits and are at risk of violating the rule.

### Fiscal Compact and Independent Advisory Board

In the aftermath of the economic and financial crisis, 25 European countries adopted the Fiscal Compact as part of the Treaty on Stability, Governance and Coordination in the EMU. After transposition of the requirements into national law, an independent institution monitors compliance with the rule that requires the general government structural-deficit target to not exceed 0.5% of GDP. To meet that obligation, the Independent Advisory Board to the Stability Council was created in 2013. In consultation with the Stability Council, it looks at the compliance with the structural-deficit rule. In doing so, it evaluates the economic forecasts provided by the federal government and the budgetary projections for all layers of government in the current year and the medium term. The Advisory Board has nine members, four of which are appointed by federal and state governments and five drawn from institutions such as the Council of Economic Experts, Joint Economic Forecast, and the Deutsche Bundesbank. The mandate of the Advisory Board is narrow, and its resources are limited (€150,000 plus travel expenses in 2018).

The architecture of German fiscal institutions is therefore quite special. Putting it bluntly: the Stability Council is a fiscal council but not independent, while the Advisory Board is independent, but not a fiscal council, at least not in the traditional sense. At the international level, however, it is the Advisory Board that represents the independent fiscal council of Germany (in agreement with the Stability Council). The European Commission recently confirmed Germany's successful implementation of the fiscal compact into national law.<sup>4</sup>

4 *European Commission*: Report from the Commission presented under Article 8 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, C(2017) 1201 final, Brussels, 22.2.2017,

## B. Assessment and Lessons

We now briefly evaluate the institutional setup described above, with special attention to the Advisory Board.

### Plethora of institutions and inefficient use of resources

Germany has many institutions involved in forecasting and policy evaluation: For example, the Joint Economic Forecast (JEF) produces economic and budgetary forecasts, the Council of Economic Experts (CEE) consults the federal government on economic policy, and the Working Party on Tax Revenue Estimates projects tax revenues. The Independent Advisory Board is yet another institution that contributes to a further diversion of competencies and capacities. Sometimes duplication of outputs occurs, such as separate GDP forecasts by JEF and CEE. While there is some value in an additional forecast, resources could be more efficiently spent with less duplication.

### Actual Strength of Advisory Board

Formal compliance with the Fiscal Compact says little about the actual work. With its narrow mandate and limited resources, the Advisory Board appears to be a weak tiger at first glance. Its assessments rely on inputs from those five institutions represented on the Board. While this has worked well so far, major disagreements among board members are a risk and input could be withheld for strategic reasons. The true strength of the Board will be tested only if the 0.5% deficit rule is in danger of being violated, something that currently seems remote.

### Mandate of the Advisory Board

The Advisory Board entered critical territory when it assessed each state's likelihood of compliance with the debt brake.<sup>5</sup> Under the debt brake, federal and state governments

5 Independent Advisory Board of the Stability Council: Second statement on compliance with the upper limit for the structural general government deficit pursuant to Section 51 (2) of the Budgetary Principles Act, 8 December 2014.

can run together a deficit of at most 0.35% of GDP, leaving 0.15% for social insurances and municipalities, to comply with the 0.5% of GDP deficit ceiling. Some of the state governments viewed state-level assessments of compliance with the debt brake as overstepping the Board's mandate and would have preferred it if only the aggregate deficit of the *Länder* were analysed by the Advisory Board. Hence, it is hardly surprising that the Stability Council, not the Advisory Board, has recently been assigned the task of monitoring the compliance with the German debt brake.

#### Information flows and reporting standards

Assessing compliance with fiscal rules is difficult for the Advisory Board (and the Stability Council), as budgetary processes and institutions of federal and state governments are not harmonised. For instance, some states run biannual budgets, while others have annual budgets. In some states, reports on pension liability funds are provided systematically, but not in others. Some have double bookkeeping accounting rules, others have simple fiscal accounting. Under the debt brake, states are free to apply any cyclical-adjustment method to determine the structural deficit, which has led to large differences.

## IV Lessons

Institution building is inherently path-dependent. Although the manifestations of potential coordination failures faced by highly decentralised countries are broadly similar – e.g. deficit bias when negative spillovers are not internalised and suboptimal macroeconomic stabilisation when positive spillovers and scale economies are ignored – historical preferences regarding centralised oversight are bound to influence the design of an institution mandated to monitor fiscal performance at the general government level.

In countries where federalism and decentralisation are in the national DNA, like Germany, the monitoring function is more naturally decentralised, putting any central

oversight initiative at risk of being weak.<sup>6</sup> This may explain why, with the Stability Council already in place, Germany pragmatically nested the Advisory Board into the Council instead of creating a new fiscal council comparable to those elsewhere in Europe.

The need to resolve the tension between subnational autonomy and joint (national and subnational levels) responsibility for fiscal outcomes (including compliance with nationwide fiscal rules) was also instrumental in the creation of fiscal councils in Belgium and Spain. In both cases, a history of relatively strong central control made it more natural to rely on a central body, either by empowering an existing advisory board in Belgium or creating a new entity with a broad mandate and a strong legal basis (organic law) in Spain.

Despite widely different institutional models, in tune with each country's history and customs, the fiscal councils in Belgium, Germany and Spain all faced the same challenge to productively engage with multiple fiscal players with often diverging interests. In all three cases, the council's credibility and effectiveness have rested on its ability to avoid the perception of tilting the delicate power balance between the national and subnational governments. In the end, fiscal councils in federations should, perhaps even more than elsewhere, have very clear mandates and full, guaranteed access to information from all level of governments.

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He started his career at the Banco de España, where he held various positions in the Research Department, and later in Europe, where he actively participated in the process of monetary integration, since 1993, as an adviser to the European Monetary Institute. With the start of the Monetary Union he became Head of the Monetary Policy Division of the European Central Bank in Frankfurt. Between 2012 and 2014 he was the Chief Representative for the Americas at the Basel-based Bank for International Settlements.

Between 2004 and 2012 he worked at the BBVA banking group, first as its global Chief-Economist and Director of the Research Department, and from 2010 as the Managing Director responsible for Global Public Finance.

He holds a degree in Economics from the Complutense University in Madrid, with honours and completed post-graduate studies in economic analysis at the same university and in econometrics at the Banco de España. During his career he has published numerous articles and research papers, primarily on financial and monetary matters.

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Having started his career in Germany ,where he obtained a Diploma degree (1990) and Ph.D. (1994) in Economics at the University of Bonn, Eckhard Janeba then moved to the US and worked as Assistant Professor of Economics at Indiana University in Bloomington (1994-1999) and as Assistant/Associate Professor (with tenure) of Economics and International Affairs at the University of Colorado in Boulder (1999-2004).

He has made important contributions to the theory of tax competition and fiscal federalism, and his recent work centers around the political economy of fiscal rules such as the German debt brake. His research has appeared in a broad range of academic outlets such as the *American Economic Review*, *European Economic Review*, *Journal of Public Economics*, *Journal of International Economics* and *Economic Journal*. From 2010-2013 he served as Co-editor for *International Tax and Public Finance*, and since 2011 he acts as Associate Editor for the *European Economic Review*.

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## 9 Fiscal surveillance in the EU: from maze to pyramid?

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**Ludovít Ódor**

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### **Introduction**

Successful fiscal frameworks ensure long-term sustainability of public finances, while allowing for economic stabilisation on a medium-term horizon. The Stability and Growth Pact (SGP) has failed on both fronts and it is very likely that it will fail again in the future, given its extreme complexity and politicised enforcement mechanisms. There are too many rules and procedures, blurred responsibilities between central institutions and Member States and too limited a role for financial markets. Quantity has won over quality. Opacity and overlaps in responsibility also complicate the delivery of clear messages to the public. This chapter argues that Europe should move towards a more decentralised and depoliticised fiscal framework based on the subsidiarity principle. Synergies between smart fiscal rules and independent fiscal institutions should be exploited both at the national and euro area level. Fiscal councils in the euro area should refuse plans for stronger central coordination and focus on mutually beneficial cooperation instead.

There is no better proof of the weak performance under the SGP than the euro area sovereign debt crisis. In good times, just before the crisis hit, the Pact did not motivate Member States to create sufficient fiscal space; in bad times, it was too restrictive to stabilise the economy. In the middle of the crisis, when market pressures heightened, the policy debate turned into austerity mode, and a plethora of fiscal rules and institutions were legislated. The mood changed only after the ECB promised to do ‘whatever it takes’ to save the euro. But again, the pendulum has swung too far.



We are now in a ‘who can introduce more flexibility?’ phase, ignoring positive output gaps in some Member States and sustainability risks lurking on the horizon in others. Moreover, financial sanctions are not credible in a politicised peer-pressure game. The fact that France could go on for a decade with deficits over the 3% limit is a clear illustration of the latter.

This chapter discusses the main deficiencies of the current euro area fiscal surveillance framework and the potential role of independent fiscal institutions in it. The main messages are the following:

- Weak performance and complexity of the current fiscal framework is a direct consequence of the incomplete institutional set-up of the euro area. The two problems are tightly connected and cannot be solved separately.
- When completing the “partially finished house”,<sup>1</sup> realism should win over romanticism: policymakers should focus on the necessary building blocks compatible with current political preferences rather than chasing unrealistic dreams.<sup>2</sup>
- Europe should move towards a more decentralised and depoliticised fiscal surveillance framework based on the subsidiarity principle. Synergies between smart fiscal rules and independent fiscal institutions should be exploited both at the national and euro area level. The European Fiscal Board (EFB) needs a significant reform to become a ‘real’ fiscal council.
- While the surveillance of national fiscal policies would benefit from decentralisation, a central mechanism seems necessary for aggregate stabilisation and risk-sharing purposes. Attempts at coordinating national fiscal stances through the European Semester are doomed to failure and the idea of using future monetary income to reduce current public debts might lead to a dangerous precedent.
- Independent fiscal institutions in the euro area should refuse plans for stronger central coordination and focus on mutually beneficial cooperation instead. The functioning of independent central banks inside the ESCB should not be a role model for them.

1 Five Presidents’ Report. Juncker *et al.* (2015).

2 As Baldwin and Giavazzi (2016) state, the Five Presidents’ report is “unrealistically ambitious in the long run... At the same time, it is insufficiently ambitious in the short run.”

## **“Undecipherable even for insiders”**

It is easy to joke about the extreme complexity of the current European fiscal framework, which can only be meaningfully described using more than 100 pages (European Commission 2017). Jean Pisani-Ferry (2016) states that “The piling up of fiscal, economic, and financial surveillance procedures has made the system of policy rules undecipherable even for insiders”. Ódor (2014) evaluated the new European fiscal framework (including the ‘six-pack’, ‘two-pack’ and the fiscal compact) based on the well-known Kopits-Symansky criteria and found that it scores low on simplicity, consistency, definition and enforceability. Especially problematic are the inconsistencies between various fiscal rules, between the fiscal compact and the preventive arm of the SGP<sup>3</sup> and the resulting noise in communication (European Commission versus local fiscal councils). Finance ministries can always choose the more favourable evaluation and thus decrease the credibility of the whole framework.

In other words, the current European fiscal framework does not look like someone designed it on purpose. It is more a collection of gradual amendments<sup>4</sup> and partial equilibrium thinking than a carefully designed system.

## **Fault lines**

It is important to note that complexity and noise are just symptoms and one should dig much deeper to find the root causes and recommend remedies. There are several important fault lines which make the framework vulnerable to future crises: i) there is a fundamental contradiction between bailouts and national fiscal sovereignty inside a monetary union, ii) the division of labour between Brussels and Member States is blurred, iii) the fiscal framework is too flexible; despite several hundred pages of rules, the decisions of the Commission/Council are extremely hard to predict, iv) crisis management tools have not been fully implemented yet and v) the decision-making process is slow, as was illustrated by the ‘too little too late’ behaviour during the crisis.

3 The fiscal compact is based on the idea of decentralisation, whilst strengthening the preventive arm of the SGP is a step towards more centralisation.

4 Each individual marginal change may have appeared sensible given the legislative and political constraints but overall they now add up to an incoherent whole.

Without tackling these fundamental deficiencies, adding more elements to the current fiscal framework will not take us very far. Quantity will not solve the problem of quality. One should first repair the basic institutional set-up of the euro area.

## Necessary building blocks

While a fully-fledged fiscal union/federation (United States of Europe) could go a long way towards solving most of the problems, the current political environment is far from conducive to this. A realistic step-by-step roadmap should focus on completing the necessary building blocks. What are these?

Baldwin and Giavazzi (2016) provide an excellent description of the emerging consensus among economists concerning the necessary steps to save the euro. Table 1 illustrates my ‘to do list’, considering the political constraint that there is no appetite for *significantly* ‘more Europe’. However, it should be noted that sharing more sovereignty and more risks is necessary to save the common currency. In other words, Treaty changes seem unavoidable down the road.

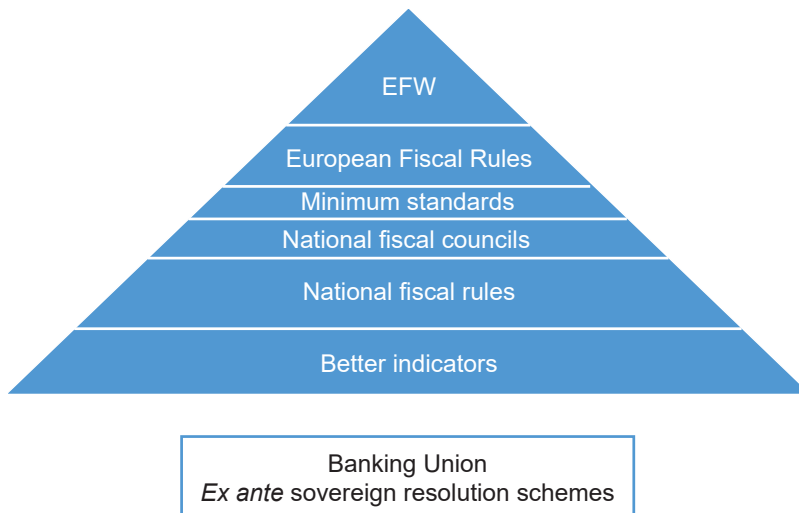
**Table 1.** Making the euro area more resilient: minimum requirements

Area	Missing elements
No bail-out	<i>Ex ante</i> sovereign resolution schemes
Banking union	Common deposit insurance
	Fiscal backstop
	Reducing the home bias
Capital market union	Reducing the degree of bank financing
Risk sharing	Stronger central budget (few % of GDP)
	Aggregate risk sharing and demand management tool
	Safe asset (centrally issued or synthetic combination of existing debt)
Monetary policy	No OMT in the long run in its current form, liquidity support only, no or limited role for individual MS bonds
Fiscal policy	Decentralised and depoliticised framework
Structural policy	Decentralised decisions

## From maze to pyramid?

Consistent with the above discussed minimum elements, Ódor and P. Kiss (2017) propose a decentralised and depoliticised fiscal framework for Europe, along the lines of Wren-Lewis (2003). The first line of defence against irresponsible fiscal policy behaviour should be at the local level, using home-grown fiscal rules and independent fiscal institutions.

**Figure 1.** Proposal for a new European fiscal framework



The community level in the proposal is represented not only by the European Commission (EC), but also by an independent fiscal watchdog for the euro area (EFW) and minimum standards defined for national fiscal frameworks.

## Separation of accountabilities

The problem of deficit bias in currency unions arises both at the local level and the level of the whole area (Krogstrup and Wyplosz 2010). One obvious approach would be to build a hierarchical system of responsibilities based on the subsidiarity principle<sup>5</sup>.

<sup>5</sup> The Oxford English Dictionary defines subsidiarity as, "the principle that a central authority should have a subsidiary function, performing only those tasks which cannot be performed at a more local level."

When there is no sign of free-riding behaviour from member countries (with potential contagion effects), the national level should be responsible for fighting against the local deficit bias. In that case, a country-specific, tailor-made solution should be designed (also more in line with theory and based on better fiscal indicators) including a stronger role for national fiscal councils. Fiscal watchdogs should boost transparency and thus bolster accountability of policymakers.

Area-level rules and institutions should primarily focus on problems concerning common interest. High on this list is possible contagion, free-riding behaviour or, for example, counter-cyclical aggregate fiscal policy and risk sharing. In the case of a fully credible no bail-out clause, *centrally-imposed* fiscal rules on Member States are not even necessary. If the euro area is successful in putting in place clear rules for burden sharing, banking union, and sovereign debt restructuring with a strong backstop mechanism, then the current trend of legislating more and more complex fiscal rules can be reversed.

In that case, one or two simple European fiscal rules would arguably suffice. These rules should not target yearly balances in national budgets. But instead, they should represent a borderline at which national fiscal policy becomes a common concern. One can imagine various possibilities suitable for this purpose (deficit or debt levels, sustainability indicators, etc.). My preference would be a fiscal rule based on sovereign risk premia (to incorporate financial markets into the fiscal framework)<sup>6</sup>. The rule would be expressed as a maximum value tolerated by the community (one common threshold). Countries operating below the threshold would be free to conduct their fiscal policy if they respect minimum benchmarks (the universal 3% deficit limit can be abolished). However, after breaching the limit, oversight from the centre should step in. The sovereignty principle should be significantly reduced when exceeding the agreed limits (i.e. Council's veto power over national budgets or centrally designed deficit targets with a potential involvement of the EFW).

6 Hatchondo *et al.* (2012) argue that in diverse monetary unions, spread limits may be preferable over debt limits.

## Coordination or central risk sharing?

While the potential free-riding problem can be mitigated by *ex ante* sovereign resolution schemes and/or reduced sovereignty, the problem of aggregate pro-cyclicality is harder to solve. Wyplosz (2017) argues that if one eliminates the legacy debt problem, counter-cyclical fiscal policy at the national level, together with ECB monetary policy, would be sufficient for stabilisation purposes. But the elimination of legacy debts to create fiscal space for counter-cyclical policy can have dangerous side effects. If jointly-backed Eurobonds are used, severe moral hazard could be the result. Similarly, if future monetary income is brought forward instead (as in Paris and Wyplosz 2014), there would be temptations to use this instrument also in the future. Eliminating these negative side-effects might become impossible in practice.

Others see greater fiscal coordination via the European Semester as the ultimate solution. Coordination of fiscal policies, while keeping the fiscal sovereignty of Member States is a hopeless exercise, in my view. Forcing any country to spend more (or less) is impossible if national parliaments have the final word. Moreover, there are a myriad of technical questions related to the issue of ‘distributing’ the euro area-desirable fiscal stance.

Therefore, in my view, the best option would be to turn to the subsidiarity principle once again and assign central tools to the common problem. In other words, instead of coordinating national fiscal stances, it would be much better to build a central counter-cyclical and risk sharing capacity. In exceptionally bad times or when monetary policy is constrained by the ZLB, the euro area (ESM) should have the possibility to borrow against central revenues and to spend more. In good times, the reverse would be true. Allard *et al.* (2013) suggested that a budget of a few percentage points of GDP would be able to smooth a significant part of shocks.

## The role of fiscal councils

To avoid duplication and blurred responsibilities, the relationships between the EC, the EFW and local fiscal councils should be clarified. I use the acronym EFW deliberately

to highlight that the EFB needs a substantial upgrade to become a standard fiscal council (measured by the OECD Principles).<sup>7</sup>

Since the EFW would function in this set-up as an independent analytical body only (at least at the beginning), major decision-making processes would remain in the hands of the EC/Council. However, there would be no role for the EC with regards to those Member States operating without gross policy errors. When breaches of the pre-agreed limits are identified by the EFW, the EC should step in and issue recommendations. If these are not followed in the draft budget, *ex ante* veto power would be exercised (based on a recommendation from the EFW). The EFW could be also part of the ‘Troika’ to evaluate debt sustainability to distinguish between problems of solvency and liquidity.

There are important arguments why cooperation between the EFW and local fiscal councils would be beneficial for all parties involved. On the one hand, the EFW might use the outputs of a local IFI when gauging individual country circumstances and measures. This way it is possible to abandon one-size-fits-all methodologies and to focus on best possible estimates/methodologies instead. It would be better to use discretion in estimation than in the interpretation of fiscal rules (as is the case now). There are at least three important areas where local IFIs can have a *significant* comparative advantage: calculation of structural budget balances, costing discretionary measures and identifying *ex ante* risks in draft budgets (especially on the expenditure side, including creative accounting techniques).

## **ESCB: a role model for fiscal councils in Europe?**

Local fiscal councils might also benefit from the presence of a euro area fiscal watchdog. Via evaluating minimum standards, the EFW would be a guardian of their independence. Moreover, by collecting international best practices and research outputs, cooperation with the EFW might also increase the quality of outputs of local IFIs.

However, it should be noted that it is of utmost importance that the independence of all councils involved be respected. Local fiscal councils should not be viewed as ‘branches’ of the EFW, but rather home-grown, local institutions responsible for monitoring local fiscal rules.

<sup>7</sup> See also Azatryan and Heinemann in this volume.

I would not recommend the ESCB model for fiscal councils for several reasons. First, it is in contradiction of the subsidiarity principle. Second, there is no central decision-making process in the hands of a European fiscal council, as in the case of the ECB. Third, every country has a unique political and institutional set-up for fiscal policy. No similar convergence seems possible, as in the case of a flexible inflation targeting regime in monetary policy.

## Conclusions

The European fiscal framework has failed. Despite many amendments, institutional changes and creative interpretation of rules, the system is still vulnerable and not fully effective. In part, this is because of the unfinished institutional structure of the euro area; especially the fundamental conflict between bailouts and fiscal sovereignty of Member States. As Eichengreen and Wyplosz (2016) state: “Europe needs both more political integration and less political integration. The trick is to understand when less is more.” As this chapter argues, national fiscal policy surveillance in the euro area is one of those areas where less centralisation might be the right way to proceed. On the other hand, for aggregate stabilisation purposes the euro area needs a central solution. However, separation of accountabilities based on the subsidiarity principle is just part of the answer. Europe also needs less politicisation in the enforcement of fiscal rules. This can be achieved only via strengthened involvement and cooperation of independent fiscal institutions.

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## About the author

Ludovit Ódor is a member of the Council for Budget Responsibility in Slovakia. In the past, he has served as a member of the Bank Board and Executive Director responsible for research at the National Bank of Slovakia, as an advisor to the Prime Minister, and as a Chief Economist at the Ministry of Finance of the Slovak Republic. He has been deeply involved in policymaking (both monetary and fiscal) in Slovakia and is a co-author of several structural and institutional reforms. Among them the most important are: euro adoption strategy, introduction of a flat tax, reconstruction of the pension system, public finance management reform, value for money initiative and the design and implementation of the Constitutional Act on Fiscal Responsibility. Ódor is a Visiting Professor at the Central European University and a former Vice Chair of the Network of EU Independent Fiscal Institutions.



### III Lessons from experience



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# 10 The UK Office of Budget Responsibility: Mission accomplished?A perspective from a former practitioner

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## Kevin Page

University of Ottawa, Former Parliamentary Budget Officer of Canada

The UK Office for Budget Responsibility was created in 2010 “to address past weaknesses in the credibility of economic and fiscal forecasting and, consequently, fiscal policy” (HM Treasury, 2014 Charter for Budget Responsibility). After seven years of operation, it is a fair question to ask: has the mission been accomplished?

### Measuring success

As a former Parliamentary Budget Officer in Canada, I appreciate that there are different perspectives on success when it comes to the work of an independent fiscal institution (IFI). However the success of an IFI is defined, it should include two core components: 1) fulfilment of its mandate; and 2) institutional sustainability through credibility.

All IFIs are judged on their ability to deliver on their *mandate requirements*. Whether defined in legislation, or elsewhere, an IFI is accountable for the timely delivery of analysis of the economic and fiscal health of a country as well as the government’s assumptions on these matters. The IFI reports its findings to stakeholders through products such as economic and fiscal forecasts, fiscal sustainability analysis, and costings, among others. Fulfilling a mandate is a basic requirement for success, but alone it is insufficient. A truly successful office is one that not only survives, but thrives.

As one of my former bosses said, “fiscal credibility, like trust, is difficult to earn, easy to lose, and once lost, almost impossible to regain.” Achieving institutional sustainability comes from the *fiscal credibility* of products and communications. We want governments, legislatures, media and citizens to be informed by the analysis in a way that promotes debate and scrutiny. Building strong institutions that practice continuous improvement, protect independence, and engender confidence and trust, all helps to lay foundations for *institutional sustainability*. Fiscal credibility and institutional sustainability represent a higher level of success than fulfilling a mandate, and one that’s more difficult to achieve.

IFIs do not hold all the cards to improve fiscal performance. Reducing forecast bias (something that is within the control of an IFI when it produces the forecast) is not the same as reducing deficit bias (under the purview of government). An IFI releasing comprehensive analysis on forecast errors, sustainability, and fiscal risks promotes information symmetry and transparency but may not result in better decision making and/or enhanced legislative fiscal scrutiny. The genesis and operation of IFIs are not without challenges. Governments have wielded political power to diminish roles of IFIs (e.g. Hungary), as well as to strengthen them (e.g. recent legislation in Canada enhances the independence of the Parliamentary Budget Office). To draw from the serenity prayer, successful IFIs should have the courage to change the things they can (within their mandate), and the serenity to accept the things they cannot change, with the wisdom to pursue fiscal credibility for institutional sustainability.

## **Establishing the OBR**

The OBR, like many other IFIs, grew out of the throes of the 2008 financial crisis. Over a two-year period, it effectively evolved from the proposal of an opposition party, to interim arrangements, to a statutory non-department public body with dedicated staff and a multi-year budget. The capacity to turn crisis into opportunity is a defining characteristic of a number of institutions that have stood the test of time.

The legislative foundations of the OBR are found in the *Budget Responsibility and National Audit Act* (2011) and subsequent *Charters for Budget Responsibility*. Formal responsibilities of the OBR rest with a three-person ‘Budget Responsibility Committee’.

Members of the committee are appointed by the Chancellor of the Exchequer, with veto power resting with the House of Commons Treasury Select Committee. Accountable to both the executive and the legislature, the OBR is moderately resourced by international standards with approximately 20 staff and a budget of £2 million GBP.

Beyond its overarching responsibility to examine and report on the sustainability of public finances, there are five specific responsibilities of the OBR that arise from the Act and Charter:

1. The production of economic and fiscal forecasts and reports as to whether the government is on course to hit its fiscal targets;
2. An assessment of the accuracy of its previous fiscal and economic forecasts;
3. An assessment of the long-term sustainability of public finances;
4. Scrutiny of the Treasury's costings of budget, tax, and spending measures; and
5. Analysis of the main risks to public finances as well as welfare spending trends.

The basic components of the OBR mandate, in letter and spirit, have not fundamentally changed since the 2011 Act. The responsibilities related to reports on fiscal risks and welfare spending represent a recent modest expansion of mandate and a signal of confidence in the OBR.

One of the exemplary features of the Act is the requirement for an external review every five years to examine the content and quality of OBR reports. I led the first external review of the office in 2014. A review focused on fiscal credibility by HM Treasury followed in 2015, and was led by Sir David Ramsden. In this chapter, I apply the two-part test for success to the findings of these reviews and to further developments of the office.



## Measuring success

### Mandate

The 2014 University of Ottawa review lays out the case that OBR products and communications have delivered fully on the requirements of the mandate. Mission accomplished.

The 2014 review assessed the content and quality of OBR products against international peer jurisdictions. In all cases, the OBR reports met or exceeded reference points on analysis, methodology and disclosure. Take for instance its Forecast Evaluation Report (published annually) that examines the OBR forecasts against outturn data, highlighting lessons for future forecasts; as well as the significant transparency gains against HM Treasury reports recorded in the 2014 review, that have since continued. The OBR's commitment to transparency is likely the gold standard in the IFI community.

### OBR and its peers

When compared to peer IFIs and to the Organization for Economic Co-operation and Development's (OECD) Principles for Independent Fiscal Institutions, the OBR is considered to have strong legislative foundations, to be moderately resourced, and to have strong provisions for access to information. A stakeholder survey in the 2014 review suggested that stakeholders believed the OBR leadership and office to be politically independent. The uniqueness of the OBR legislation and operating framework with respect to its dual accountabilities to the executive and legislature and the certification of policy costing (with limited staff) was viewed as both a risk to independence and a strength that encouraged the leveraging of resources from other departments. The challenge to date has been ably managed, with leadership mindful of the need for independence and transparency.

### Fiscal credibility and institutional sustainability

The 2015 HM Treasury review defined credibility with respect to fiscal policy as *"people believe the government will do what it says."* Clark (2011), a former Deputy Minister of Finance in Canada, has laid out four critical factors for fiscal credibility:

1) realism - a balanced view of economic and fiscal prospects; 2) responsibility – establishing and maintaining a sustainable medium- and longer-term fiscal framework; 3) prudence – reasonable insurance against forecast error and the impact of unforeseen events; 4) transparency – full disclosure of analysis and information. The OBR covers all components of the Clark (2011) frame for fiscal credibility through its analysis and transparent reporting practices on its assumptions and errors. The quality of its analysis and the confidence of its stakeholders in its work reaffirm it .

Beetsma and Debrun (2016) have made the case that two pre-conditions underpin the effectiveness of an IFI: 1) its ability to address sources of deficit bias (e.g. through forecast bias); and 2) signal enhancement capacity. The signal enhancement of an IFI is strengthened by independence, engagement with budget makers, accessible communications and transparency. The OBR has a unique mandate which requires it to provide the economic and fiscal planning framework for the government, an assessment of fiscal sustainability, and fiscal risks to the legislature. While they make no comment on fiscal targets, the merits of policy measures or policy options, the OBR is the primary signal on fiscal policy credibility. Paired with its exceptional reporting practices, it can be argued that the OBR does as much as its mandate permits to address sources of deficit bias.

The OBR's signal enhancement capacity is strong, with independence protected in legislation, and with the characteristics of independence defined in its Charter (2016). Deeply integrated in the budget process, the OBR is interdependent with government agencies for some 125 full-time employees in the provision of forecasts, and the analysis, and certification of policy costings. The high levels of stakeholder confidence recorded in the 2014 review, are largely tied to the OBR's leadership, methodological approaches, and transparency.

The institutional sustainability of an organisation rests on its ability for continuous improvement as it navigates the realities of its context. There are several moments at the genesis and throughout the life of an institution that define it. The OBR has had a number of such moments in its seven-year history.

### Evidence of effectiveness

In November 2011 and March 2016, the OBR made clear that the government was not on track to meet its fiscal targets. In both cases the government responded with measures to put fiscal policy on course. 'Signals' were followed up with government actions.

In line with the 2015 HM Treasury review definition of fiscal credibility, citizens were given reason to believe “*the government will do what it says.*” In 2013, the OBR provided the analysis to support politically contentious debate regarding the impact of fiscal consolidation on the economic and fiscal outlook. This moment highlighted the role played by effective IFIs through effective communications and independent analysis that promotes transparency. The OBR’s analytic contributions to significant national debates on the Scottish Referendum and the Brexit vote are also important, although such work does not come without contention.

## Conclusion

As the number of IFIs around the world continues to grow, their success through credibility and sustainability matters. The OBR deserves to be considered a leader among IFIs for the transparency of its work and the credibility it derives. Has OBR accomplished its mission with respect to the requirements of its legislative mandate? Yes. Has OBR accomplished the IFI mission to promote fiscal credibility? Yes. Has OBR, in its seven-year history, laid the foundations for institutional sustainability? Yes. As the OBR demonstrates, institutional success is a constant work in progress. Existing and new institutions would do well in looking to the OBR’s practices as a benchmark for how to strive for success. There are three key takeaways for IFIs from the OBR experience:

1. Pursue excellence in fulfilling your mandate by delivering timely, and credible fiscal analysis;
2. Improve transparency and accessibility through your reporting practices;
3. Promote institutional sustainability through leadership and stakeholder engagement.

Contextual factors inevitably enable or constrain the progress of IFIs. The factors can however, be mediated by IFIs through focusing on their mandate, transparency, and their people.

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# 11 Children of the crisis: Fiscal councils in Portugal, Spain and Ireland

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**Michal Horvath**

University of York

*The adverse public finance implications of the global crisis spurred a wave of institutional reform in budgetary policy in the European Union. The Irish, Portuguese and Spanish independent fiscal watchdogs were created in circumstances in which the commitment of the national authorities to ensuring sustainability in public finances needed a dose of credibility. In this chapter, I study the strengths and the challenges of these ‘children of the crisis’. Instances of exemplary compliance with the international institutional benchmarks defined in the OECD (2014) principles are highlighted. I argue that improved communication and better access to information, including from the EU level, could enhance the effectiveness of the watchdogs in performing their oversight function. Staff recruitment and retention is not without problems either. Where applicable, the mandates could be independently reviewed to reflect changing fiscal challenges.*

The financial crisis left the Irish, Portuguese and Spanish public debt at substantially elevated levels. Whilst the reasons behind the dire public finance situation were country-specific, the need for authorities to project a credible path towards significantly lower debt levels eventually was common.

The solution in all three cases was seen in a combination of more medium-term orientation in budgeting, backed up by numerical fiscal rules, and overseen by an independent monitoring body. The complementarity between these different elements is thought to result in a visible improvement in fiscal performance over the medium term (see Nerlich and Reuter 2013, for some evidence).

As a part of broader packages of institutional changes, the Irish Fiscal Advisory Council (IFAC), the Portuguese Public Finance Council (CFP) and the Spanish Independent Authority for Fiscal Responsibility (AIReF) were established between 2011 and 2013.

The rationale behind and the potential channels of influence of independent fiscal institutions (IFIs) are set out in greater detail in Calmfors and Wren-Lewis (2011), IMF (2013) and Beetsma and Debrun (2017) as well as in Part I of this e-Book.

This chapter studies the experience of the above-mentioned three watchdogs. It paints an overwhelmingly positive picture of the three institutions, whilst highlighting important challenges. This reflects the conclusions from the more systematic assessment of the potential for effective scrutiny of these institutions as evaluated comparatively across EU IFIs in Horvath (2017), formal external evaluations such as Jonung *et al.* (2015) as well as judgment based on publicly observable output and personal interaction with the institutions within the Network of EU IFIs.

## **The cornerstones of effectiveness**

The idea of introducing independent fiscal oversight at the national level enjoyed broad political support in all three countries. Commitments towards outside bodies clearly played a role in all cases, whether as a part of conditionality under programmes of official financial assistance or as a part of institutional reform at the European level. The need for reform was, however, recognised internally at the national level and enjoyed cross-party support (see OECD 2016 a,b,c). Hence, ownership, a key principle that should underpin any potentially effective independent monitoring body according to the OECD (2014), was fulfilled. Discussions about the exact nature of political skirmishes surrounding the establishment or early functioning in some of the cases should not devalue the importance of the consensus around the idea of the need for independent oversight. Understanding the preconditions for the emergence of this consensus is an interesting ongoing research agenda (see Beetsma *et al.* 2017, for an insightful political-economy inquiry).

All three bodies are clearly non-partisan, operating independently with their leadership appointed on the bases of merit and competence. The Portuguese council, whose

members are not exclusively Portuguese by nationality, is also a good example of embracing international expertise to the benefit of national public governance.

The core of the tasks of the IFIs, in line with EU legislation, is the evaluation of the fulfilment of numerical fiscal rules, and the endorsement of official macroeconomic and fiscal projections. The execution of this mandate to a high standard requires advanced analytical and specialist skills. In addition to full-time hiring, the IFAC as well as the AIReF have been recruiting their staff from other independent public bodies through secondments, particularly in the early stages of their existence. This is a neat way of addressing the commonly seen shortage of readily available experienced staff in the area of fiscal policy analysis for young institutions, which has wider benefits to the local community of experts.

In spite of broad similarity in mandates, the three councils operate with significantly different resources. The IFAC has to make ends meet with €800,000 and a staff of five, whilst the AIReF operates with a budget of €4.5 million and 35 staff members. The CFP lies in between with a budget of around €2.5 million and a staff of close to 20. Importantly, however, funding is adequately safeguarded in all three cases.

The mandate of the AIReF involves extensive coverage of subnational budgets and the social security administration, which explains a lot of the difference in size between AIReF and the rest. It is also a peculiarity of AIReF that it charges a fee for the scrutiny it does at various public institutions and also for specific tasks it is asked to carry out. While this introduces an element of uncertainty into its funding, it also establishes a transparent link between its tasks and resources. Conflict of interest like the one associated with private-sector rating agencies could be a cause for concern but has not been an issue in practice.

## **Early impact**

A key strength of the AIReF is derived from its extensive legal powers to issue recommendations in a wide range of areas to the different institutions of the public sector both at the national and subnational levels. The European Fiscal Compact envisages a comply-or-explain-type arrangement specifically in the context of medium-term convergence of the budget balance to an aggregate target.



AIReF's powers in this regard, however, extend into questions of fiscal transparency or budgetary targets at the regional level, for example. Although the legislation is vague with regards to the expected timing and the content of the responses by the relevant authorities, the practical application of the provisions *vis-à-vis* regional governments in the area of fiscal transparency has been encouraging, following steps by AIReF to increase the reputational costs of untimeliness or evasiveness. There were, however, cases when calls from AIReF for regional authorities to introduce preventive or corrective measures to deal with (risks of) deviations from fiscal targets were left without a response.

The CFP has contributed to transparency in public finances in Portugal by publishing a detailed list of one-off and temporary revenue and expenditure operations from early on. Diligent reporting of such operations adds a lot of useful knowledge about the true state of public finances relative to relying on headline indicators only. It also gives politicians the right incentives in both policy design and reporting. There is little guidance in law or non-legal text in this area, and the EU Commission publishes aggregate figures only, which leaves an IFI with an important gap to fill.

IFAC's advantage relative to its peers is the position it occupies in the debates about fiscal policy in Ireland. Its engagement with the specialist public, and presence in the reporting by the media is comparatively extensive. Data on online searches suggest the general public interest in the nation's budget seems to be waning as the memory of the crisis fades. Yet, the IFAC continues to appear in the media frequently. Publicity is important as the influence of fiscal watchdogs on budgetary policy is indirect and operates mainly through increasing transparency in the debates. Given that the leadership of the IFAC consists of part-time appointments, and they are assisted by only a small secretariat, good public relations are also a testimony to the commitment and coordination at IFAC. Its concentration on a relatively narrow set of issues concerning the Irish budget, the state of the macro-economy and compliance with fiscal rules appears to work well, although may well be a virtue out of necessity. Weak response to reports or lack thereof from governments and lack of interest from legislatures is a common experience of EU IFIs, and the IFAC stands out as one of the better examples in this regard too. This is due to the relatively clear legislation in place that guides such interactions.

## Challenges

Timely and adequate access to data and qualitative information is a significant limitation on the effectiveness of the scrutiny IFIs carry out in many countries. The three examined institutions are no exception. Getting detailed information about the costing of measures proposed and implemented by national governments is a general problem. The work of at least two of the institutions examined is, however, rather adversely affected by the nature of information flows between the EU and the national level too. In Ireland as well as Portugal, the national numerical fiscal rules are the rules defined at the EU level, and so the task of the IFIs is *de facto* to mimic the evaluation conducted by the EU Commission. Numerical as well as qualitative input into the analysis from the EU level, however, often arrives incomplete and with a significant delay. The IFIs concerned would need timely and complete information on the latest Commission assumptions underlying its estimate of the cyclical position of their economies, its assessment of the outlook for potential growth, transparency in what it considers discretionary revenue measures and one-off/temporary budgetary items, and more clarity in (an increasing number of) areas where qualitative judgment is applied in Commission evaluations. The absence of such information may lead to a cacophony of policy messages, and, in one important instance, ultimately led to the questioning of the authority of the IFI by the executive (Jankovics and Sherwood 2017).

The IFIs also face notable human resource challenges. Succession planning at the top is obviously of paramount importance but there are also aching day-to-day problems. There is undue ministerial control over hiring at the AIREF and the IFAC. According to OECD (2016a, c), hiring at IFAC is subject to “prior consent of the Minister following consultation with the Minister for Public Expenditure and Reform”, whilst the Spanish Ministry of Finance and Public Administrations retains control over the number and type of positions as well as overall staff costs at AIREF. More flexibility in recruitment and remuneration would, among other things, be desirable in order for the institutions to be able to hire professionals with rare skills. As regards staff already in house, given the lean nature of the IFIs, there is not much in terms of career progression the institutions can offer to motivate their usually young and ambitious staff. Diversity in tasks can go a long way to complement monetary incentives (often limited within the public sector). This may include work of an academic nature, as recommended also in Jonung *et al.* (2015), which would raise the profile of both the individual and the institution.

## Looking ahead

Periodic reviews of the mandate of watchdogs could establish if changes are needed, since the main challenges that the public budgets face may also be changing as the economies gradually emerge from the post-crisis period.

In the case of the IFAC, for example, recognising more explicitly the importance of studying the long-term challenges for fiscal solvency in the watchdog's mandate would bring the institution closer to the industry best practice. The lack of information about individual policy measures could be addressed by developing capacities for such costing exercises within the three IFIs. Whenever a change in the (practical interpretation of the) mandate is considered, it is important to consider the adequacy of resources for such an enlarged role.

Enhancing the effectiveness of communication should be high on the agenda as it is a key precondition of impact for bodies without significant decision making powers. The IFIs should devote adequate resources and attention to making their communication more professional and tailored to the relevant audiences. In all three cases studied here, the target audience involves the broad public, and this should be borne in mind when presenting publications.

## The broader EU context: The orphans of the crisis

The positive experiences of the CFP, AIREF and IFAC should be studied in the broader context of institution building in EU member states. All EU member states, except Poland and the Czech Republic, now have an independent body appointed to monitor public finance developments. All countries nominally satisfy the requirement of legal transposition of EU law and the Fiscal Compact (European Commission 2017). The practical implementation at times, however, falls well short of the spirit of the legislation. As documented in Horvath (2017), all EU IFIs score well on legally granted independence and competence of their leadership. This is, however, where convergence to best practice ends.

There are IFIs across the EU whose potential effectiveness is severely constrained by lack of staff, finances, access to information or engagement by other authorities.

The cases of the Cypriot, German, Estonian, Finnish, Latvian, Luxembourg and Maltese IFI – to name a few from the euro area – would deserve a closer scrutiny. Whilst being cautious when drawing strong inferences from a small sample, one common theme in all cases seems to be that the bodies are seen as somewhat alien elements in the national institutional framework.

The cases of Portugal, Spain and Ireland, however, demonstrate that it is possible for local ownership of good governance to emerge, even if commitments towards external bodies play an important role in triggering institutional reform, given the right set of circumstances in the local political economy. This is not to argue that we have to wait for (a return of the) conditions of severe public finance strain to provide an impetus for further reform where it is needed. One way ahead from where we are would be to build on the existing legal basis, and make sure, through peer support or pressure from the EU level, that the basic pre-conditions for effective scrutiny by these bodies are in place. The reinforced institutions could then be left to build reputation locally, and jostle their way within the national institutional architecture by displaying concrete outcomes. The first shoots of such organic growth emboldened by peer support can be seen in Lithuania. Otherwise, in the absence of a stronger follow-up from peers or the EU level, these institutions may well be left – as orphans often are - unwanted by their adoptive families of national institutions, and seemingly not cared for by anybody else.

## Summary

Portugal, Spain and Ireland took what many see as a significant step on the road to better fiscal performance when they decided to establish independent fiscal monitoring bodies whose setup complies with recommendations based on international best practice. Broad political consensus at the national level, instigated by the urgency to offer a credible way out from the post-crisis fiscal stress – largely absent in other countries – may have played a crucial role in these cases of positive institutional development. To build on their solid start and early impact, CFP, AIReF and IFAC should work on the effectiveness of their communication. At the same time, information flows should be improved both at the national level and from EU institutions. The adequacy of their mandates and their human resource needs could be independently reviewed over time.

Ensuring that capacities are commensurate to tasks through peer support or better enforcement of the legislation from the EU level could promote convergence among EU IFIs to the good practices displayed by these successful children of the crisis.

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# 12 Homegrown: The Swedish fiscal policy framework

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**Lars Jonung**

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*At present, Swedish public finances are among the strongest in Europe with a government debt-to-GDP ratio of around 35% and expected to fall in the near future. The Swedish fiscal framework, including the fiscal policy council, is one factor behind this successful performance. The Swedish fiscal policy framework has emerged through a long political and administrative process, following the deep economic crisis in the early 1990s. It has been driven almost exclusively by domestic developments. In international comparison, the Swedish framework now stands out as quite restrictive. Looking into the future, the fiscal framework appears well entrenched in the political system.*

The rise of the Swedish fiscal policy framework appears quite surprising in a historical perspective. In the 1970s and 1980s, Swedish fiscal policy was strongly inspired by a Keynesian approach. Optimism about the powers of discretionary fiscal policy in stabilising the economy was widespread. There was no fiscal framework in place binding the fiscal behaviour of the government. Today, this picture has changed profoundly. Swedish fiscal policy is strongly rule-based. The belief in discretionary measures as the main strategy of stabilisation policy has melted away.

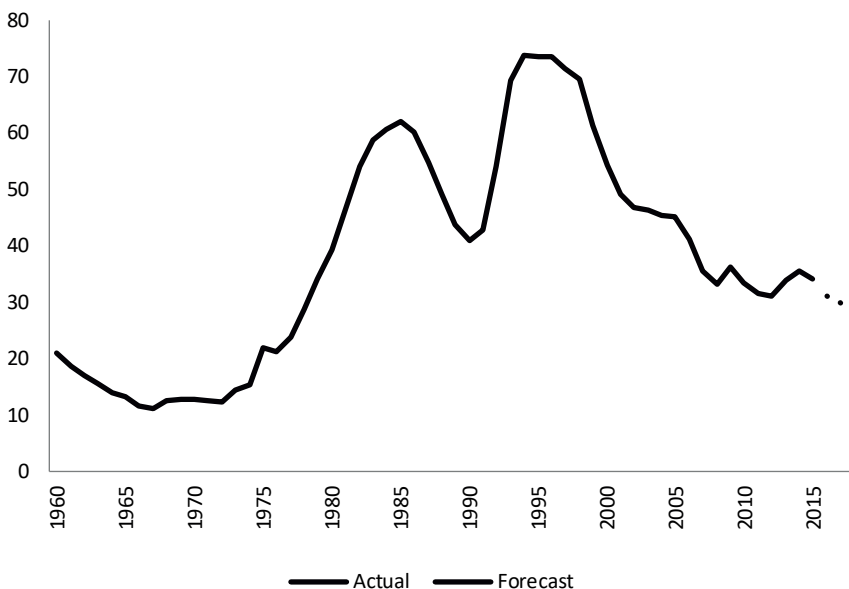
How should this complete turn-around in macroeconomic policy-thinking, as manifested in the rise of a new fiscal framework, be explained? The deep financial crisis that erupted in Sweden in the early 1990s holds the key. The crisis was accompanied

<sup>1</sup> I have benefitted from constructive comments by Fredrik N G Andersson, Anders Borg, Lars Calmfors, Harry Flam, Niklas Frank, Oskar Grevesmühl, Jens Henriksson, Christina Håkanson, Martin Larch, Ingvar Mattson, Per Molander, Joakim Sonnégård and Hans Tson Söderström.



by huge government budget deficits. The volume of public debt rose dramatically as shown in Figure 1. This sharp and unexpected deterioration in public finances inspired a thorough rethinking of the role of fiscal policy, eventually paving the way for a fiscal framework, including a fiscal policy council. The process has taken roughly a quarter of a century, driven almost solely by domestic forces.<sup>2</sup>

**Figure 1.** Government debt-to-GDP ratio in Sweden 1960-2018. Forecasts for 2017-18 (%)



## The emergence of the fiscal framework

A first step towards the present framework was a study published in 1992 by a research group close to the Ministry of Finance. The report, inspired by Jürgen von Hagen (1992), demonstrated that the Swedish budgetary system was weak compared to that of other European countries. One reason was that additional expenditures could be added in Parliament to the budget presented by the Government. In 1994, the report contributed to a parliamentary reform encompassing a top-down approach, where the Parliament first decided the total volume of expenditures and then their distribution across 27 expenditure areas, valid from the budget of 1997.

<sup>2</sup> The rise of the Swedish fiscal framework is described i. a. in Calmfors (2013) and Jonung (2015).

In 1997 an extended fiscal framework was introduced, including a central government *expenditure ceiling* – decided by the *Riksdag* (the Parliament) – to cover expenditures for the central government budget three years ahead, except interest payments on government debt, and expenditures for the old-age pension system. Initially the ceiling was a voluntary measure, only later was it made compulsory. The ceiling sets a cap in nominal terms. At the same time, open-ended appropriations were eliminated. In addition, a *surplus target* for general government net lending was adopted. Public finances were required to reach a surplus, initially set to 2% of GDP over the course of a business cycle for the whole public sector, later adjusted to 1% due to changes in the calculation of government net savings. In 1999, a *balanced budget requirement for local governments* was made law, valid from 2000. In 2010, the budget act, originally introduced in the mid-1990s, was amended and the use of the expenditure ceiling and the target for general government lending was made mandatory.

## The Fiscal Policy Council

A major building block of the fiscal framework was put in place in 2007 when a *fiscal policy council* was established. The idea of a fiscal policy council stems from a government commission report in 2002 on the role of fiscal policy were Sweden to adopt the euro.<sup>3</sup> However, the Social democratic government of that day expressed no interest. One objection was that such a council would give political power to unelected officials. Instead, it was the centre-right government that came to power after the election of 2006 that established a fiscal policy council in 2007. The minister of finance at that time, Anders Borg, was instrumental in this process. He became attracted to the idea of a fiscal council when he, as an economist at the Riksbank, was involved in the preparation of the statement made by the Riksbank on the above-mentioned commission report of 2002 on fiscal policy. In a paper published in 2003, he advocated the use of an independent group of experts to monitor fiscal policy.<sup>4</sup> The council initially met with critical reactions from the opposition parties, but later became accepted by all parties.

3 Charles Wyplosz (2002) prepared a contribution on fiscal policy councils to the commission.

4 Borg (2003).

The Swedish Council is an agency under the Ministry of Finance. Its budget is proposed by the Government and decided by parliament as a separate line in the annual national budget. The annual appropriation is about 10 million SEK, approximately €1 million. The Council has a small secretariat of five people, three of them being senior economists, thus a very small body by international comparison. However, it regularly commissions reports from outside experts to serve as inputs into the annual report of the Council. These reports are commonly presented at a yearly conference organised by the Council.

The Council has six members with fixed terms of appointment. They have a background in academia and/or have made careers as high level civil servants. They serve as members on a part-time basis, thus as a supplementary activity to their ordinary jobs or positions. Presently, the Council is in principle, as well as in practice, a self-perpetuating body. It proposes replacements for members who are leaving to the Government. So far, the Government has not refused any proposal for new members. The reputational cost of a rejection would likely be very high.

## **Remit of the Council**

The mandate of the Council is set out in a remit framed by the Government. The present one, from 2011 with minor modifications from the beginning of 2017, is short, about one page long, stating that the main task of the Council is *to review and evaluate the extent to which the fiscal and economic policy objectives proposed by the Government and decided by the Riksdag are being achieved, and thus to contribute to more transparency and clarity about the aims and effectiveness of economic policy*. In short, the Council examines whether the fiscal policy of the Government, as set out in the Spring Fiscal Policy Bill and the Budget Bill, is consistent with:

1. *long-term sustainable public finances, and*
2. *budgetary targets, particularly the surplus target and the expenditure ceiling.*

*The Council is also obliged to:*

1. *assess whether the fiscal stance is consistent with the cyclical position of the economy, and*

2. *evaluate the Government's forecasts of economic development and reports to the Riksdag on the public finances. This evaluation should comply with Article 4(6) of European Council Directive 2011/85/EU of 8 November 2011, in its original wording.*

*The Council is also tasked with reviewing and assessing whether fiscal policy is in line with healthy long-term sustainable growth and leads to long-term sustainable high employment, examining the clarity of the Spring Fiscal Policy Bill and the Budget Bill, particularly with respect to the stated basis for economic policy and the reasons for proposed measures, and analysing the effects of fiscal policy on the distribution of welfare in the short and long term.*

*The Council also works to stimulate more public debate on economic policy.*

This remit constitutes a broad mandate, in particular the request to examine the effects of economic policies on the distribution of income and wealth - a new task first given by the remit of 2011 as part of a compromise between the Government and the opposition on the tasks of the Council.

The basic task of the Council is to examine to what extent the policy measures proposed by the Government are consistent with the fiscal framework, most importantly with the rules concerning the surplus target and the expenditure ceiling. This assignment facilitates the Council's work by giving it a benchmark for its evaluation of the policies of the Government. The Council is free to express its opinion concerning any issues it deems of importance for fiscal sustainability, as well as concerning issues it finds to be neglected or ignored by the Government.

The main tool of the Council for communicating its message is its annual report published in the spring. Shortly after publication, the report is presented at a public hearing before the Committee on Finance of the Riksdag (*finansutskottet*) where the Minister of Finance responds as well. The report serves as an input for the Committee's evaluation of the economic policies of the Government. The Government replies in the Budget Bill to the report of the Council, usually in September of the same year.

## **The independence of the Council**

The Council is set up at arms-length from the Government with no informal contacts with the Government. It is not involved in policymaking consultations with the Government; nor does it provide the Ministry of Finance with any forecasts or recommendations except what is made public in the annual report of the Council and the reports prepared for the Council by outside experts. Practically all communication with the Government takes place in the public sphere.

By now, the Council has established a reputation of being independent. This independence is based on various mechanisms, formal as well as informal; some of which may not work or may not be as effective in other countries. The Council is made up of members who are independent of the Government, since they are recruited from academia or from end-of-career positions. An important pillar of the independence of the Council is the tradition of open debate in Sweden where the economics profession has a strong standing in public opinion.

## **The impact of the fiscal framework**

It is too early to make any firm assessment of the impact of the fiscal framework as it has only existed since the mid-1990s and has evolved over time. A cursory glance may suggest that the framework has been successful. Government debt-to-GDP has fallen from a peak of above 70% in the mid-1990s to a level around 35% today (Figure 1). However, causality does not run in a simple unidirectional way from the fiscal framework to a falling debt ratio. Rapid economic growth has been a major factor behind the fall in the ratio. The fiscal framework has rather evolved as part of a policy of fiscal prudence. It has been established to facilitate fiscal consolidation, by making it easier for the Government to argue for debt consolidation in good times. The fiscal framework should also be regarded as an attempt to create an institutionalised collective memory with the aim of keeping the experience of the large and persistent budget deficits of the early 1990s alive in the minds of present and future policymakers. So far, it has served this function well.

## The future of the Council

A parliamentary committee with representatives from the government and the opposition parties, with the official title of the Surplus Target Committee, recently reviewed the fiscal framework, in particular the role of the surplus target. It recommended some revisions of the fiscal framework which it viewed as minor.<sup>5</sup> Most importantly, it suggested that the surplus target for general government net lending should be retained, but the current target level of 1% should be reduced to 1/3% of GDP over the business cycle, to be applied from 2019 onwards. This change was proposed in the 2018 budget bill and approved by the *Riksdag*.

The fiscal framework was also to be supplemented at the same time by a *debt anchor*, viewed as a benchmark for general government consolidated gross debt (the Maastricht debt) of 35% of GDP. The workings of the surplus target will be reviewed every other electoral period. Furthermore, the committee proposed that new members of the Fiscal Council should be selected by a body where members of the Committee on Finance of the *Riksdag* participate. This proposal met with harsh criticism from the Council as well as from other referral bodies, viewing it as a potential threat to its independence. Instead, the government, in December 2017, decided that new members of the Council will be selected by a body of five where the majority consists of three heads of different government agencies. The remaining two seats will be filled by the chair and the deputy chair of the Committee on Finance of the *Riksdag*. The future will show to what extent this change will infringe upon the independence of the Council.

The recommendations of the committee were supported by parties from both the government and the opposition. Thus, the report can be taken as evidence of the strong standing of the fiscal framework in the Swedish political system. This bodes well for the future of the framework.

5 See SOU 2016:67.

## Conclusions

The fiscal experience of Sweden can serve as a source of inspiration for countries now searching for new ways to achieve stable government finances. Of course, the Swedish framework cannot be copied by other countries without paying attention to country-specific circumstances. Still, several lessons can be condensed from the Swedish experience.<sup>6</sup>

First of all, the fiscal framework including the Fiscal Policy Council has been created *within* Sweden's domestic political process. Thus, it has not been forced upon Sweden by outside pressure, as was the case in a number of EU member states recently. A fiscal framework created by domestic forces is likely to have a wider public acceptance and credibility and thus a stronger impact than one established 'from the outside'.

A second lesson is the importance of the mutual interaction between the fiscal framework and the fiscal policy council to ensure strong overall fiscal performance. The impact of the fiscal framework, that is the rules binding the fiscal authorities, benefits from having an independent fiscal council as a watchdog ready to bark when the rules of the framework are threatened. The task of the council is facilitated by having a fiscal framework as the benchmark for its analysis when evaluating fiscal policy. By referring to the framework, the council can more easily serve an important role in the public debate about fiscal policies as well as about other policies influencing the fiscal stance of the government budget. In addition, a fiscal policy council visible in the media strengthens the adherence to the fiscal rules and the credibility of the fiscal framework.

A third lesson is that the Swedish fiscal framework, including the Fiscal Policy Council, is evolving over time, adjusting to new circumstances. Such adaptability, while maintaining the basic structure of the framework, increases its chances of survival.

A fourth lesson from Sweden is that a fiscal framework, including a fiscal policy council, serves as a method for maintaining a collective memory of the dangers of fiscal overexpansion, supporting a long-run view of public finances. Serving this task, a fiscal framework fosters the workings of a democratic society.

6 A lengthier list of conclusions is found in Jonung (2015).

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# 13 Some myths about independent fiscal institutions

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**George Kopits**

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Initially, the emergence of independent fiscal institutions (IFIs), beginning in the closing decades of the 20<sup>th</sup> century in advanced economies, was attributable to country-specific circumstances. More recently, the proliferation of IFIs has gained momentum in the aftermath of the financial crisis. To be sure, the principal motive for establishing these institutions has become the prevention of future crises, including under the influence of (or pressure from) the IMF in the context of fiscal adjustment programmes. In the European Union, the adoption of an IFI by each EU member country is being promoted under EU Regulation 473/2013. Increasingly, it has been recognised that a well-designed IFI – in line with the OECD Principles for Independent Fiscal Institutions – can be an effective catalyst for good fiscal governance.

Now, as a result of the rising number and prominence of IFIs, there is considerable information available on their design and experience.<sup>1</sup> Yet, perhaps because of the large variety of types and models, there are prevailing myths about such institutions which need to be examined and dispelled. The purpose of this chapter is to help identify these myths, in light of the evidence accumulated so far. Most myths relate to the *raison d'être* of the institutions and their role in policymaking; others have to do with their composition and functions; and yet others involve unrealistic expectations about their effectiveness and success. Let us discuss them one by one, without any pretence of being exhaustive.

1 Updated information on IFIs, in the light of the OECD Principles, can be found in von Trapp *et al.* (2016) and the underlying OECD IFI database. See also Debrun *et al.* (2017) on an alternative dataset collected by the IMF.

1. *There is no need for a new institution to conduct independent monitoring of fiscal policy developments; such a role is already performed by the national audit office (or in some countries, by the central bank) endowed with sufficient autonomy and technical capacity.*

In principle, with an appropriate mandate and competent staffing, an independent central bank or national audit authority could perform the basic tasks of an IFI (assessing the budget bill, costing policy proposals, monitoring compliance with rules, estimating fiscal sustainability, preparing macro-fiscal forecasts, etc.). In practice, however, past attempts to outsource such tasks, for example, to the National Audit Office in the United Kingdom and the Central Bank in Peru have failed. The former was not equipped to do forward-looking monitoring, given its focus on backward-looking financial and legal surveillance. The latter was inhibited from making critical assessments of the budget bill, prompted by the fear of losing its own independence *vis-à-vis* the finance ministry. Both countries have since adopted IFIs.

The recent political debacle in Brazil illustrates a major drawback of *ex post* surveillance, as performed by the supreme audit authority, in contrast to the preventive monitoring by an IFI.<sup>2</sup> As a possible exception, in France, the IFI's monitoring role, exercised by the *Haut Conseil des Finances Publiques*, as a quasi-separate entity endowed with its own technical capacity for *ex ante* monitoring within the *Cour des Comptes*, seems to have met with success. So far, the *Conseil* has benefited from the well-established reputation of independence of the *Cour*, apparently without any internal conflict between preventive monitoring by the *Conseil* and conventional auditing by the *Cour*.

2. *The IFI interferes with fiscal policymaking, which should be the exclusive domain of elected government officials rather than technocrats.*

In the academic literature, a number of authors had recommended establishment of apolitical fiscal councils, to be charged with various roles in policymaking.<sup>3</sup>

2 The *Tribunal de Contas da Uniao* found the government in violation of fiscal rules, which led to the impeachment of former President Rousseff.

3 For a survey of this literature, see von Hagen (2013).

In a departure from this advice, existing IFIs are strictly monitoring entities, without any policymaking function. The closest to such a function is a policy advisory role in Ireland and Sweden, at risk of appearing to have a political preference when recommending an appropriate fiscal stance. In Sweden, the government rejected the Fiscal Policy Council's recommendation of a stronger expansionary stance than the government felt warranted, at the onset of the financial crisis.

*3. The IFI has no influence on policy, since its opinions can be ignored by the executive and the legislature, who do not modify a policy proposal to satisfy the views of the IFI<sup>4</sup>*

IFI assessments seldom lead to withdrawal or modification of a government policy proposal.<sup>5</sup> A recent example was the pivotal estimate from the US Congressional Budget Office (CBO) of the large number of citizens eligible for medical benefits who would be disenfranchised by a proposed reform of health-care legislation, which contributed to the failure of passage of the proposal. More generally, however, an established IFI exercises a subtle but effective influence in a pre-emptive manner, whereby finance ministry staff alert their superiors about the adverse reception that a proposal under consideration is likely to get from the IFI, and consequently, from the media and public opinion.<sup>6</sup>

Nonetheless, it is a fact that the government or the legislature can ignore the assessments of the IFI – which never have a binding character – because of short-run political expediency. In any event, the observation by Alice Rivlin (2013), the founding chair of the CBO, is highly pertinent: IFIs “can play an important role in ensuring realistic and well-informed debate based on honest numbers, focusing attention on the consequences of action (or inaction), and identifying more or less sustainable solutions to budget dilemmas. They cannot instil political courage to make unpopular decisions. Political leaders have to do that for themselves.”

4 I heard this view for the first time from the late Luigi Spaventa at a seminar I chaired in 2011 in Italy's Chamber of Deputies.

5 Arguably, IFIs with a costing role tend to have greater influence on policy proposals.

6 See for example Joyce (2011) on the US experience.

4. *The independence of IFIs from all other public institutions is guaranteed in a legally binding statute.*

Generally, the structure and mandate of an IFI are specified in various legislative statutes, but without necessarily conferring independence. In a number of countries, with proven autonomy, the IFI operates within the executive (Netherlands), the legislative (United States) or the judicial branch (France). Conversely, in some countries, the IFI's independence is explicitly limited: the head of the IFI has a qualified tenure (Canada), or the IFI is attached to the finance ministry (Chile, Peru, Slovenia).<sup>7</sup> In a few countries, where the IFI operates basically to satisfy an external requirement, it is independent on paper only (Hungary).<sup>8</sup>

In other words, *de jure* autonomy does not necessarily mean *de facto* autonomy.<sup>9</sup> Most IFIs gain effective independence over time through actual practice – speaking truth to power – with support of the media and the general public, by setting precedents that can be costly for the government to reverse in terms of reputational damage in the financial and political arena. But virtually all IFIs are fragile and open to challenge almost continuously by the government, through attempts to publicly discredit the institution or threats to reduce its funding.<sup>10</sup> In rare instances, the IFI may face an existential challenge.<sup>11</sup>

7 In Canada, initially, the Parliamentary Budget Officer served at the pleasure of the Prime Minister, who in principle could dismiss him at any time; however, according to a recent amendment, he can only be removed for cause. In Chile, President Bachelet replaced the fiscal council appointed by her predecessor, without cause.

8 In Hungary, the members of the present fiscal council (including *ex officio* the heads of the central bank and the state audit office) are close allies of the Prime Minister. The council issues perfunctory commentaries on the budget bill. While the council fails to meet most OECD Principles, it does conform nominally to the rather loose criteria under EU Regulation 473/2013.

9 In the Netherlands, the legal basis of the CPB has been strengthened only quite recently, while in practice it had already operated independently.

10 In Canada and Sweden, tensions between the government and the IFI over its assessments of fiscal measures escalated into threats to the IFI's budget, as documented by Calmfors (2013) and Page and Yalkin (2013), respectively.

11 In Venezuela, under the late President Chavez, and in Hungary, under Prime Minister Orban, the government replaced a well-functioning IFI with a trimmed Potemkin-type IFI. The abolition of Hungary's original IFI and its repercussions in financial markets are discussed by Kopits (2011) and Kopits and Romhanyi (2013).

5. *An IFI consisting of collective leadership, as a fiscal council, should be bipartisan, with a balanced representation of key interest groups and political parties.*

To serve as an effective instrument of surveillance, the IFI should refrain from evaluating policy proposals by averaging the views of representatives of various interest groups from across the political spectrum. In this respect, in the corporatist model followed by Austria, Belgium, and Germany, the IFI essentially operates under a collective leadership composed of appointees by political parties and regional governments, besides academics.<sup>12</sup> Contrary to this view, in order to gain credibility, the IFI should be nonpartisan (instead of bipartisan), comprised of independent professionals who express expert opinion, purely on the basis of evidence-based analysis.

6. *The IFI should be supported by a lean technical support staff and limited resources.*

The more far-reaching the mandate of the IFI, the weaker the public financial management, and the deeper the opacity of public finances, the greater is the need for a large professional support staff. IFIs entrusted either with costing the government's budget bill and proposed policy measures (US), or with preparing fiscal sustainability and fiscal risk analysis (UK), or with monitoring subnational governments (Spain), or with assessing the electoral platform of political parties (Netherlands), need to be supported by a relatively large technical staff, consisting of economists, budgetary specialists, and lawyers.<sup>13</sup> By the same token, lack of sufficient clarity in the government's objectives, accounts and projections warrants a substantial staff for monitoring fiscal policy trends and for preparing projections. Indeed, to enhance the credibility of official forecasts, responsibility for fiscal forecasts and/or the underlying macroeconomic forecasts should be shifted from the finance ministry to the IFI (Netherlands, UK). Arguably, high transparency and accountability obviate an IFI staff, as in the case of Sweden. At the limit, there is no need for an IFI in New Zealand, the top-ranking country in terms of transparency, of accountability, and of good practices in public financial management.<sup>14</sup>

12 See the critique of the Advisory Board (which serves as Germany's IFI) of the Stability Council in Kopits (2013).

13 Given the scale of its mandate, Ireland's fiscal council is significantly understaffed, as observed by Kopits (2014).

14 According to the Open Budget Survey, published by the International Budget Partnership (2015), New Zealand has scored the highest and Sweden second highest among more than 100 countries. By contrast, for example, Japan has not even participated in the Survey, as a reflection of the opacity of its public finances, which argues for the creation of an IFI with a large technical staff.

7. *An IFI should begin operations in a measured, gradual fashion over a prolonged period of time, before reaching cruising speed.*

In most countries, at its inception, the IFI is usually greeted by the media and public opinion with unrestrained scepticism, or, at best, simply indifference. If, further, the IFI is seen as hesitating or simply reluctant to venture beyond issuing pronouncements (in the genre of ‘on the one hand and on the other’) about a budget bill or a policy proposal, the public will eventually regard the institution with apathy and ignore its views. To avoid such a prospect, the IFI must prepare and disclose real-time quantitative estimates and projections – as soon as available staffing and computational resources permits – of the likely impact of proposed legislation. Such estimates, along with all the necessary caveats, can then be used as the basis of an informed dialogue, both in legislative and public domains, as an essential input to actual policymaking.

8. *The IFI must refrain from preparing macro-fiscal projections, as it may be at a disadvantage vis-à-vis projections by other official and private institutions, which might turn out to be more accurate.*

In comparison with macro-fiscal projections by other entities (governments, central banks, international organisations, private financial institutions, and most think-tanks), projections prepared by the IFI have two distinct attributes. First, unlike other institutions, the IFI discloses all underlying data and assumptions, whether model-based or judgmental, and makes them available in real time for examination and evaluation by specialists and the general public. Second, the IFI prepares baseline projections, which are, in essence, conditional forecasts that assume no change in fiscal policy – analogous to conditional forecasts prepared by central banks assuming unchanged interest rates. Such unbiased projections, especially those with a medium-term horizon, provide valuable information for the government to formulate and implement policies for maintaining (or restoring) public debt sustainability or complying with fiscal rules. Baseline projections contribute to eliminating the optimistic forecast bias in many official fiscal projections<sup>15</sup> that incorporate implicitly the unexplained impact of proposed policy measures.

15 See evidence of overoptimistic fiscal forecasts in the euro area in Frankel and Schreger (2013). A major reason for adopting an IFI in Italy was the strong optimistic bias in medium-term projections; see Balassone and others (2013).

As a result, the IFI can help anchor the expectations of economic agents and thus strengthen the effectiveness of fiscal policy.<sup>16</sup>

*9. The effectiveness, success or failure of an IFI can be ascertained relatively soon after its creation.*

As indicated, establishing the credibility and the effectiveness of an IFI is a rather time-consuming process. Several examples (including the US CBO) attest to the initial widespread distrust toward the newly adopted institution. Even after the IFI successfully gains trust in its technical skills and impartiality, having faced one given government cycle and one given economic cycle, there is no guarantee that a succeeding government will be equally as open to the IFI evaluations as its predecessor. Typically, it takes a full electoral cycle (that is, two consecutive governments of different political parties), and possibly a full economic cycle, to declare that an IFI has a reasonable chance of success. Regrettably, there have been two episodes (Hungary, Venezuela) of IFIs that, despite a track record of competence and nonpartisanship, could not survive the transition to a new government that did not tolerate independent institutions.

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Independent fiscal institutions, being adopted in an increasing number of countries around the world, are often exposed to criticism from various quarters questioning the institutions' rationale, functions, and effectiveness. This chapter reviews these critical views and demonstrates that most of them are tantamount to myths that can be refuted with factual evidence accumulated over the years. Indeed, such institutions – if designed and implemented along internationally accepted standards of good practice, enshrined in the OECD Principles for IFIs – can make a major contribution to good governance and can help enhance the transparency, credibility and overall quality of fiscal policymaking.

<sup>16</sup> This is a strong argument for establishing an IFI in Japan where, given the opacity of fiscal policymaking, expectations have been unanchored over a prolonged period; see Kopits (2016).



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## About the Author

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# 14 Addressing the communications challenges facing an independent fiscal institution: A view from the Congressional Budget Office

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**Robert A. Sunshine**  
Congressional Budget Office

CBO's founding director, Alice Rivlin, knew that effective communication would be of paramount importance for the nascent agency. In two early memos to her staff, more than four decades ago, she explained some fundamental principles that have infused all forms of communication at the agency to this day:

*I feel strongly that our reports should be lucidly written and comprehensible to noneconomists. We should break with the ponderous prose of most official economic writing and aim at giving Congressmen themselves something they can actually read and understand. We should assume that the reader is an intelligent, well-informed person without formal training in economics ... [W]e should avoid jargon and explain all the concepts as we go along.*

.....

*As we begin the first full year with the new Congressional budget procedures in place, I want to emphasize once again that CBO must be, and must be perceived to be, an objective, non-partisan, professional organization in the service of the Congress ... Our work and our publications must always be balanced, thorough and free of any partisan tinge ... Our task is to provide information which will help the whole Congress in reaching its decisions.*

## Who Are CBO's Audiences?

CBO's mission is to serve the US Congress. By law, CBO's primary responsibility is to provide information to committees of the Congress, so much of CBO's service – which includes providing objective, impartial information about budgetary and economic issues – is provided directly to the Congress through committees and their staff.<sup>1</sup> But Members and their staff also receive information about CBO's analysis from other sources, including the press, academics, researchers in think-tanks and related organisations, and members of the public. Therefore, CBO also endeavours to ensure that those secondary audiences portray the agency's work as accurately as possible.

## What are CBO's communications goals?

The agency is committed to providing information that is objective, insightful, timely, and clearly presented. For CBO, *objectivity* represents not the personal opinions of CBO staff but the consensus and diversity of views of experts from around the country; both the analysis and the presentation must reflect that objectivity. CBO endeavours to provide Congress with *insight* by applying the best new evidence and innovative ideas as well as the lessons of experience. *Timeliness* means responding as quickly as possible to the Congress's priorities for information and analysis. And *clarity* requires making results and the underlying analysis accessible, explaining in detail with minimal use of jargon and technical language, so that policymakers and analysts can understand the basis for the agency's findings and have the opportunity to question the analysis and methods used.

The need for timely analysis in the context of a fast-moving legislative process may conflict with the desire for a clear and complete presentation of the results and the basis for them, because preparing such a presentation can be time-consuming. CBO sometimes has to make trade-offs between those two objectives in the face of time constraints.

<sup>1</sup> CBO's intimate involvement in the legislative process differs significantly from the role of some independent fiscal institutions.

Precision, completeness, and consistency are other important goals. Because of the significant impact CBO's work can have on the legislative process, *precision* – ensuring that the written words mean exactly what the agency intends and cannot easily be misinterpreted – is important. *Completeness* is also essential. In its reports, CBO tries to cover all of the important issues related to any particular topic and to explain and address the uncertainty inherent in projections of future outcomes. And *consistency* among products and over time, in analysis and presentation, is critical to the credibility of CBO's work. For bodies of work on any number of topics, the agency attempts to identify and explain key changes in its findings and approaches that occur over time.

### **What are CBO's modes of communication?**

Cost estimates and analytic reports have long been CBO's core products. Those formal documents provide information about the potential effects of proposed legislation and other policy options and projections of the budget and the economy. To help ensure independence and objectivity, drafts are not shared with Members or their staff before the documents are issued. Once they are issued, CBO posts them on its website so that they are immediately available to all who are interested.

Personal communication with Congressional staff is also critical to the agency's operation. The agency's analysts proactively reach out to committee staff to understand what their priorities and goals are – fostering constructive working relationships. Analysts informally discuss issues with Congressional staff on the telephone and by email, meet in person, and sometimes give prepared presentations. The content ranges from a quick heads-up that some information or analysis is forthcoming, that a preliminary analysis has yielded results that may be surprising to the requester, or that the legislative language would not accomplish what the requester intends – to daylong sessions of technical assistance, working to understand a policymaker's goals and explaining how different policy options might or might not achieve them. CBO staff are also readily available to answer questions about their analysis from Members or Congressional staff.

Because CBO is primarily responsible to Congressional committees, however, its ability to assist individual Members is limited. When CBO analysts receive requests for estimates from individual Members, they try, if time permits, to provide informal feedback on the possible budgetary effects of the proposals. Unfortunately, the demand for such informal analyses far exceeds the agency's capacity to provide them, so it is sometimes not able to provide even these informal evaluations. CBO regularly consults with committees and Congressional leaders to ensure that its resources are focused on the work that is of highest priority to the Congress.

The agency also communicates in many other ways. For example, in blog posts and in answers on the website to FAQs (frequently asked questions), CBO provides additional insight into aspects of the agency's work and highlights certain updates to its budget and economic projections and other analyses. In briefings and presentations to groups of Congressional staff, members of the press, and gatherings of researchers, CBO analysts explain their research and conclusions. Often, to facilitate those interactions and to provide a handy summary about a particular topic, the agency publishes data visualisations: slide decks, chart books, and infographics.

In seeking to foster accurate press coverage of CBO's work, the agency strives to develop constructive relationships with reporters by being responsive and providing access to CBO staff on a timely basis when questions arise about CBO's work. CBO often holds widely attended formal press briefings about the budget and economic outlook reports and sometimes holds telephone conference briefings after other reports are released. CBO staff also speak frequently with reporters on a background basis to help them better understand the agency's work.

In recent years, CBO has established a presence on social media – Twitter, SlideShare, and YouTube – to make the agency's work more accessible. (CBO recently surpassed 24,000 followers on Twitter and has more than 20,000 followers on SlideShare.) And the agency has redesigned its website to be easier to navigate using smartphones, tablets, and other devices with smaller screens, significantly improving the accessibility of its work. Mobile users now account for nearly half of the traffic on CBO's website.

CBO has developed new pages on its website to provide users with a 'one-stop shop' for major recurring reports, budget and economic data, baseline projections for selected programmes, CBO products related to particular topics, and reports with policy options.

In addition, visitors to the website are now able to use dedicated search tools to find policy options with substantial budgetary effects (by major budget and programme categories) and mandates in bills and laws that impose costs (above specified amounts) on state and local governments or the private sector.

### **What are CBO's processes for attaining its communication goals?**

All of CBO's estimates and reports are reviewed internally for objectivity, analytical soundness, and clarity. That rigorous process involves multiple people at different levels in the organisation – including professional editors for many projects. For a particularly sensitive report or analysis, the team of analysts who contributed to it may gather to review the text page by page (or paragraph by paragraph) to ensure its accuracy and completeness. In addition to those review processes, analysts benefit from technical training and formal and informal instruction about how to write and to communicate on behalf of the agency.

CBO's analysts routinely consult with outside experts when preparing cost estimates, and CBO's analytic reports are typically reviewed by outside experts who specialise in the issue at hand. In some cases, those experts are members of CBO's Panel of Economic Advisers or Panel of Health Advisers. (Although such experts provide considerable assistance, CBO is solely responsible for its work.)

Prior to a major release, CBO staff with expertise in communications, legislative affairs, editing, and production coordinate with analysts about the presentation on the agency's website, the supplemental materials to accompany the primary publication, the notifications to provide to Congressional staff, and any other communications issues.

### **How does CBO balance openness and confidentiality?**

CBO makes its work widely available to the Congress and the public. In some circumstances, though, the needs of the Congress lead the agency to keep the results of an analysis confidential. The agency performs two kinds of work, broadly speaking, and its procedures for releasing results depend on which category the work falls in.



The first category – consisting of formal cost estimates and analytic reports – includes work addressing public legislative proposals or broad policy issues. Public legislative proposals include introduced bills and amendments, proposals in the President’s budget, policy options that CBO has analysed in one of its reports, and bills that have been voted on by committees or by the House or Senate. They also include proposals that have been widely discussed in the public domain or that have been publicly discussed in some detail by their sponsors. CBO releases all of those formal estimates and reports publicly. It delivers the work simultaneously to interested Members of Congress and their staff, including, in particular, the sponsor of legislation or requester of a report, the Chairman and Ranking Member of the committees of jurisdiction, and the Budget Committees. That process aims to create a ‘level playing field’, such that all key participants in the legislative process have access to the same information from CBO at the same time when dealing with a public legislative proposal. Promptly after delivery to those key interested parties, the agency posts the work on its website. In addition, an email service, Twitter announcements, and RSS feeds notify subscribers when the agency publishes work.

The second broad category of CBO’s work consists of informal cost estimates and other types of information produced to assist in the development of legislation. That work is preliminary because it has not undergone the same review procedures required for formal estimates and reports. In some cases, such work is provided for legislative proposals that are already public; in those situations, CBO’s analysis is available to any interested party in the Congress. In other cases, the work occurs when Members or their staff are evaluating alternative proposals to accomplish their goals, have not made any specific proposals public, and need the flexibility to modify their proposals before they become public, sometimes in response to CBO’s preliminary work. In fact, CBO’s analysts often provide informal, preliminary estimates and information to committee staff for a broad range of legislative options, allowing the consideration of different approaches before a specific legislative path is decided upon. In such situations, CBO recognises that the confidentiality of its work is critical to committee deliberations, so it keeps its informal estimates confidential as long as the proposals are not made public. (Such confidentiality does not apply to proposals that differ only in minor details from ones that are in the public domain.) However, once such a proposal becomes public – as introduced legislation or through public discussion of its major elements – CBO’s estimate for that proposal is available to any interested party in the Congress.

## **How do CBO's experiences apply to smaller organisations?**

Ultimately, the value of CBO's work – and that of other parliamentary budget offices and independent fiscal institutions – depends not only on the quality of the analysis, but also on the effectiveness with which it is communicated. Doing high-quality analysis that is not accessible and understandable can greatly limit the value of that work. To avoid such an outcome, about 7% of CBO's staff is devoted to various types of communication – mostly editorial and publications staff and people doing work related to the website. Much of what they do is scalable to the size of an organisation and in smaller organisations might involve some combination of devoting some people to communication less than full-time and obtaining help from contractors. In addition, analysts at CBO are encouraged to focus on effectively communicating their analyses, and many take training to enhance their writing and communication skills. Given the complexity of the work that CBO and like institutions do, and the political sensitivity of some of their products, devoting time and resources to effective communication seems essential.

## **About the author**

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## IV The way forward



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# 15 The European Fiscal Board: An experiment at the supranational level

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**Zareh Asatryan and Friedrich Heinemann**

Centre for European Economic Research and University of Mannheim; Centre for European Economic Research and University of Heidelberg<sup>1</sup>

*The European sovereign debt crisis has led to numerous reforms of fiscal governance in the euro area. The year 2016 saw another potentially important innovation that is the launch of the European Fiscal Board (EFB). The EFB was one of the elements envisaged by the Five Presidents' Report in June 2015 (Juncker et al. 2015) for a future 'Fiscal Union'. It is the only element among those in the report to have been established within this short time span.<sup>2</sup> This chapter briefly describes this new institution, its economic rationale, the shortcomings of its initial set-up and gives recommendations on how to strengthen it.*

## **The rationale for independent fiscal councils**

Recent years have seen a rapid increase in the number of countries with fiscal councils, from one in 1945 to 12 in 2007 and 37 in 2015 (Debrun *et al.* 2017). Increasingly, these independent fiscal watchdogs are established to complement fiscal rules, often with

1 *Acknowledgements:* We would like to thank Xavier Debrun, Michal Horvath, Ludovít Ódor and Mustafa Yeter for our joint work on "Making the Most of the European Fiscal Board" (SEEK-ENBI ZEW Policy Brief No3, Mannheim, May 2017), on which this chapter is based

2 The decision to create this new institution was taken by the European Commission (EC) in October 2015. The Board began operating shortly after its members were appointed in October 2016. Commission Decision 2015/1937 (European Commission 2015), amended through Commission Decision 2016/221 with respect to Head of Secretariat (European Commission 2016).

the explicit mandate to monitor compliance with these rules. In federal contexts, such councils may have the additional mandate of policy coordination. The basic rationale for councils in general is to bring more political independence and unbiased (academic) expertise into budgetary debates. Contrary to monetary policy, where independent central banks have the executive power to make decisions on monetary policy, fiscal councils lack this kind of decision power. However, a successful council can influence fiscal outcomes by providing parliaments, governments, and the general public with reliable information on the budgetary situation, its prospects, and the potential impact of certain policy initiatives. Effective councils alleviate the problem of asymmetric information between voters and media on one side and acting politicians on the other side.

## **The mandate of the EFB**

The EFB is unique in that it is set up at the supranational level. This contrasts with the numerous independent fiscal councils that have been established in both unitary and federal countries around the world, and particularly in individual European countries over recent years, following the Fiscal Compact (Treaty on Stability, Coordination and Governance, 2012, Article 3).

Unlike national councils, EFB does not directly address the EU budget or the budgetary decision makers. Instead, the EFB's first mandate is to advise the European Commission on its responsibility to implement the European fiscal framework.<sup>3</sup> Whereas a national council typically serves as the immediate watchdog for the budgetary actors (i.e. the national parliament and government), the EFB is rather a 'watchdog for another watchdog'.<sup>4</sup> The EFB does not have an executive role with respect to the application of enforcement rules and sanctions of the Stability Pact, and nor does it have a direct say on budgetary decisions at the national or European level.

3 In particular, to ensure evenhanded decisions with respect to budget surveillance and non-compliance with fiscal rules, to pinpoint unequal treatment in cases of violations of the Framework, and to make suggestions for the future evolution of the Framework.

4 Although the Commission is admittedly a special watchdog, one that can bite through enforcement powers.

The *second mandate* of the EFB is to advise the Commission on the actual and prospective fiscal stance appropriate on both the national level and the aggregate euro area level. In contrast to the first mandate, which has the goal of ensuring sustainable public finances, the objectives of an appropriate fiscal stance are much broader and include macroeconomic stabilisation and fiscal policy coordination. Since the euro area fiscal stance is the aggregate of sovereign fiscal policy of the Member States, recommendations by the EFB may interfere with Members' discretionary policy actions. Given that the current fiscal governance framework does not have any rules (or instruments) to manage the aggregate fiscal stance, it remains unclear which principles the EFB is going to use in its assessments to balance the objectives of sustainability and macroeconomic stabilisation.

Finally, the EFB's *third mandate* is to cooperate with national fiscal councils in EU Member States. The cooperation between the EFB and national fiscal councils might be beneficial for both parties involved. On the one hand, the EFB may benefit from using data and other information provided by national local councils. On the other hand, national councils may benefit from the presence of a euro area fiscal watchdog, by learning about best practices among similar fiscal councils, by using this additional channel to amplify their messages and, more generally, by strengthening its position given that the EFB will try to ensure horizontal consistency in the Commission's actions.

## **Requirements for strong independent fiscal institutions**

The experience with national fiscal councils and their particular strengths and weaknesses has led to an understanding of the importance of specific design features of fiscal councils (see Calmfors and Wren-Lewis 2011, Debrun *et al.* 2013, Beetsma and Debrun 2016, Horvath 2017). These lessons have been condensed most prominently in the OECD Principles for Independent Fiscal Institutions (IFI), adopted by the OECD Council in February 2014 (for details see OECD 2015, von Trapp *et al.* 2015, and Nichol and von Trapp 2018 in this volume).

The most important principles are listed in the first column of the table below. An effective council should have the support of the respective jurisdiction and not just be the result of an octroy ('local ownership'). It must have sufficient resources



and have excellent access to necessary budgetary and economic data. In order to fulfil its information function, it must make use of powerful communication tools and channels to reach the media and general public, ideally in real time (when budgetary decisions are prepared). A high degree of independence is an indispensable and defining characteristic of an effective council. A developed relationship to the legislature (e.g. through regular hearings) is conducive for effectiveness. Finally, a council's mandate must be consistent and sufficiently broad to fulfil the surveillance and information task.

The newly established EFB has a very short track record, so that any judgment is inevitably speculative in nature. Nevertheless, some cautious first assessments based on those principles described above are possible and summarised in Table 1.<sup>5</sup>

**Table1.** EFB versus Principles for independent fiscal institutions (OECD)

Principle	EFB	Evaluation
Local ownership	Consensual proposal in the Five President's Report	+
Resources	Significantly under-resourced compared to the mandate.	-
Access to information	Access to information directly via Commission. Scarcity of resources a handicap for information as well.	+/-
Communications	Open communication is expected. Not yet clear how regularly and whether on own initiative only. Noise to signal problem.	+/-
Independence and non-partisanship	Decision of the EC. Selection process by the EC. Staff from the EC. Part-time positions.	-
Relationship with the legislature	No link to Council or European Parliament.	-
Mandate	Mandate embedded only in a Commission's decision. Contrast between 'fiscal stance' and SGP-framework is problematic.	-

5 For a more detailed, one-by-one, discussion of the OECD principle, see, Asatryan *et al.* (2017).

## Assessing the EFB in the light of OECD criteria

The overall conclusion is that the initial design of the EFB – compared to many national councils – may set the stage for a relatively weak type of fiscal council in several respects. In particular, serious deficiencies exist with respect to the new institution's independence, its resources and its diverse mandate. On the other hand, ownership does not seem to be a crucial problem, since the EFB proposal has been made by the Five Presidents' Report and has been consensual.

Although formal independence is guaranteed in the Commission Decision (Article 4),<sup>6</sup> all five members are appointed by the Commission, which is itself the object of the Board's scrutiny. The term length of Board members, set at three years (with one possible renewal), is short and below the five-year term of the Commission. Another imperfection is the Board's lack of its own staff. The EFB must rely primarily on the Commission's staff for its secretariat. The integration into Commission services has the advantage of good access to information. The substantial downside is the closeness to an institution which is the subject of surveillance. Although the initial selection of members clearly reflects a strong focus on academic merit and expertise, the lack of organic independence might reduce its credibility as an independent advisory body (European Central Bank 2016, International Monetary Fund 2016), thereby diminishing its potential as a counter-weight against the potentially politicised application of European fiscal rules.

Concerns regarding the Board's *de facto* independence are amplified further given its resource constraints. The chair and the members are hired for only 20 and 10 days a year, respectively. The secretariat has a staff of six. In comparison, the top third of the national boards in Europe (excluding the Dutch Central Planning Bureau) have on average 20 employees. This relative scarcity of resources, particularly those allocated to the members and the president of the board, raises questions as to how the EFB can convincingly carry out its broad tasks. This resource constraint may also imply an information constraint, in the case that the EFB lacks the capacity to re-assess the Commission's analyses and to experiment with new ones (e.g. on output gap estimations).

6 "The members of the Board shall act independently and shall neither seek nor take instructions from the Union's institutions or bodies, from any government of a Member State or from any other public or private body."

This architecture should be re-considered by giving full organisational independence to the Board's staff, and by increasing the involvement as well as the term lengths of its members and the chair.

The perceived independence of the EFB may also suffer, given that the Board is accountable only to the Commission and, thus, lacks any backing from other institutions. One way out would be to establish firm links with the Council and the European Parliament. A more direct approach, initially proposed by the Five Presidents' Report, would be to introduce a clause implementing the 'comply or explain' principle. Even in the absence of this clause, the EFB should insist on careful answers from the Commission in cases of major disagreements. Developing a high level of public awareness over time, such as through a comprehensive and proactive communication strategy, will be another indirect instrument in the hands of the EFB to establish authority over the decision makers.

Important questions arise also with respect to the EFB's broad mandate for analysing and commenting on the 'aggregate fiscal stance'. In fact, the EFB's first report of June 2017 focuses on this issue (EFB 2017). The 'fiscal stance' dimension, with the embedded goal of macroeconomic stabilisation, can potentially conflict with surveillance carried out under the Stability and Growth Pact. The former can be interpreted as a discretionary demand management approach whereas the latter is a set of operational rules and last-resort ceilings that aim at long-run sustainability. Any sound analysis of macroeconomic stabilisation in the euro area is challenging analytically and is bound to raise questions for which no academic consensus exists. In this context, it is essential that, in its reports, the Board does not trade-off long-run sustainability objectives against short-run stabilisation needs. The Board may be most effective in, for example, making suggestions as to how to move towards a simpler and more transparent EU fiscal framework, and providing assessment of the relative weight of countercyclical considerations in such a future framework based on sound analytical work.

## Summary

The EFB can potentially make a substantial contribution acting as a critical check on a Commission which, as a political entity, may be biased in its budgetary surveillance and cannot be regarded as an independent guardian of the fiscal soundness enshrined in the EU fiscal framework. This analysis has discussed potential weaknesses of the new institution including the institutional requirements for genuine independence as well as efforts to improve its analytical credentials, communication strategies when dealing with the public, and cooperation plans with national fiscal councils, among others. These objectives should be addressed in the early stages of EFB's operations, which will be a crucial time in determining its future path. Otherwise, the EFB is at high risk of proving a lost opportunity for guaranteeing a non-politicised approach to EU fiscal surveillance. To a large extent, the EFB's actual effectiveness will depend on its own decisions and initial working praxis.

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# 16 Fiscal councils: A first step towards fiscal delegation in Europe?

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**Henrique S. Basso and James Costain**

Banco de España <sup>1</sup>

The recent history of Europe's Economic and Monetary Union (EMU) demonstrates the challenges of ensuring sustainable fiscal policies, and hence financial and macroeconomic stability, in a monetary union. Several factors drive high and volatile deficits and debt levels in member states: (i) lacking monetary policy instruments of their own, member states have an incentive to wield time-varying fiscal deficits to offset business cycle fluctuations; (ii) likewise, without monetary independence, they face potentially large fiscal costs from banking crises or speculative fluctuations in sovereign risk premia; and (iii) each member state may fail to internalise the effects of its debt on other members, implying a free-riding problem that biases deficits and debt upwards (Beetsma and Bovenberg 1999, Chari and Kehoe 2007).

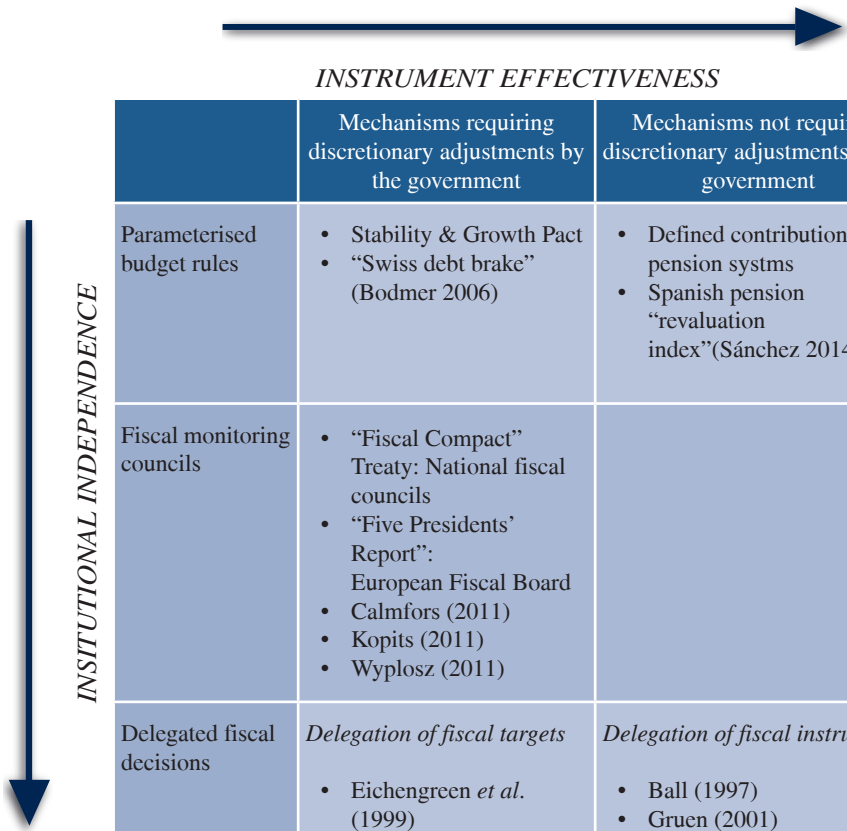
Bias towards high and volatile debt not only hampers the economic performance and stability of each member state and of the EMU, but also prevents the union from incorporating important mechanisms to prevent crises and/or share risks, such as a fully-fledged Banking Union, issuance of Eurobonds, or a union-wide unemployment benefit system. The reason is moral hazard: fiscally sound members justifiably fear that they will end up paying for the profligacy of others when shared fiscal mechanisms reduce the incentives of each individual country to put its own fiscal affairs in order.

<sup>1</sup> The ideas expressed in this article are those of the authors, and should not be taken to represent the views of the Banco de España or the Eurosystem.



For these reasons, it remains urgent to reinforce the mechanisms for fiscal discipline in the EMU. We organise our discussion around Table 1, which categorises a wide range of available options, highlighting two key directions for improvement: shifting some responsibility for fiscal sustainability to institutions independent of member governments (*Institutional Independence*), or redesigning the budgeting process to establish across-the-board shift variables that would facilitate adjustment of the overall fiscal stance (*Instrument Effectiveness*).

**Table 1.** Overview of possible mechanisms to restrain deficit bias.



<i>INSTRUMENT EFFECTIVENESS</i>		
	Mechanisms requiring discretionary adjustments by the government	Mechanisms not requiring discretionary adjustments by the government
<i>INSTITUTIONAL INDEPENDENCE</i>	Parameterised budget rules	<ul style="list-style-type: none"> <li>• Defined contribution pension systems</li> <li>• Spanish pension “revaluation index”(Sánchez 2014)</li> </ul>
	Fiscal monitoring councils	<ul style="list-style-type: none"> <li>• “Fiscal Compact” Treaty: National fiscal councils</li> <li>• “Five Presidents’ Report”:</li> <li>• European Fiscal Board</li> <li>• Calmfors (2011)</li> <li>• Kopits (2011)</li> <li>• Wyplosz (2011)</li> </ul>
	Delegated fiscal decisions	<p><i>Delegation of fiscal instruments</i></p> <ul style="list-style-type: none"> <li>• Ball (1997)</li> <li>• Gruen (2001)</li> <li>• Seidman &amp; Lewis (2002)</li> <li>• Calmfors (2003)</li> <li>• Costain/deBlas (2012a)</li> <li>• Basso/Costain (2016, 2017)</li> </ul>
	<p><i>Delegation of fiscal targets</i></p> <ul style="list-style-type: none"> <li>• Eichengreen <i>et al.</i> (1999)</li> <li>• Calmfors (2003)</li> <li>• Wyplosz (2005)</li> <li>• Maskin (2016)</li> </ul>	

*Note:* This table classifies various ways for the government to partially relinquish discretion over its deficit and debt, mentioning historical examples or citing academic analyses of hypothetical alternatives.

*Source:* Literature reviews of Debrun *et al.* (2009), Calmfors and Wren-Lewis (2011), and Costain and deBlas (2012b), updated to include recent developments.

The EMU experience shows that simple rules to limit deficits and debt, such as the Stability and Growth Pact (top left corner in Table 1), are insufficient to guarantee fiscal sustainability. We will discuss how delegating one or more fiscal shift parameters to an independent authority (bottom right corner in Table 1) would permit effective control of fiscal imbalances while improving stabilisation of shocks, and how this mechanism could build on existing EMU institutions. We focus on Europe, both because it is unusually vulnerable to fiscal indiscipline and because its unusual institutional structure may provide fertile ground for novel fiscal solutions

## **From simple to complex fiscal rules**

Fiscal rules are central to Eurozone architecture, and these rules have become more complex and more state-contingent since the early days of the euro. Initially, member states pledged under the Stability and Growth Pact (SGP) to maintain debt levels and deficits below 60% and 3% of GDP, respectively. Subsequent widespread violation of these limits reflects the lack of strong enforcement mechanisms in the SGP and the reluctance to activate those that did exist (such as fines on member states). Such reluctance to enforce is unsurprising, considering the high cost of suboptimal limits on cyclical stabilisation. Therefore, in 2005, the deficit limit was redefined in ‘structural’ terms (that is, cyclically adjusted and excluding one-off and other temporary measures). Making the limit contingent on the cycle enhances welfare by giving automatic stabilisers greater leeway, at the cost of making compliance less transparently verifiable.

Scope for stabilisation is also enhanced by the fact that the SGP deficit limit is now interpreted as a medium-term constraint, rather than a year-by-year limit. While details of implementation vary across countries, one way to define a medium-term constraint is to make the fiscal rule contingent on the debt trajectory, an approach that was pioneered by Switzerland. The Swiss federal government’s ‘debt brake’ (described by Bodmer 2006) limits public expenditure to cyclically-adjusted revenues, but is also contingent on an ‘adjustment account’ which cumulates previous deficits and surpluses. When this account exceeds a given threshold, the rule automatically mandates a tightening of fiscal policy over three years to rebalance the account. The Swiss rule has inspired several euro area countries, including Germany.

To make structural balance even more automatic, it may be useful to build broad-based shift parameters into the budgeting process. ‘Defined contribution’ pension systems are an example: the pension budget will balance automatically if the underlying legislation specifies a shift parameter to alter benefit levels for consistency with the revenues from mandated contributions (see Sánchez 2014, for the case of Spain). The fact that these systems balance revenues with expenditures after fiscal shocks without requiring new government actions is an advantage relative to the SGP, which, even in its recent flexible interpretation, requires discretionary policy adjustments by member state governments to ensure compliance. While establishing a self-correcting rule for the budget as a whole would be more challenging than it is for the pension system alone, defining *effective fiscal instruments* could be part of the solution for balancing the overall budget too.

The challenge of enforcing the SGP rules has motivated the EU to further restrain member government discretion by mandating independent ‘fiscal monitoring councils’, as discussed elsewhere in this volume (see also Calmfors 2011, Kopits 2011, and Wyplosz 2011). These councils can reinforce fiscal sustainability and improve countercyclical policy by providing apolitical forecasts and advice, and assessment of proposed policies and of compliance with rules. The establishment of national fiscal councils and the new European Fiscal Board (see Asatryan and Heinemann in this volume) has gone together with cross-country monitoring and negotiation under the ‘European Semester’. However, while this new framework may allow greater flexibility to respond to unforeseen shocks, it makes compliance even more opaque and could bring politics – inevitably accompanied by deficit bias – back to the centre of fiscal decisions.

## **From fiscal rules to fiscal delegation**

While fiscal councils offer scope for improving both fiscal discipline and countercyclical policy, their potential is limited by their purely advisory role. Therefore, it is natural to ask whether establishing monitoring councils is only a first step towards a sounder fiscal system. Indeed, many economists have advocated delegating executive power over one or more fiscal decisions to an independent authority with a mandate to restrain debt.

One series of proposals, running from Eichengreen *et al.* (1999) to Maskin (2016), has suggested that fiscal councils should set a deficit limit at the outset of each year's budget cycle. Unlike a fiscal rule, this would permit discretionary responses to unanticipated challenges, while partially avoiding the deficit biases and policy lags associated with discretionary government action. However, since the deficit cumulates countless tax and spending decisions at various levels of government, it is better understood as a target than as an instrument directly controlled by the executive. Therefore, this form of delegation suffers from the same basic enforcement problems as the EMU's existing rules-based framework: it only improves policy outcomes if member governments subsequently make discretionary adjustments to comply with fiscal councils' targets.

A possible solution to this problem, explored by Calmfors (2003), would be to delegate control of an instrument, rather than a target, to an independent authority (this is akin to monetary policy delegation, as discussed by Rogoff 1985). This instrument could be an across-the-board shift parameter acting either on the revenue side or on the spending side of the budget. For example, on the revenue side, Gruen (2001) proposed multiplying all rates in the Australian tax system by a shift factor  $X$ , which would initially be set to one, but would thereafter be raised or lowered by an independent authority to maintain long-run budget balance. This setup leaves all the distributional decisions about the structure of taxation under the democratic control of the elected government, but does not require any deliberate government action to achieve intertemporal budget balance, which could instead be ensured (when necessary) by the fiscal authority resetting  $X$ . This mechanism restrains deficit bias and also makes countercyclical fiscal policy more agile and less political, as advocated by Ball (1997) and Wren-Lewis (2002).

Alternatively, budget shift parameters could be defined on the expenditure side. For example, Seidman and Lewis (2002) suggest designing a stimulus programme of transfer payments that would be triggered automatically in the case of a sufficiently severe recession. Costain and de Blas (2012a) argue that adjusting expenditure rather than taxes could mitigate the trade-off between budget stabilisation and macroeconomic stabilisation that arises after a demand shock. Fiscal adjustment on the expenditure side could be facilitated by introducing a shift factor in public payments (such as transfers and payments to civil servants) which would be controlled by an independent authority, tasked with ensuring long-run budget balance.

Basso and Costain (2016, 2017) study dynamic games to compare macroeconomic outcomes under different fiscal frameworks in a monetary union, including the delegation of fiscal instruments. They compare the status quo monetary union to several alternative frameworks, including one in which each member government delegates a tax shifter like that of Gruen (2001) to a debt-averse, union-wide fiscal authority. They find that fiscal delegation achieves large long-run welfare gains by reducing debt and thus lowering the tax distortions implied by debt service. Strikingly, they also find that countercyclical policy becomes more effective, because offsetting deficit bias by means of fiscal delegation reduces the losses associated with lack of commitment. While the fiscal authority imposes greater ‘austerity’ after a fiscal shock, facing most of the distortionary costs up front, this is less costly than the persistent rise in debt, accompanied by interest costs and higher inflation, that would occur under the discretionary response of the *status quo* monetary union.

## **Fiscal delegation: Implementation in the EMU**

Our analysis suggests that the current EMU framework of rules, monitoring, and penalties is suboptimal, and that delegating effective fiscal instruments to an independent authority with a mandate to avoid excessive debt could improve both fiscal sustainability and cyclical stabilisation. Basso and Costain (2016) discuss how fiscal delegation could build on existing European governance structures. Member states might willingly opt into a regime of robust fiscal discipline – such as delegating an across-the-board budget shift parameter to an independent EU fiscal authority – if this were a prerequisite for participation in European mechanisms to reduce their vulnerability to financial or macroeconomic shocks. We now summarise key aspects of this institutional *quid pro quo*.

- **Quid.** Delegation of fiscal instruments is most likely to prove politically palatable if it is just one facet of a system for reducing macroeconomic instability in the EMU. Thus, it might be undertaken when the European Council chooses to establish a full-fledged Banking Union, or a Eurobond scheme to reduce the risk of crises in banking and debt markets (see Corsetti *et al.* 2016) or a European unemployment insurance scheme (see Boeri and Jimeno 2015). In general, we will refer to these mechanisms as EU risk-reduction schemes.

- **Quo.** At the same time, the Council would designate an institution (call it the European Fiscal Authority, or EFA) to manage any fiscal instruments delegated by the member states, with a mandate to maintain long-run fiscal sustainability in those members. A natural candidate to assume these responsibilities would be a reformed European Fiscal Board with strict guarantees of political independence and adequate resources.
- **Designing an instrument.** Access to the new EU risk-reduction scheme would be conditioned on delegating executive control of one or more adequate fiscal instruments, either on the revenue side or the expenditure side of its budget, to the EFA. In principle, each government might be permitted to freely design the instrument most suited to its own economy, and submit its proposal to the EFA for approval.<sup>2</sup>
- **Evaluating the instrument.** The EFA would evaluate the effectiveness of the proposed instrument. Ideally, it should be defined at a high level of aggregation so that it is administratively simple and quick to adjust, and so that it has a broad-based impact on revenues or expenditures, enabling the EFA to ensure long-run budget balance in the face of possible future fiscal shocks or government policy changes.
- **Activation.** As soon as the EFA has approved the instrument proposed by a given member state government, that member would be included in the EU risk-reduction scheme(s). The EFA would evaluate the macroeconomic and fiscal prospects of that member state, and choose an initial quantitative setting for the delegated instrument.
- **Monitoring.** Subsequently, the EFA would regularly monitor the member state's macroeconomic performance and fiscal stance, advising on fiscal trends and about proposed policy changes, and ultimately loosening or tightening the delegated instrument as required for long-run budget sustainability. Since long-run balance is consistent with nonzero deficits in the short run, the EFA could relax its fiscal stance countercyclically to reduce macroeconomic fluctuations, but on average it would tighten its stance as a function of the debt-to-output ratio.

2 The government's instrument design might include a quantitative rule of thumb recommending how the EFA should adjust the instrument setting in response to changes in debt or in other macro-variables such as output or unemployment. While the EFA would ultimately have discretion to adjust the instrument as necessary for fiscal sustainability, specifying a rule of thumb might help the government communicate its intentions about the behaviour of the instrument.

- **Learning from experience.** The instrument delegated to the EFA need not be set in stone. If the member government discovers its instrument is poorly designed, or if a new government prefers a different instrument, a new budget shift parameter could be designed, to substitute the old one upon EFA approval.
- **Deviation?** Would member states have an incentive to renege on their commitment to delegation, or to try to undo the EFA's instrument adjustments by shifting other fiscal levers? No, because the effectiveness of the delegated instrument would always be subject to re-evaluation by the EFA. If the government attempts to renege on its commitments, either by formally revoking the delegation of the instrument or by otherwise gaming the system, the EFA would be obliged to declare that it no longer controlled an effective fiscal instrument, rendering the *quid pro quo* void. The member state would immediately become ineligible for the EU risk-reduction scheme(s) it was participating in, potentially increasing the vulnerability of its banking sector, raising the risk premium on its sovereign debt, and/or losing the European component of insurance for its unemployed. This would serve as a quick and powerful disincentive to deviation.
- **Breakdown and default?** Of course, regardless of the EFA's effectiveness, no fool-proof system exists for making a sovereign government fully repay its obligations under all circumstances. But at least, the political bias that leads to excessive debt accumulation can be eliminated, reducing the probability of default. If, in spite of fiscal delegation, some unlikely sequence of errors and shocks leaves a given member state with an extreme debt burden, the EFA's task would still be to set its delegated instrument at a level consistent with long-run budget balance. In such a scenario, the government might consider other options, such as seeking a restructuring. But, consistent with its mandate, the EFA would never participate in a restructuring, default, or rescue decision.

## Conclusions

Moving from a system based primarily on rules and sanctions to one based primarily on instrument delegation could improve fiscal discipline in two crucial ways: (i) by encouraging member states to design simple, across-the-board shift parameters for budget-balancing purposes, and (ii) by transferring control of those instruments from

an agent with deficit bias (the government) to an agent with a bias against deficits (the EFA). At the same time, these two mechanisms are also likely to improve macroeconomic stabilisation, because an independent authority controlling an effective fiscal instrument could adjust its stance on the basis of an unbiased assessment of cyclical conditions. Coupled with the establishment of European mechanisms to reduce financial or macroeconomic risk, such a framework could be attractive both to creditor and debtor states.

Delegation of budget balancing instruments might appear to cede sovereignty over some decisions that have traditionally been made by governments. But how much control would the government really relinquish? Note that once the EFA judges that a member government has designed and delegated an effective fiscal instrument, that government would be free to manage its own fiscal affairs, subject only to *its intertemporal budget constraint*, as imposed by the EFA. Political and redistributive aspects of fiscal policy would remain fully under the control of the government. In this sense, the member state would not cede any dimensions of its sovereignty, other than the ‘right’ to violate its own budget constraint. But perhaps that loss should be considered a gain, since having the discretion to run unsustainable policies is at the root of the problems under consideration. By tying its hands in this way, the government would gain credibility, reducing risk premia, and thereby relax its intertemporal budget constraint.

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# 17 Are fiscal councils here to stay?

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The world has seen a surge in the number of institutions dubbed ‘fiscal councils’ or ‘independent fiscal institutions’ over the past two decades and especially since the Great Recession and Europe’s subsequent public debt crisis. Currently, there exist about 40 such institutions around the world, up from 25 in 2010.<sup>1</sup> Euro area countries were mandated to set up such institutions by the so-called ‘Two-Pack’ Regulation of 2013, which was part of the EU’s response to its public debt crisis (European Commission 2013). In fact, 24 of the existing fiscal councils are in EU countries.<sup>2</sup>

Debrun *et al.* (2013, p.8) define a fiscal council as “a permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government’s fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances, short-medium-term macroeconomic stability, and other official objectives. In addition, a fiscal council can also: (i) contribute to the use of unbiased macroeconomic and budgetary forecasts in budget preparation, (ii) facilitate the implementation of fiscal policy rules, (iii) cost new policy initiatives, and (iv) identify sensible fiscal policy options, and possibly, formulate recommendations.” Existing fiscal councils vary largely in terms of the scope of their work, see e.g. the European Commission’s recently published *Scope Index of Fiscal Institutions* which provides a quantitative measure of the scope of responsibilities assigned to individual councils around Europe.<sup>3</sup>

1 See Beetsma *et al.* (2017), and von Hagen (2013) for a review of fiscal councils that existed in 2010.

2 Austria, Belgium, Bulgaria, Cyprus, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, the Netherlands, Portugal, Romania, Slovakia, Spain, Sweden, and the UK.

3 See European Commission (2017)

In view of this diversity, it is impossible to give a single answer to the question posed in the title of this chapter. Beetsma *et al.* (2017) develop a model of fiscal councils showing that their desirability and effectiveness depends on the specific circumstances in which they were created and the properties of the political system whose weaknesses they are supposed to address. As economists, we tend to think that things that are not deemed desirable or effective are bound to disappear, as societies will not invest to maintain them. This should also be true for institutions, although institutions may be able to survive for long periods of time, even though they are neither desirable nor effective, simply because it can be (politically) costly to abolish them. Many of the fiscal councils created in the European Union in recent years likely fall into this category: even if they turn out not to be useful, countries will keep them, simply because they do not wish to act against European Union rules.

Even though I do not agree with the analysis in Beetsma *et al.* (2017), for reasons explained below, I take my cue from them and discuss, first, reasons for setting up fiscal councils, second, whether existing fiscal councils are likely to be useful, and third, what the threats are to the survival of fiscal councils. In the last section, I will ask whether we should mourn for deceased fiscal councils.

## **Good and bad reasons to install fiscal councils**

In the context of the European Economic and Monetary Union, the creation of independent fiscal councils, or ‘national debt boards’, was first proposed by Ian Harden and myself (1994) in a study of budgeting procedures in EU countries. Ian and I noted that government budgeting involves a common-pool problem resulting from the fact that government spending or tax breaks are typically targeted at specific groups in the electorate, which perceive the full marginal value of the policies benefitting them, while being financed from general tax funds. The costs are, therefore, spread over all tax payers so that the groups benefitting from individual policies perceive only a small part of the marginal cost and, therefore, tend to demand more spending and tax breaks than optimal. In a dynamic context, this common-pool problem gives rise to excessive deficits and debts. Bail-outs, be it of banks or industries, are among the most vicious examples of common-pool problems.

In the context of public budgeting, it is not appropriate to speak of ‘the government’. Different members of the executive have different positions relative to the common-pool problem, and the executive’s position is different from the legislature’s position. Spending ministers typically represent individual interest groups and are likely to demand excessive spending or tax breaks for their constituencies. In contrast, the finance minister and the head of government take a more comprehensive view of the budget and internalise the common-pool problem by equating the relevant marginal costs and benefits. As much empirical research has shown in the past two decades, institutions in the budgeting process that promote a comprehensive view of the budget can mitigate the deficit and debt bias. Depending on the political system, this can be achieved by giving the finance minister the power to rein in the demands of the spending ministers, or by negotiating binding budget contracts among all parties of a governing coalition.<sup>4</sup>

This is where fiscal councils come in. Their institutional independence from the electoral process allows them to develop a comprehensive perspective on the budget and point out where government expenditures or tax advantages are excessive. They thus represent the general tax payer’s interest in the process. Doing so, they can strengthen the position of the finance minister or support the enforcement of a budget contract. In an intertemporal context, fiscal councils can also be regarded as representatives of future tax payers. In order to fulfil this role, fiscal councils must have some veto power over the government’s budget proposal. Ian and I proposed that they should be able to impose across-the-board spending cuts. A much weaker form of veto power would be to publish opinions and make the voters aware of the spending, deficit, and debt bias, thus forcing the executive to justify its proposed fiscal policies.

In contrast, much of the recent literature on fiscal councils, including Beetsma and Debrun (2017) and Beetsma *et al.* (2017), has taken a different approach. They argue that excessive spending, deficits and debt are the results of fiscal opacity – voters not being able to understand the true state of public finances nor to discern the true competence of the ruling government. The role of fiscal councils then is to improve transparency and provide information voters do not have.

4 See Hallerberg *et al.* (2009) for details.

There are two problems with this view. The first is that the idea that fiscal councils have superior information is hard to swallow. One interpretation of this argument is that fiscal opacity is the result of a conscious decision of the government in power. That is, the government has all the desired information, but it has decided not to reveal it. The argument then is that the fiscal council can find out that information and make it public. In practice, however, governments control the information about themselves that fiscal councils can obtain and publish. Whatever information they do not wish to reveal, they will not reveal even to the fiscal council. Could a fiscal council force them to do so by legal means? No, since a government can always argue that it does not have the information itself, a statement that cannot be disproved. Another interpretation of the argument is that the government itself, because of its wish to be re-elected, cannot credibly convey the relevant information to the voters, or that the government itself does not have it. The fiscal council could then improve transparency by using analytical tools the government does not have and by providing independent and, therefore, credible information to the voters. That may be the case but it paints a rather optimistic picture of the ability of the council members not to err in their interpretation of the available data.

The second problem relates to the assumption that ‘the government’ is a unified actor. In practice, it is not. The withholding of information, causing fiscal opacity, may occur in the bureaucracies working under the relevant political decision makers and these bureaucracies pursue their own interests even against the members of the executive. In practice, the latter often do not get the information they desire, because the bureaucracies keep it for themselves to preserve their own power. Coming from the outside, fiscal councils have no chance to obtain information that even the members of the executive cannot get.

A related point is the idea that fiscal councils should be charged with giving assessments and approvals of the governments’ macroeconomic forecasts underlying the annual budget proposals. This is part of the mandate of national fiscal councils under the ‘Two-Pack’. It aims at preventing governments from using overly optimistic forecasts allowing them to avoid or postpone budgetary reactions to economic and fiscal shocks

with negative impact on the budget balance.<sup>5</sup> While the idea seems convincing, its practicability is very much in doubt. Macroeconomic forecasting is a complex art, requiring a lot of human resources to maintain appropriate models, more than existing fiscal councils typically have. Even if fiscal councils limit themselves to ‘no-policy-change’ scenarios, producing competent, state-of-the art forecasts also requires information and data they are unlikely to have at the time when their assessment must be made. At best, they can judge the plausibility of those assumptions that a government has chosen to make explicit in its own forecast. But that is far less than judging publicly that a forecast is or is not overly optimistic. In practice, therefore, fiscal councils’ assessment of macro-economic forecasts is likely to either be perceived as comments the government can easily brush aside or to become mere rubber-stamps. Instead of increasing transparency, they may even diminish it.

For similar reasons, fiscal councils can do little to enforce fiscal rules at the national level, which again is included in the ‘Two-Pack’ mandate. Fiscal rules include escape clauses referring to exceptional circumstances and one-off measures which are, by definition, based on subjective assessments of current economic developments and policies. A brief look at the European Commission’s record of dealing with this issue shows how confusing and opaque it is. Unless fiscal councils were given the sole right to define what is exceptional and one-off, there is little they can contribute to the enforcement of rules, other than, perhaps, drawing the media’s attention to some particularly questionable cases of governments making use of escape clauses. How effective that is to enforce fiscal rules is an open question. I conclude that fiscal transparency arguments give no good reasons for having fiscal councils.

## **Are existing fiscal councils likely to be useful?**

Several fiscal councils around the world have been in existence already for several decades and have proven to be influential in their countries (von Hagen 2013). In Europe, these include the Austrian *Stabilitätsrat*, the Belgian High Council of Finances, and the Dutch Central Planning Bureau (CPB). Outside Europe, there are the Australian

5 Jonung and Larch (2006) noted that some EU governments use overly optimistic forecasts to gamble on the opportunity to avoid painful fiscal adjustments.



Loan Council, and the Indian Finance Commission. Apart from the CPB, these councils operate in federal settings, where common-pool problems between the states and the federation are important (see Janeba *et al.* 2018, in this volume). All of them have significant political influence in the budget process. In the cases of Belgium, Australia, and India, this influence is based on formal powers, in Austria and the Netherlands, it is based on informal powers arising from political context and tradition. These institutions have records of useful contributions to the performance and quality of their countries' fiscal policies. It is likely that they are here to stay.

Among the new European fiscal councils, some seem to have been stillborn, e.g., Germany's '*Beirat beim Stabilitätsrat*', which has gained no visibility in the public debate over fiscal policies.<sup>6</sup> Others have developed activities of considerable number and scope since their creation and have managed to gain a voice that is heard in the public debate. Examples are the Spanish Independent Authority for Fiscal Responsibility, the British Office for Budget Responsibility, the Irish Fiscal Advisory Council, and the Portuguese Fiscal Council. That seems like a good start.

But that is not enough to ensure that fiscal councils are here to stay. In order to stay and become influential, they will have to prove that they are useful, not just to an academic community but to the general public, and they need to gain enough political support to prevent any government action aimed at weakening or abolishing them. Given that their focus is on transparency and for the reasons explained in the previous section, I doubt that many of them will succeed.

## Vulnerabilities of fiscal councils

Fiscal councils without formal political powers depend on the goodwill of the government, especially if their mission is focused on transparency and macroeconomic forecasting. They need information which is private to the very governments they are to

6 '*Beirat beim Stabilitätsrat*' translates as advisory council attached to the Stability Council. The latter is a group consisting of the federal ministers of finance and of the economy and the state finance ministers.

monitor Governments can undermine their effectiveness simply by not giving them the information they need. The CPB's position is exceptional in this regard: it gathers and processes public finance and macroeconomic information for the Dutch government and thus has an information advantage which makes it independent from the goodwill of the government. This may explain its effectiveness despite its lack of formal political powers. Governments can also undermine the effectiveness of fiscal councils through administrative obstacles, such as by slowing down appointment procedures of council members, and by draining fiscal councils of financial and human resources.<sup>7</sup>

One might argue that fiscal councils can go to the courts and enforce their statutory information and resource rights. Formally, this is true. In practice however, a council will face retribution from a non-cooperative government, as the latter can choose to be even slower and more restrictive in providing the necessary information and resources in the future. In view of that, fiscal councils will go to the courts only in highly exceptional cases. A similar point holds regarding public complaints of non-cooperative government behaviour.

One protection for fiscal councils might be that finance ministers see them as allies in their own pursuit of fiscal sustainability. Finance ministers might find fiscal councils useful, especially if their own position within the executive is weak. But such weakness is often due to fact that the finance minister himself does not have access to all the information he needs to control the budget process. Weak finance ministers offer weak support at best to fiscal councils.

The best defence for fiscal councils against unfriendly government actions is support from public opinion. But such support needs to be gained first, as the public must be convinced of the importance and effectiveness of fiscal councils. Having been created by new EU legislation, many European fiscal councils risk being perceived as yet another case of external intervention into domestic affairs, which would reduce their acceptability to the general public. Any attempt of the new European Fiscal Board to

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7 For example, the Portuguese government imposed a ban on the Portuguese Fiscal Council hiring from outside the public sector and barred individuals working for the Council from teaching at Portuguese universities, which made it much less attractive for academics to work for it.

coordinate and dominate the work of the national councils can only contribute to such antagonisms (see Asatryan and Heinemann 2018, in this volume). Whether or not the new fiscal councils in Europe can muster sufficient public support remains to be seen.

## **Should we mourn for deceased fiscal councils?**

Fiscal councils can die in many ways. They may be formally abolished, their work may become a process of mere formalities, or they may simply be forgotten by the public. The history of Germany's 'Council of Wise Men' offers an example of a deceased institution that has not been formally terminated.<sup>8</sup> To 'stay' is not the same as to be alive and effective.

The financial crisis of 2007-2009 and the public deficit and debt problems that resulted from it are the most blatant cases of common-pool problems in democracies. Public funds were abused to 'rescue' and 'save' private financial and economic interests - often quite narrow ones. Fiscal opacity had no major role in the crisis: the underlying weaknesses and vulnerabilities of public-sector budgets and balance sheets were largely known before and they were the result of political choices. The fiscal councils that were created following the crisis were, deliberately perhaps, designed to address the wrong problem. If these councils die in one form or another, it will be because of that. No one should mourn for them. But some of them may succeed in redefining their missions and address common-pool problems effectively. They will stay alive and we will cheer their survival.

8 The council, called "*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Lage*" annually produces a report which is presented to the German chancellor in a public ritual only to be soon forgotten.

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"Taxation without representation is tyranny." From the premises of the American Revolution to this day, the idea that control over the public purse rests with the People is a cornerstone of liberal democracies. Yet, more than two decades after putting unelected central bankers in charge of monetary policy, many countries have recently established independent fiscal institutions (or councils). Unlike central banks, fiscal councils do not exert any policy responsibility: they only analyse, comment, forecast, and advise. As watchdogs of fiscal sanity, they must bark at careless political masters, but they can never bite them. Frustration with fiscal policy rules as well as a sense of urgency in reaffirming commitments to sustainable public finances largely explain the emergence of such institutions, particularly in Europe. Still, toothless or not, their effectiveness hinges on their ability to somehow constrain or guide policymakers. So, do independent fiscal councils (IFCs) silently carry the seeds of tyranny? And if not, why and how can they make any difference?

The essays in this book survey the motivations for IFCs, analyse their core features and effectiveness in varied institutional settings, distill elements of best practice, and discuss future developments. The consensus emerging from the book is that fiscal councils can be useful in fostering sound policies if they benefit from strong political ownership, protections against partisan pressures, resources commensurate to their tasks, and a well-defined mandate addressing country-specific threats to fiscal sustainability and stabilisation. Contentious points remain, however. While some embrace IFCs as a welcome first step towards full-blown fiscal policy delegation, others doubt they can thrive for long in political settings where memories of past crises fade rapidly. Also, the role they can play at the supranational level – as in the overall design of the European Union's fiscal governance – remains subject to many question marks.

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