Independent Fiscal Councils in Continental Europe: Old Wine in New Bottles?

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Fiscal councils and the quest for fiscal discipline

The budgetary footprint of the economic and financial crisis of 2008–09 brought to the fore renewed concerns about governments' commitment to sustainable public finances, leaving financial markets increasingly jittery. Indeed the crisis-related spike in government debts came in addition to worrying upward trends observed since the 1970s and before rapidly intensifying demographic pressures on unfunded entitlement spending have reached their peak. While today's debt levels are not unprecendented, current dynamics are inconsistent with public sector solvency, unless action is urgently taken (Figure 1).

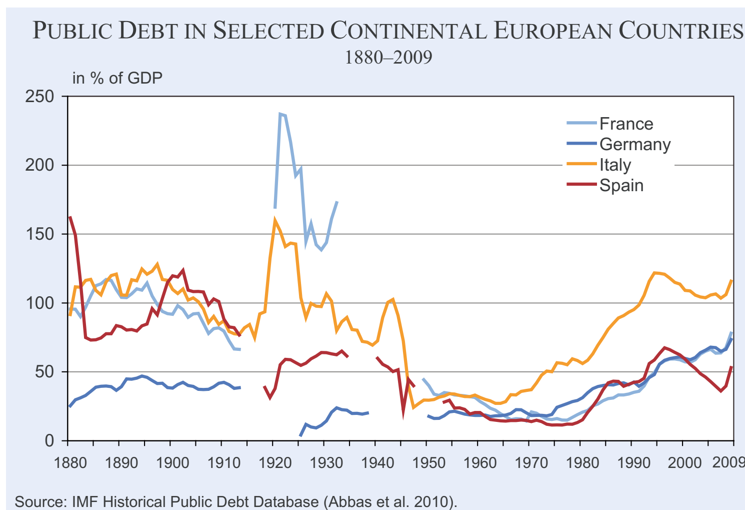
Action certainly means ambitious, sustained and probably painful consolidations combined with profound entitlement reforms. However, with financial markets on the watch and rapidly eroding credibility, *present* governments also need to anchor *future* fiscal policy in a corridor of trajectories deemed consistent with sustainable debt dynamics.

For governments, committing to operate within a range of socially desirable policies is a perennial challenge. As formally shown by Kydland and Prescott (1977), time-inconsistency looms large because short-term considerations often lure policymakers into undesirable deviations from ex-ante optimal strategies. The commitment problem is particularly severe for fiscal policy, as distributive concerns – across groups and over time – complicate policy formulation in ways that make excessive deficits and debts irresistible. This problem is generally formulated as the "common pool" theory of deficit bias (Krogstrup and Wyplosz 2010). Other related causes of deficit bias include politicians' myopia resulting from re-election concerns or a collective failure by voters to appreciate the consequences of the intertemporal budget constraint for current policies. (For a useful survey, see for instance Calmfors 2005).

Fiscal policy rules have long been used to contain tendencies toward fiscal profligacy (e.g., Fabrizio and Mody 2006; Debrun et al. 2008). Yet the operational limitations of rules undermine their own credibility, as they have to be simple and are therefore likely to be inadequate in a non-trivial set of "unusual" circumstances. This led some to argue that non-partisan agencies could more effectively constrain fiscal discretion for the good of all. The institutional raw model of the *constrained-discretion regime* is the delegation of monetary policy *instruments* – not objectives – to independent central banks subject to a well-defined mandate.

Figure 1

Public Debt in Selected Continental European Countries
1880–2009



Source: IMF Historical Public Debt Database (Abbas et al. 2010).

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However, there are fundamental differences between monetary and fiscal policies that preclude the delegation of fiscal policy instruments to an *independent fiscal authority* (IFA). The first argument against delegation is normative: policy instruments that have first-order distributive implications – as do most fiscal levers – should stay in the hands of elected policymakers (Alesina and Tabellini 2007). Some authors, although they do not dispute this generalization of the "no taxation without representation" principle, have nevertheless argued that imposing binding deficit limits to elected officials was a sufficiently neutral task from a distributive standpoint to be delegated to an IFA (Wyplosz 2005). This proposition does not survive the second argument against fiscal delegation, which is purely positive. To the extent that the deficit bias is a feature of the ex-ante political equilibrium, elected policymakers simply have no incentive to delegate any policy-setting prerogative to an IFA – nor to establish really binding policy rules for that matter (Debrun 2011). Thirdly, the greater variance of opinions about what constitutes an appropriate fiscal policy in given circumstances (as opposed to monetary policy) would make delegation even more difficult to establish and sustain in practice.

If delegation or any form of binding constraint on discretion is unlikely to be supported in a political equilibrium, how can we establish a regime of "constrained discretion" for fiscal policy? The only credible option in a representative democracy is by enabling the principal –i.e., voters – to hold politicians accountable for implementing "sensible" policies (which is generally understood as stabilizing and consistent with debt sustainability). Greater transparency increases the visibility of deviations from these policies and correspondingly raises the reputational costs of deviations. As a result, accountable policymakers are less likely to misuse policy discretion. *Independent fiscal councils* (FCs) can help by improving the quality of the public debate on fiscal policy. Formally, their effectiveness arises from their ability to reduce the informational asymmetries that provide fertile ground for the deficit bias. Only well-informed voters can credibly sanction poor policies. In practice, FCs can in particular:

(i) provide unbiased analyses of the likely economic and budgetary consequences of alternative policy strategies with respect to ultimate societal objectives (growth, employment, equity, stability) and constraints (sustainability, possibly expressed as numerical fiscal rules),
(ii) publish nonpartisan assessments of the extent to which current and planned policies contribute to achieve the government's stated objectives,
(iii) enhance transparency through unbiased macroeconomic and budgetary forecasts, including the costing of specific measures,
(iv) foster fiscal policy coordination among different government entities (central administrations, decentralized entities, social security, large public enterprises benefitting from explicit or implicit guarantees), and
(v) assess fiscal risks and propose risk-mitigating strategies.

An effective fiscal council can take many forms. Indeed, the sources and manifestations of the deficit bias vary across countries so that the specific remit of a council should only incorporate a subset of these tasks, and many combinations are possible. Also, the specific institutional form and modus operandi of a fiscal council depends on elements of the political system shaping the intereaction between voters and elected policymakers (proportional vs. majoritarian voting rule, presidential vs. parlementarian system, centralized vs. decentralized state, transparency requirements, etc.). The implied diversity of possible FCs explains why despite a fairly active public debate, no full-fledged theory has either established the desirability of such institutions or derived first-order principles likely to secure their effectiveness.[1] Unsurprisingly, the literature on independent fiscal agencies covers a wide array of specific (and sometimes outlandish) academic proposals as well as a number of existing institutions. Although some papers propose a taxonomy (Debrun et al. 2009; Calmfors 2010), there is no consensus on the tasks these agencies should be assigned, what institutional form they should take, and on whether they should complement or instead substitute for a rules-based framework.

What qualifies as an independent Fiscal Council?

In principle, any non-partisan institution seeking to actively inform and foster the quality of the public debate on fiscal policy could qualify as a fiscal coun-

[1] See Debrun (2011) for further discussion and Kopits (2011) for a description of the emerging international best practice. The latter emphasizes four pillars for FC effectiveness: political ownership of the mandate and modus operandi, guarantees of operational independence, adequate staffing, and a remit focused on a neutral assessment of fiscal policy, the analysis of sustainability and the promotion of transparency in budget preparation.

cil. This includes specialized think tanks or research institutes – e.g., the Institute for Fiscal Studies in the United Kingdom, or the Austrian Institute of Economic Research (WIFO) – but also official bodies exerting macroeconomic surveillance, such as the OECD, the IMF and the European Commission.

In line with Debrun et al. (2009), our definition is more restrictive. First, we exclude private bodies not explicitly mandated by the government to perform at least one of the tasks listed above. The existence of an official mandate – and the related public funding – is arguably a necessary condition for sufficiently large reputational costs to materialize if governments deviate from their own commitments or fail to deliver on announced objectives. Second, international agencies are also excluded. Their surveillance responsibilities are often too broad to generate the kind of reputational costs a national body with a specific fiscal mandate can deliver; they lack the local anchorage needed to effectively influence the national policy debate through continuous interaction with policymakers and a deep understanding of political customs; and they are not expected to fully internalize the objectives of the government in office. In sum, full ownership of the institution is necessary for effectively shaping the national public debate and fostering accountability, a point formally illustrated by Debrun (2011) and emphasized by Kopits (2011) as part of best practice. Finally, we do not treat audit institutions as FCs. Although they contribute to democratic accountability and transparency, their approach is essentially backward-looking and legalistic, as opposed to the primarily forward-looking and economic work of FCs.

The issue of independence from politics is less clear-cut. The notion of independence as it is used and undertsood in the case of central banks calls for explicit guarantees against any type of interference by elected officials on the bank's actions within the limits of its mandate. While such guarantees are desirable for fiscal councils as well, the absence of *de jure* independence does not exclude considerable *de facto* autonomy. Indeed, FCs, unlike central banks, are not expected to have actual decision-making responsibilities or to be able to impose hard constraints on policy choices, which reduces the immediate reward of regular interfering for the government. That said, *de facto* independence is unlikely to survive repeated divergences of views between elected officials and the FC, especially if the latter has some direct leverage on the conduct of fiscal policy through high-impact normative analysis and recommendations, or the provision of forecasts. The experience with the High Council of Finance (HCF) in Belgium is telling in that respect (Coene and Langenus 2011).

In the remainder of this paper, we review key features of actual (or in-the-making) institutions across continental Europe that have been (or can be) commonly classified as fiscal councils. We identified 15 FCs in 12 countries (Belgium and Slovenia each have two separate FCs, according to our definition). This includes the defunct Hungarian fiscal council and the FC being created in Portugal. Other countries – for instance Slovakia – are currently fairly advanced in their reflection on the introduction of FCs. In our survey, we make a distinction between the "veterans" and the new generation of councils.

Veterans vs. the new generation?

The veterans are relatively old institutions, the "dean" being Belgium's High Council of Finance, created in 1936 to advise the Ministry of Finance. The HCF has since then considerably evolved along with the transition towards federalism in a context of sustained fiscal consolidation. HCF's new responsibilities include recommending specific borrowing limits for subnational entities consistent with Belgium's commitments under the EU convergence and stability programs. Other veterans in our sample are the Belgian Federal Planning Bureau, Denmark's Economic Council, the German Council of Economic Experts, the Netherlands' Bureau for Economic Policy Analysis, and Slovenia's Institute for Macroeconomic Analysis and Development. New institutions have emerged since the late 1990s, starting with the Swedish Fiscal Policy Council, Austria's Government Debt Committee – created in 1970, but which received new responsibilities in 2002 – and more recently, numerous Fiscal Councils in Central and Eastern Europe (Bosnia-Herzegovina, Hungary, Romania, Serbia, and Slovenia) and in Portugal.

A natural question is whether the new generation is fundamentally different from the veterans. The design of these institutions may have been influenced by the intensifying academic debate on their potential role in improving the conduct of fiscal policy (von Hagen and Harden 1994; Eichengreen, Hausmann and von Hagen 1999; Calmfors 2003; Fatàs et al. 2003; and Wyplosz 2005 to cite the most prominent contributions) but also by the experience with setting up polit-

ically independent agencies in other policy areas such as central banking and various regulatory or supervisory responsibilities. After screening publicly available information on fiscal councils (mainly the European Commission's surveys of 2005 and 2009 on "fiscal institutions" and national sources), only a few notable differences emerge between the two groups.

Looking at the remit, all FCs under review are mandated to provide independent positive assessments of fiscal policy (Figure 2). A majority of them are also required to analyze long-term sustainability and either to assess the quality of macroeconomic and/or budgetary forecasts or to prepare such forecasts themselves. However, only Belgium, The Netherlands and Slovenia generally (or are obliged to) use these forecasts for budget preparation.[2] Interestingly, newer institutions are less frequently involved in forecasting, in part because they are often lean in terms of staffing (see below). Checking compliance with national or supranational fiscal policy rules is a fairly common task assigned to FCs on the European continent, particularly among the new institutions, pointing to a growing perception that rules and institutions are complements rather than substitutes.[3] This is in contrast with a number of early papers advocating the introduction of FCs and IFAs to replace ineffective rules (e.g., Wyplosz 2005 and Fatàs et al. 2003). Normative assessments and policy recommendations are only required from one half of all councils (regardless of their age). FCs are rarely involved in coordinating budgets among government entities. Finally, newly established councils are more often tasked to score specific measures than older agencies, perhaps reflecting a greater awareness of the importance of transparency in policymaking.

The channels through which councils can influence fiscal performance vary widely, ranging from informal or technical advice to public communications and formal procedures specifically aimed at magnifying the reputational and political costs of deviations from ex-ante commitments. In line with theory, relatively "soft" channels of influence – public reports and analysis – clearly seem preferred to "harder" channels whereby the council's activity creates an obligation for the government, such as public explanations of policy slippages or biased forecasts, and the possibility for the council to access elected representatives through formal hearings in Parliament. The latter feature is more prominent in recent councils, possibly to compensate for the lack of pre-existing reputation and the correspondingly lower visibility of (and lesser public trust in) their work. Indeed, veteran councils generally enjoy significant media impact which helps them influence the public debate on fiscal policy (Figure 3).

Figure 2

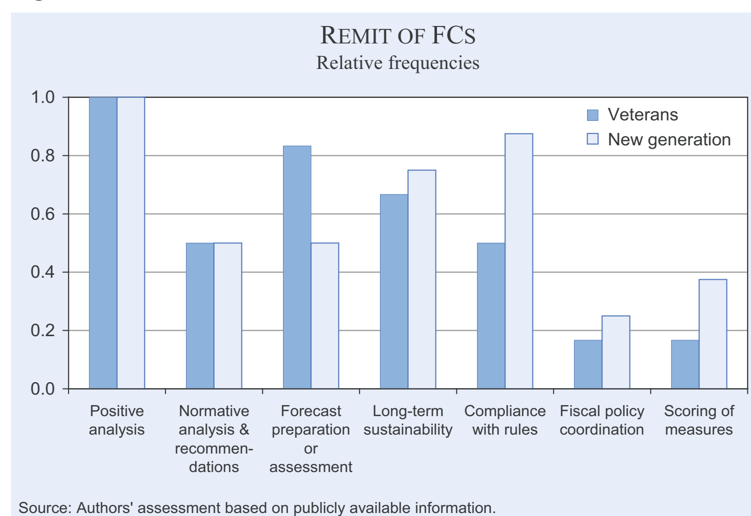
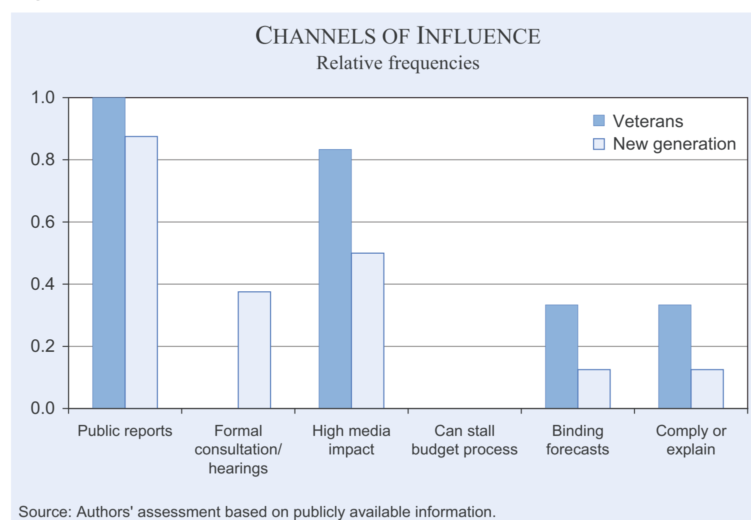


Figure 3



[2] Jonung and Larch (2006) show that independent forecasts reduce the risk of an optimistic bias.

[3] Numerical rules provide simple guideposts facilitating assessments by the FC. Conversely, the existence of an FC may help in the implementation of simple numerical rules by providing an objective evaluation of the causes for deviations and eventually proposing options for remedial actions.

Still reflecting a revealed preference for soft influence, the new councils are rarely tasked to provide binding forecasts for budget preparation – again a reflection of their often parsimonious staffing – and governments are in general not compelled to formally respond to the council's assessments. Of course, such an obligation need not be enshrined in law and can emerge spontaneously, as the council's work progressively gains traction in the public. It is important to note that no FC is allowed to block the budget process in case a draft budget violates objectives or constraints the council is mandated to monitor.[4]

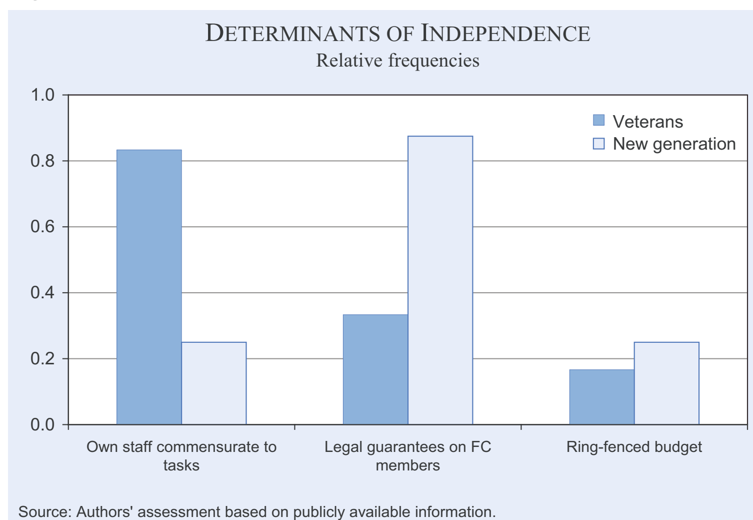
Turning to the degree of political and operational independence, we looked at three dimensions: the existence of legal guarantees similar to those in place for central banks (e.g. long, non-renewable tenures for the council's management, prohibition of political activities prior to the appointment, etc.), the appointment and retention of dedicated staff commensurate to the tasks of the council and secured multi-year financing (Figure 4). The latter dimension is particularly important because, unlike central banks, FCs cannot generate significant own revenues. And it is indeed through financial starvation that certain governments – in Sweden and most egregiously in Hungary – have attempted to curtail (or virtually eliminate) their FC. Only a handful of FCs enjoys some form of guaranteed financing, most likely a manifestation of elected policymakers' natural reluctance to permanently cede too much influence on the discretion to tax and spend.

Regarding the other dimensions of independence, there appears to be a sharp contrast between the veterans and the new generation. While the latter rely more on legal safeguards, the former count on the expertise and size of their staff to continue to influence the budget debate. Of course, this stylized fact is more a reflection of history than of an ex-ante trade-off between adequate staffing and legal guarantees of independence. Ideally, the two should go hand in hand, as was the case for the Hungarian FC.

A key question is whether certain combinations of those features are more likely to improve fiscal performance than others. Assessing the effectiveness of FCs is clearly beyond the scope of this paper and existing attempts are rather unconvincing. It is indeed vexingly difficult to test the impact of FCs on fiscal performance. Not only the small size of the sample severely impedes a rigorous statistical analysis, but the subtle and varied ways in which a fiscal council can shape policy outcomes dramatically complicates attempts to quantify its influence on the conduct of fiscal policy. To end on a positive note, the good news for researchers is that as more FCs are likely to emerge, the universe of potentially interesting case studies will expand significantly.

[4] This was a feature of a first proposal of the Hungarian FC. According to the proposal, the council would have had the right to prevent – through a rubber-stamp ruling of the constitutional court – that a draft budget deemed inconsistent with the overarching principle of budget responsibility be tabled in parliament.

Figure 4



Conclusions

Fiscal councils have been a fairly old fixture of budget institutions in some countries of continental Europe. While academic curiosity and the recent policy debate on ways to maintain or regain fiscal credibility have revived interest in them, the newcomers have little to do with the independent fiscal authorities imagined in academic circles as a substitute for ineffective numerical fiscal rules. This paper has presented descriptive evidence that the newly established councils are not radically different from their ancestors, except for the stronger legal anchorage (most notably in terms of formal guarantees of independence), a tendency to limit their size to a

strict minimum and an explicit mandate to monitor compliance with numerical fiscal rules.

Our discussion rejoins Kopits (2011) views on an emerging best practice in setting up effective FCs: (i) they should be fully owned by the local political sphere in terms of their objectives and modus operandi, (ii) they should have their own staff and ring-fenced long-term resources, (iii) their management should enjoy formal guarantees of independence from elected officials, and (iv) their remit should be strictly limited to informing budget preparation and fiscal policy formulation. Looking forward, limited resources available to create new institutions could be a constraint on FCs operational independence and effectiveness, especially if the corresponding appropriations are not adequately ring-fenced or if extra-budgetary resources (e.g., a claim on central bank's seigniorage) are not available.

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