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OVERCOMING DEFICIT BIAS:
THE ROLE OF FISCAL POLICY COUNCILS

Por

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Biography Note

Miguel Queiró Pedroso de Lima was born in Coimbra on the 29th of September, 1988. He completed his undergraduate degree in Economics at the Faculty of Economics of the University of Coimbra in 2009. Since then, he has been enrolled in the Masters Program in Economics at the Faculty of Economics of Porto, specializing on Competition and Regulation. The present essay is his Master's Dissertation. Presently, he is working as an analyst in the Payment Systems Department of Banco de Portugal.

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Abstract / Resumo

In a number of developed countries, lack of discipline in domestic fiscal policy has been driving sovereign debt to unsustainable levels. The combination of severe political failures and ineffective budgetary rules has allowed the establishment of lingering fiscal deficits that must be eradicated. In this paper, the causes of fiscal indiscipline as well as the role of some institutional mechanisms aimed at controlling them are analyzed, and it is argued that independent fiscal agencies are suitable complements to rules and regulations. These independent agencies are divided into independent fiscal authorities and fiscal policy councils. With a greater focus on the euro area, this work surveys the literature for explanations of how independent fiscal agencies – councils in particular – may help avert fiscal profligacy. Existing councils from a handful of countries are presented and some lessons are drawn from their recent experiences. The conclusion drawn is that the impact of these agencies on policy is generally perceived as positive and significant.

Presentemente, a acumulação excessiva de dívida pública é uma verdadeira ameaça à sustentabilidade financeira de muitos países desenvolvidos. Na base do problema está o estabelecimento generalizado e prolongado duma cultura de indisciplina orçamental nos órgãos de decisão que alimentou a criação de défices crónicos. Concretamente, a indisciplina orçamental resulta duma panóplia de falhas políticas e da ineficácia das regras orçamentais. Neste trabalho são analisados quais os melhores mecanismos institucionais para garantir a disciplina orçamental e conclui-se que um bom complemento às regras orçamentais serão as agências orçamentais independentes. Estas podem ser subdivididas em autoridades orçamentais independentes e conselhos de finanças públicas. Enfatizando o caso dos países da área do euro, este trabalho procura na literatura económica explicações acerca da forma como estas agências – particularmente os conselhos – podem contribuir para o rigor orçamental. São apresentados alguns conselhos e são retiradas lições das suas experiências recentes. Conclui-se que os impactos destas instituições na política orçamental são, de um modo geral, tidos como positivos e significativos.

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1. Introduction

Over the past 40 years, the sovereign debt[1] of the member countries of the Organisation for Economic Co-operation and Development (OECD) have suffered a significant increase from about 30 to 90 percent of total Gross Domestic Product (GDP). This astonishing debt escalation in developed countries is unprecedented. In value, public debt in these 34 countries totalled more than 39 trillion dollars in 2011[2].

A major concern about this trend is that, unless it is reversed soon enough, it may eventually result in a collapse of the global economy. The world seems to have forgotten a basic principle, which is that debt must be repaid. Fiscal laxity and procrastination have led to a situation that is beyond alarming – it is now absolutely urgent as it may assume uncontrolled proportions sometime in a near future. After the end of the 1990s economic boom and the 2008 world crisis, growth has cooled in the developed world, which means that a collapse of the global economy is now more likely if developed countries start defaulting on their sovereign debt.

In the particular case of the European Economic and Monetary Union (EMU), the recent events in Greece and Portugal must be recognised as a serious indication of how important it is to quickly address the debt issue in a concerted manner. These countries recently entered a debt spiral: as they started borrowing in order to pay interests owed from prior debt, their interest rates in capital markets rose to unbearable levels, forcing them to ask for international financial bailouts. However, these events were the culmination of a long history of lack of fiscal discipline and macroeconomic imbalances; more specifically, a history of consistent budgetary deficits in public finances that often prevented compliance with euro area fiscal rules, a history of opacity in the accountability of public finances, and a history of not only provoking a sovereign debt crisis, but also endangering the stability of all other euro area member states.

Objectively, problems of excessive public debt are primarily up to policy-makers to solve. Therefore, a strong wave of political will towards resolving debt is vital. In

[1] Sovereign debt corresponds to a country's aggregate general government gross financial liabilities.
[2] According to OECD statistics, in 2011 estimated GDP in the OECD area was approximately 43 524 480 million dollars (43,5 trillion) – See http://stats.oecd.org/Index.aspx?DatasetCode=SNA_TABLE1.

addition, it is necessary to unveil the causes of this fiscal profligacy. Only by attacking its causes is it going to be possible to attain fiscal sustainability. Thus, effective solutions to discipline fiscal policy have to be set up. This is the only viable way of re-establishing a stable and growth-enhancing macroeconomic environment.

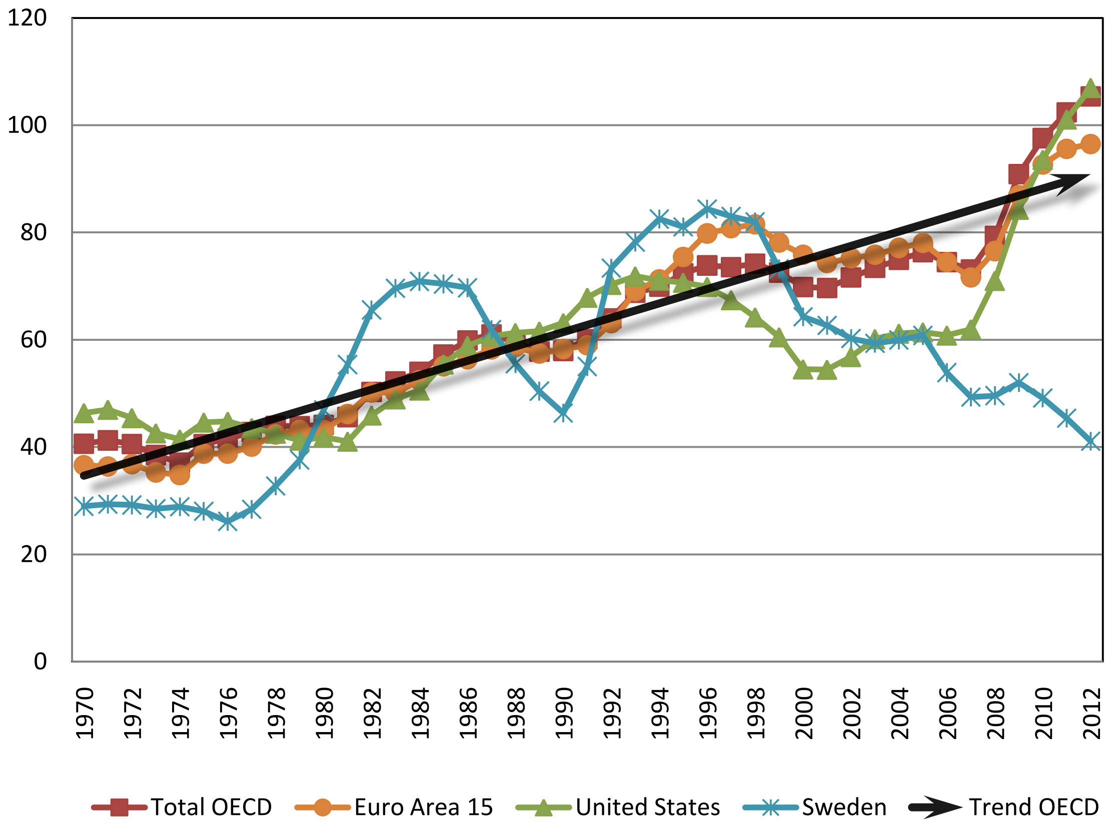
The purpose of this work is to contribute to the clarification of the reasons behind and solutions to the aforementioned fiscal policy problems. To achieve this, the fiscal landscape will be depicted – especially with regards to the euro area – and its problems identified; then the failure of current institutions will be discussed and new and more efficient ones proposed. The work is organized as follows: Chapter 2 describes the causes of the deficit bias; Chapter 3 describes the pros and cons of rules in overcoming the bias as well as how those can be complemented by other institutions, notably independent fiscal agencies; Chapter 4 discusses the theoretical underpinnings of independent fiscal authorities and fiscal councils; Chapter 5 draws from the experiences of existing fiscal policy councils, namely by exploring their major challenges and gains. At the end, some final remarks will be put forth.

2. Bias in fiscal policy

In the last 40 years, fiscal policy-making in most democracies has been inherently biased towards budgetary deficits. In general, a deficit bias in public finances occurs when the government's expenditure repeatedly exceeds its revenues.

Most of the time, budgetary deficits are financed by issuing public debt. Therefore, as a result of deficit bias, industrialized countries have been experiencing an increasing accumulation of sovereign debt. Many economists repeatedly describe the current indebtedness of developed economies as excessive and harmful in terms of the societies' welfare. Excessive government debt accumulation is typically against the long-run interest of voters.

Figure 2.1 – General government gross financial liabilities (%GDP), 1970-2012

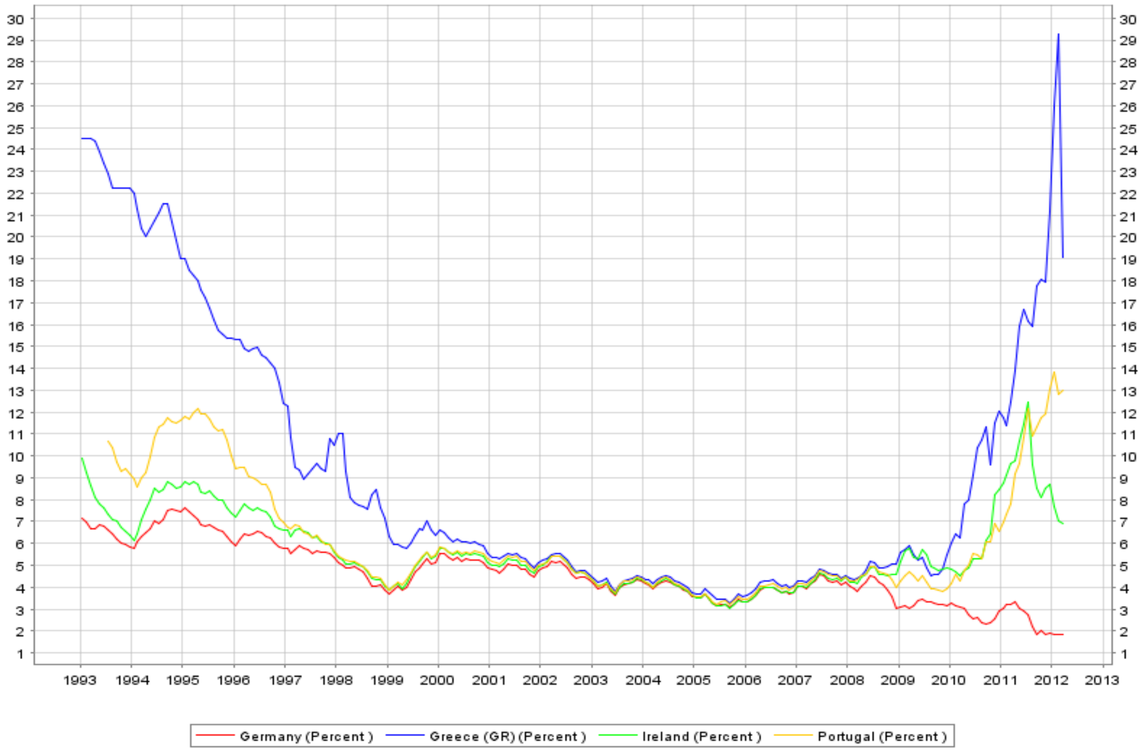


Source: OECD (2011) – Dataset: Annual Projections for OECD Countries

Figure 2.1 depicts the notorious upward trend in the OECD countries' debt. The general debt build-up observed in the OECD has not been equal from one country to another. For example, as illustrated in the figure, while the United States continues procrastinating budget consolidation efforts, in Sweden, the governments have been changing policies, procedures and institutions to overcome the Swedish deficit bias since the mid-1990s. Anyhow, in four decades, the average debt-to-GDP ratio in OECD countries rose about 60 percentage points. Nevertheless, the recession in the aftermath of the financial crisis in 2008 has played an important role in the expansion of debt, being true that the effects of which could have hardly been anticipated or controlled.

The latest and more paradigmatic cases of excessive and punitive indebtedness are the ones of Greece, Ireland and Portugal. In 2010, the financial crisis triggered a sovereign debt crisis in Greece, which was then followed by both Ireland and Portugal. All three countries share the same currency, the Euro, which was launched in 1999 within the EMU and includes another 14 member states of the European Union (EU).

Figure 2.2 – Harmonized long-term interest rates (percentage), 1993-2012



(Percentages per annum; period averages; secondary market yields of government bonds with maturities of close to ten years)

Source: ECB (2012a) – SDW dataset: Interest rate statistics

Figure 2.2 shows the long-term (10 year) interest rates in the secondary market for government bonds of Greece, Ireland, Portugal and Germany. One noteworthy observation is that, since the beginning of the Euro, the peripheral countries – Greece, Ireland and Portugal – have benefited from interest rates nearly as low as the ones of 'well-behaved' countries in the euro area, like Germany. A second remark is that before 1999, interest rates for Germany were markedly lower from the ones of the three countries. Hence, a reasonable *ex post* interpretation may be that, after 1999, markets should not have charged Greece, Ireland and Portugal the same interest rates as those of Germany solely because the four of them then belonged to the EMU. A likely reason for this homogenization between 1999 and 2008 was the general belief among both rating agencies and investors that all euro area countries' debt involved similar risks.

Unfortunately, the benefits of low interest rates have been taken advantage of by a number of undisciplined countries. These nurtured the vicious habit of constantly borrowing at low prices which did not reflect the true health of their public finances. In the aftermath of the financial crisis the capital market began to increasingly discredit the Greek economy, and later the Portuguese. The Irish case is somewhat different since it was only after the 2008 financial crisis that the Irish debt escalation took place. Instead of a budgetary crisis, Ireland faced a severe banking crisis that culminated in the nationalization of banks and the State's assumption of their liabilities. Only after the collapse of the banking system did Ireland have the need to borrow increasing amounts of funds from capital markets. After diminishing its public debt from 82 to 26% of GDP between 1995 and 2006, Ireland has had an astonishing amplification of debt reaching almost 110% of GDP in 2012 (see Figure 2.3).

The sustainability of these countries' sovereign debt and the soundness of their public finances (and also of the financial system in the Irish case) have since been questioned, and a sense of unpredictability about their future grew among investors in the capital market. In general, investors have become less confident in the capability of governments to repay their public debt, and that was aggravated when these countries started to enter the dangerous vicious cycle of issuing new debt to repay prior debts and interest. Therefore, the risk *premia* associated with their additional credits rose at a considerable pace.

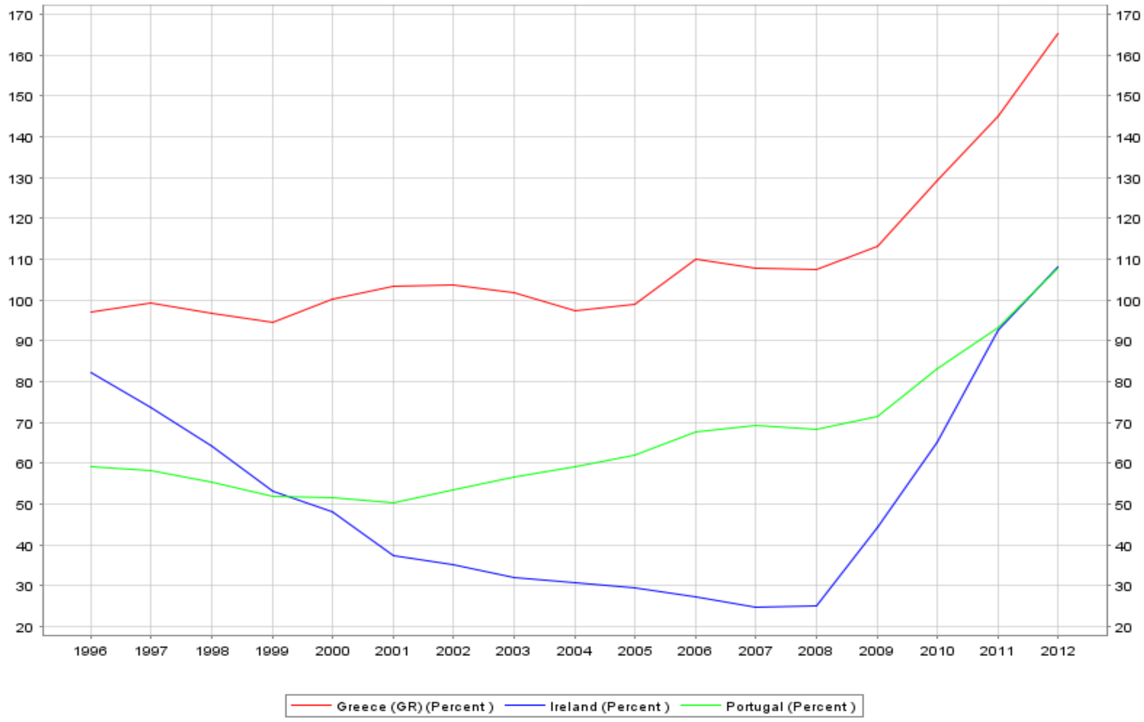
The remarkable rise in interest rates depicted in Figure 2.2 was a clear reaction to the apprehensiveness of investors in face of the growing probability of bankruptcy of Greece, Ireland and Portugal. In April 2010, Greece was forced to formally ask for the EU/International Monetary Fund (IMF) financial rescue. Ireland later did the same in November, and Portugal in April 2011. Hence, as can be observed in Figure 2.2, 2010 was a critical year, in which the long-term interest rates in the secondary market for government bonds shot up in Greece as well as in Ireland and Portugal. In Greece, however, the market turmoil continued to increase sharply throughout 2011 and up until the 21st of February 2012, when the private sector creditors agreed on a 53,5% haircut on the value of their Greek government bonds, swapping them into new bonds with a 3.65% interest rates and a maturity of 30 years. In addition, previously in July 2011, the leaders of the euro area had approved a further comprehensive package of measures to help Greece get back on track.

All three countries have to now fulfil formal fiscal consolidation agreements with their international creditors. The memorandum of understanding signed between each country and the international creditors dictates severe expenditure cuts and increases in revenues, both in the short and the medium to long terms, and imply a wide array of reforms, most of them structural, ranging from restructuring health and pension systems to liberalizing the labour market. This consolidation effort is the only viable way to restore the soundness in public finances required to foster domestic competitiveness and economic growth.

Even though it was the 2007/08 financial crisis that was the trigger of the sovereign debt crises, what really led Greece and Portugal into a debt trap was, essentially, the continued increase of their expenditure during the last three or four decades hardly had a corresponding adjustment in terms of tax intakes. All credits have to be repaid someday, yet this did not scare or deter successive governments in those countries from relentlessly borrow. As may be observed in Figure 2.3, in Portugal, the public debt rose from approximately 60% to 108% of GDP since the mid-1990s. In Greece, the increase was from 97% to 165% of GDP[1] [OECD (2011)].

[1] The latter figures already account for the IMF-EU financial rescue package corresponding to 2011.

Figure 2.3 – Public debt in Greece, Ireland and Portugal (%GDP), 1996-2012



(Percentage points, series(t)/GDP(t); all sectors without general government (consolidation) (ESA95) - Financial stocks at nominal value)

Source: ECB (2012b) – SDW dataset: Government Statistics

A systemic problem of indebtedness was thus installed in these small economies that, in combination with procrastination in introducing needed fiscal consolidation reforms, resulted in a crisis. The sovereign debt crises in Greece and Portugal were like the eruption of a scorching volcano that had been repeatedly fed with embers. Nevertheless, even though these two countries came first, they are not the only ones infected by a deficit bias and excessive debt problems. If fiscal behaviours are not changed in several OECD countries, their 'volcanoes' will probably also 'ignite' sooner or later. The recent developments in the capital markets for Spanish, Italian and Cypriot government bonds are confirming these fears.

Fiscal discipline and sound public finances are vital to create a stable macroeconomic environment that fosters potential and sustainable growth. Conversely, lax fiscal conduct is a major determinant of excessive indebtedness[2]. In distinguishing between a disciplined and an undisciplined government, four major aspects stand out.

[2] See, for example, Wyplosz (2002), Reinhart and Rogoff (2010), Calmfors (2010a), von Hagen (2010).

First, a disciplined government conducts discipline-enhancing countercyclical fiscal policies and combines the use of fiscal discretion with the role of automatic stabilizers. In contrast, undisciplined governments conduct procyclical policies instead – expansionary, for the most part, during economic upswings. Accordingly, undisciplined governments do not save or decrease their levels of debt in good times in order to gain leeway in bad times. Therefore, in face of negative shocks, unprepared governments may find themselves unable to use fiscal discretion as a complement to automatic stabilizers.

Procyclical behaviours during good times often result from the inability of governments to control their spending and/or increase taxes when needed. Eventually, this kind of conduct necessarily intensifies budgetary deficits. In a number of EU Member States, for example, the prevalence of procyclicality in good times has contributed significantly to major unsustainable increases in the stocks of public debt [European Commission (2006a)]. Hence, if policy is not countercyclical during upswings, public debt may ascend to levels that may force governments to suddenly adopt severe measures – like abruptly raising taxes and/or cutting spending – even if doing so exacerbates the effects of a recession. Greece and Portugal, given their excessive sovereign debts, are recent examples on how procyclical policies are truly unsustainable in the long run and may cause serious bottlenecks in the economy.

Along this vein, a second major aspect distinguishing a disciplined government from an undisciplined one is that only the former is truly concerned about the long-run sustainability of public finances. Thus, fiscal discipline implies that fiscal policy should allow for enough short-run fiscal flexibility while respecting the intertemporal budgetary constraint. Furthermore, a disciplined government would not permit a continuous rise of public debt, and when high debts are too much of a burden, it would compromise to bring the debt down to more comfortable levels [Wyplosz (2002, 2005)]. On the contrary, undisciplined governments often preclude long-term sustainability concerns from the usual course of their short-term fiscal policy-making. Fundamentally, these governments do not (want to) restrain their levels of public debt. Ultimately, the mix of stubborn deficits and increasing debt resulting from indiscipline undermines macroeconomic stability and sustainability.

To clarify what fiscal sustainability stands for, it is useful to refer to the work of the European Commission (EC). The EC claims that a country's sustainable fiscal position is one where, given current policies and projected budgetary trends, the country is able to meet its intertemporal budget constraint and still continue to comply with the budget rules in force [EC (2010a)]. In turn, respecting the intertemporal constraint implies that a government ensures today that in the future the country will manage to have sufficient budgetary surpluses to service debt and to be solvent, i.e., to have the ability to meet its current and future financial obligations. Nevertheless, the intertemporal constraint is necessary but not sufficient for sustainability; other factors are important as well. For instance, the relation between the primary balance and public debt, the analysis of the debt-ratio trend (sustainability concerns are completely different when debt is receding from when it is increasing) and the fiscal adjustment needed to stabilize or reduce the debt-ratio are all aspects that must be considered when discussing the sustainability of public finances [Celasun et al. (2006)]. Furthermore, apropos the importance of budget sustainability, one can compare a governmental budget to an individual budget: anyone who persistently spends more than s/he earns, with no view to reversing the situation, will eventually be declared bankrupt. Facing a similar situation, and assuming bankruptcy is not an option, a government has to choose: either it raises taxes substantially, thus burdening future generations, or it allows inflation to rise significantly, diminishing the value of the public debt but also of savers' wealth[3]. As both outcomes are largely undesirable, budget sustainability concerns should therefore be seriously considered as a chief criterion governing fiscal policy [Wren-Lewis (2003)].

A third contrasting aspect concerns prudence. A disciplined government typically strives to reduce fiscal imbalances in order to guarantee the soundness of public finances in the medium and long run. Prudence in fiscal policy is advisable in order to promote a stable and sustainable macroeconomic environment. Besides, fiscal policy-makers should be prepared for unexpected contingencies in the short-term by amassing a satisfactory level of precautionary savings [Calmfors (2010a)].

[3] Even though, this is not an option for euro area countries.

The last difference concerns intergenerational equity or, in other words, an equitable distribution of welfare across generations. In the event of a growing need to borrow, a disciplined government would question if it is legitimate to shift tax burdens on to future generations or if an alternative path should be found. A traditional argument against high debt is that it may place an unfair burden on future generations. Notwithstanding, as Musgrave (1988) notes, if contemporary voters do not sufficiently care about future generations, then they may elect governments that will exploit them. Therefore, in this case, the government is not the only agent being selfish and undisciplined but, there are also citizens who are impatient and greedy.

Given the propensity for indiscipline in many developed economies and how unsustainable that may be, it is necessary to design feasible measures to counteract it. Before searching for solutions, one first has to uncover the roots of the problem. The current literature lifts the veil on a number of issues related to the problem of deficit bias and its underlying causes. To understand these phenomena we must recall some topics in political economy. In what follows, the most important causes presented in the literature will be listed, such as issues related to the common-pool of resources, time inconsistency and impatience, political failures, over-optimism and other explanations.

(i) Common-pool problems. Several authors link common-pool problems to budgetary deficits and other fiscal imbalances. Among them are von Hagen and Harden (1994), Eichengreen et al. (1999), Calmfors (2005), Krogstrup and Wyplosz (2006, 2009), Debrun et al. (2009) and von Hagen (2010). Some conclusions can be drawn from their work on this subject.

Common-pool problems – or "tragedy of the commons" as was first called – play a central role in deficit bias[4]. When there is political fragmentation, that is, several decision-makers involved in the budget process (e.g., unthrifty ministers, lobby groups and/or parties in a coalition government), they compete for their preferred public goods but they do not internalize the current and future costs associated with their choices. These costs typically entail deficits and additional debt and, therefore, higher taxes to repay them.

[4] The seminal work about the commons problem is Hardin (1968).

The commons problem occurs when various interest groups lobby in favour of expenditure increases or tax decreases to their own benefit, disregarding the economy-wide effects. In this case, some interest groups and constituencies view government revenues as a common pool of resources open to competing demands. In addition, the common-pool problem can also be defined as an externality - while the benefits of additional expenditure are enjoyed only by specific groups, all tax-payers will have to finance it and, hence, the beneficiaries only pay for a small part of their benefits. Thus, without a mechanism to coordinate the actions of these interest groups, the pressures from lobbyists can result in excessive spending and, given that raising taxes is always politically difficult, excessive deficits.

Common pool problems and procyclicality are not unrelated. During good times, the government faces pressure from constituencies in order to spend extra revenues for their own benefit and not according to the preferences of society as a whole. As a result, revenues tend not to be used to improve the government’s fiscal position during upswings, and as this position always worsens during downturns, a rise in public debt may become unavoidable. The relationship between the commons problem and procyclicality can also be presented in a dynamic context. Some authors believe that intertemporal distortions may lead governments to squander the benefits of economic booms. In essence, different groups have an incentive to grab all the resources they find if they fear that other groups may anticipate the boom and do the same. This attitude tends to lead to the immediate dissipation of any additional resources a government happens to have at its disposal, rather than these being carried over as public savings.

(ii) Time inconsistency and impatience. The time inconsistency of preferences is another major explanation for the deficit bias plaguing the public finances of many modern economies[5].

The decision-makers’ commitment to optimal, medium-term fiscal plans holds little credibility, much in the same way as in monetary policy. Thus, time inconsistency happens when policies that were optimal *ex ante* – when private sector expectations were formed and actions were taken accordingly – are no longer so *ex post* – after the

[5] The seminal work about time inconsistency is Kydland and Prescott (1977).
See also, for example, Alesina and Tabellini (1990) for an early formalization of the problem and Beetsma and Debrun (2004, 2005) for its application in fiscal policy.

actions of the private sector. One example of time inconsistency in fiscal policy is straightforward: *ex ante,* governments usually acknowledge that countercyclicality is optimal and formulate the budget accordingly, namely aiming at budget consolidations during expansions in order to have sufficient leeway to adopt countercyclical measures during downturns; however, during economic upswings – that is, *ex post* – governments have strong incentives to undervalue countercyclicality and fail to pursue the *ex ante* optimal policy – consolidate the budget – in order not to damage their electorate. Hence, if countercyclicality is not preserved, that is, if in good times fiscal policy does not compensate for the larger deficits run in times of recession, then debt will increase over the business cycle [von Hagen (2010)][6].

Not infrequently, governments find it more rewarding to deviate from their pre-announced fiscal policies rather than sticking to them. Even if governments anticipate some long-term costs, the circumstances may tempt them to reach some short-term policy goals that require the adoption of deficit-enlarging measures. This attitude is often referred to as the 'impatience of governments' in view of the fact that they may discount the long-term costs at a higher rate than the electorate because they fear losing at upcoming elections. Consequently, before elections, a government may have incentives to boost its popularity with the electorate by running expansionary fiscal policies which would eventually result in larger deficits and additional debt. In this way, the impatience of governments helps explain why time inconsistency may be present in medium-term fiscal plans. More specifically, after a plan has been announced, the government's mindset shifts mainly to the short-term; that is, the governments' concept of fiscal optimality shifts from the distant to the near future thus precipitating the deviation from the pre-announced policies.

Besides impatience, a closely related explanation for excessive debt accumulation is short-sightedness or present-bias. Typically, a person's discount rate denotes impatience. People prefer immediate rather than delayed rewards. In addition, people's impatience is bigger facing short-run rather than long-run trade-offs. These sets of preferences can lead to sub-optimal behaviours. Applied to ('naïve') policy-makers, this kind of preferences may result in procrastination: they often postpone raising tax

[6] Besides von Hagen (2010), there are several other studies devoted to time inconsistency, namely Calmfors (2005), Rogoff and Bertelsmann (2010) and Calmfors and Wren-Lewis (2011a).

revenues to cover expenditures. Policy-makers often (purposely) forget that at some point in the future a larger sum of debt will have to be serviced. Such delays may force public finances to a stage where, to raise sufficient revenues, the introduction of economically damaging tax rates is inevitable.

A last insight on time inconsistency in fiscal policy is from Castellani and Debrun (2005), who argue that monetary policy delegation to independent central banks (ICB) in order to solve problems of time inconsistency may end up in merely moving time inconsistency from monetary to fiscal policy. The explanation is simple. If the central bank induces monetary restraints (i.e., operations aimed at diminishing inflation and achieving price stability), then inflation decreases, unemployment increases and incentives are created for the government to engage in expansionary fiscal actions to offset these recessive effects. This will probably result in amplified government spending (or diminished revenues), which, in turn, would enlarge budgetary deficits.

(iii) Political failures. Fiscal indiscipline is the result of political failure. Many researchers argue that deficit bias is the result of a political set with perverse incentives, notably disrupted by a wide array of strategic behaviours of elected politicians. A number of these failures have been identified in the literature.

A political failure often pointed out is the strategic use of debt by governments. Typically, governments in power do not completely internalize the costs future governments will bear servicing the public debt issued in the current legislature [Krogstrup and Wyplosz (2009)]. Such a situation creates perverse incentives to current governments as it makes issuing debt less costly than otherwise. Hence: "*Disagreement amongst alternating policy-makers and uncertainty about who will be appointed in the future prevent the current government from fully internalizing the cost of leaving debt to its successors*" [in Alesina and Tabellini (1990), p.404]. Besides, from this fact it can also be deduced that the lower the re-election chances of the current government, the bigger its incentives to use debt strategically to affect the activity of the next one. Accordingly, when re-election chances are low the stock of public debt tends to be larger than the social optimum. Thus, in these cases, political failure is characterized by the non-coincidence between the governments' preferences and the average citizens' preferences.

Another form of governments' misuse of debt relates to electoral strategy. If two parties, alternating in government, have different spending preferences, the one in government may have incentives to build-up the stock of public debt in order to pre-commit the other on its future level of spending. For this reason, a government can use debt service to strategically crowd out spending from the subsequent legislature [von Hagen (2010)]. As a consequence, governments become successively stuck with excessive levels of debt and the public finances' imbalances persistently deteriorate.

In addition, Rogoff (1990) identified the existence of political budget cycles in fiscal policy. These arise from the coincidence of elections and economic policy cycles and help explain the deficit bias of modern democracies. Their existence is mainly justified by the incumbent government's necessity of signalling competence and efficiency near the electorate. Therefore, during election years, all levels of government boost their consumption. Besides, typical election frameworks may include other policy changes that necessarily increase budgetary deficits, such as tax cutbacks, larger transfers and highly visible projects supported by government spending.

An additional important political failure may occur at the end of the legislature when the political parties in power, particularly those that are about to lose elections, start to favour their own constituencies [Calmfors (2005)][7]. Moreover, a related hypothesis sometimes put forward is that the shorter the term of office in government and the more rapid the political turnover, the higher the deficits and debt are. A possible reason for this is that in short-lived governments, politicians tend to overestimate the benefits of spending and consumption [see Grilli et al. (1994) and Rogoff and Bertelsmann (2010)].

(iv) Over-optimism problems. A further problem plaguing fiscal policy that is mentioned in the literature is over-optimism [e.g., Reinhart and Rogoff (2010), Rogoff and Bertelsmann (2010) and Calmfors and Wren-Lewis (2011a)].

Over-optimism can be defined as the belief often held by politicians and the electorate that the future will be brighter than the present. Over the years, over-optimism has fostered behaviours that lead to debt and banking crises. The underlying

[7] However, the view that this kind of uncertainty over re-election usually results in deficits is controversial. For instance, Roubini and Sachs (1989) find some support for this theory while Lambertini (2003) does not find any.

reason is that people and governments are comfortable with overspending and borrowing given that they believe in a more prosperous future in which they are going to be able to repay their debts. Moreover, when a government has overly optimistic beliefs about some key macroeconomic variables – growth, for example – some budgetary plans, dependent on the evolution of such variables, may not turn out as expected. For instance, tax revenues may persistently remain below expectations resulting in deficit creation/enlargement. Nevertheless, the need for short-term financing often overlaps the deficit-constraining concerns. The underlying rationale is based on the belief that future generations will be richer and, thus, it is acceptable to borrow more today to smooth consumption across generations. Thus, over-confidence can be interpreted as a psychological phenomenon that results in people believing all things will remain stable in the future. This impels them to make poor judgments under conditions of uncertainty. Hence, over-confidence often results in people – and governments – under-saving and under-insuring, which makes it another important determinant of deficit persistence.

Jonung and Larch (2006) look at governmental over-optimism from a different perspective. In their work, the problem is identified as the use of biased official growth forecasts in the budget process. Specifically, it is argued that in some countries, the projections of the macroeconomic variables used to build medium-term budgetary plans are recurrently over-optimistic in order to make the budget balance look better *ex ante*. When, *ex post*, the outcome is not satisfactory, governments often blame bad luck or extraneous circumstances. These biased forecasts then translate into fiscal actions that are more expansionary than would be the case otherwise, accelerating the accumulation of debt. On a similar note, Strauch et al. (2004) name some political economy explanations for errors in forecasting. Once again, elections (or the political business cycle) are one of the most influential sources of those errors. In a nutshell, incumbent politicians want to signal an overly healthy economy and budget balance to voters, issuing, for this purpose, over-optimistic forecasts. If the public believes the forecasts, it will appear that the government is doing well.

(v) Other explanations. The issues discussed above are only some of the most important political economy explanations for deficit bias. There are other relevant considerations surrounding this bias, two of which are delineated below.

Representative democracy presupposes that elected politicians will reflect their electorate's preferences in decision-making[8]. In turn, the very process of representation presumes that a large part of the electorate lacks some information about the functioning of the State. This discrepancy can thus be exploited: as voters are often unaware of the government's true fiscal position, they allow the government opportunities to run fiscal policy under political rather than economic criteria. This offers clear incentives for the government to create a political business cycle, namely to cut taxes or boost spending in order to increase its chances of re-election. In the end, since there is no equal incentive to raise taxes or cut spending, a deficit bias will follow [Calmfors and Wren-Lewis (2011a)].

Second, in most countries, the process of assembling the budget lacks effective mechanisms/procedures of control. The absence of appropriate rules, checks and balances within that process makes it difficult to channel policy-makers' incentives into fiscal discipline [Fabrizio and Mody (2006)]. The budget process is often decentralized, it is seldom audited from external entities and only a few countries have applied top-down approaches to it. This amateurism in the budget process has often resulted in over-spending and so helped fuel deficit biases. However, during the 1990s, some countries made efforts to centralize their budget processes, notably those that were torn by rather fragmented decision-making structures. Paradoxically, in many of them, these efforts gave rise to some budgetary coordination problems instead of resulting in a more effective elimination of spending biases. Along these lines, Hallerberg et al. (2006) further found that the type of government (namely if it is a coalition government or a single-party one) also influences the strength of fiscal discipline. Therefore, in some countries, the existence of coalition governments may have also contributed towards preventing the existent mechanisms/procedures of budget control from eliminating the persistent deficits and excessive indebtedness.

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[8] On the other hand, as Maskin and Tirole (2004) [p.2] ask, "(…) *if representatives decide for the public, what induces them to act in the public interest?*" There could be two motivations for the representative: he wants to leave a legacy and/or he values being in office for its own sake. So, "(…) *the public can harness these two motives by making the official accountable, that is, by requiring her to run for reelection every so often*". It is then possible that an elected representative will not maximize the average citizen's utility (roughly the same as social welfare) but rather its own preferences (or a mix of these two sets of preferences).

3. Overcoming deficit bias: rules vs. institutions

The unsustainability of persistent budgetary imbalances has been, since the end of the twentieth century, a major cause for institutional reforms in several countries. Since then, fiscal rules have been paramount in the domestic fiscal framework reforms. The IMF (2009) identifies an increasing popularization of fiscal rules during the 1990s, with their adoption growing more than ten-fold between 1990 and 2009.

One possible definition of rules comes from Kopits and Symanski (1998). They define rules as permanent constraints on fiscal policy that specify a numerical target or a limit for key budgetary aggregates such as the annual budget balance, expenditure, revenue, or debt. The primary objective of a rule is to enhance budgetary discipline. More specifically, however, fiscal rules may be seen as intermediate objectives in order to facilitate the attainment of more fundamental, higher-level objectives, notes Calmfors (2010b). Among these are long-run fiscal sustainability, social efficiency through tax smoothing (i.e., minimizing the distortionary costs of taxation, thus improving social welfare), intergenerational equity (i.e., equitable distribution of welfare across generations) and, lastly, precautionary savings, which is the same as being prepared for unanticipated contingencies both in the short and long run. All these aims can only be realised within a reliable fiscal environment, notably when governments are disciplined and truly represent social preferences. If this is not the case, and distortions cause fiscal policy to diverge from society's preferences, there are then reasons to introduce a fiscal rule [Milesi-Ferretti (2004)]. A fiscal rule, unlike the higher-level objectives, is a simple and well-defined benchmark against which fiscal policy can be judged in the short and medium terms. Rules give an intermediary objective to fiscal policy and permit the attainment of the more complex objectives in the long run.

One can find a number of *raisons d'être* of fiscal rules. One lies on the fact that, given that decisions on rules are independent from the governments' office terms, they may help offset the deficit bias that results directly from political short-sightedness and rent-seeking behaviours. Another rationale is that, as they do not change with different circumstances, rules also address the problems related to time-inconsistency. Besides, as noted by Calmfors (2010b), they offer an opportunity for agents to rise above the day-to-day struggle for resources and thus help to internalize the common-pool externality. Fiscal rules also play an important role in constraining perverse incentives of politicians when there is no political commitment to fiscal discipline (or it is insufficiently strong). Besides, in a transparent fiscal process and with fiscally committed politicians, numerical/quantitative fiscal rules can also improve fiscal performance [Hagemann (2010)].

The OECD has argued for the effectiveness of rules, notably by noting that countries that adopt well-designed fiscal rules may achieve better fiscal performance [OECD (2007)]. Even so, there is an unclear causality between rules and fiscal discipline. It is difficult to distinguish if governments are adopting rules because they were already disciplined and want to signalize it or, instead, if it is the adoption of rules that is leading to a stronger governments' commitment to fiscal discipline [Debrun (2007)]. Nonetheless, a crucial condition for a fiscal rule to be effective is that it needs to be well adjusted to the country's existing institutions and political system. Not everything is country-specific though; all countries share key common features when introducing rules that one can identify. First, transparency in the process of instituting rules is crucial, and it has to be combined with sufficient flexibility to face shocks. Second, rules must cover all the relevant budget items and, lastly, there must be effective enforcement mechanisms. Still, depending on the contingencies, some fiscal rules prove more effective than others. For example, fiscal deficit rules may be less effective than instrument-specific rules [Castellani and Debrun (2005)]. Additionally, rules in the form of deficit or debt ceilings may not restrain fiscal policy as effectively as one can imagine, as governments normally end up very close to the ceilings. This reflects a weak commitment to fiscal discipline and prudence as governments do not worry about creating sufficient leeway to overcome adverse shocks.

In addition, the effectiveness of rules depends mainly on the government's perception of the costs of breaching them. Implicit here is a major vulnerability of rules, which is that they can be (and routinely are) broken [Debrun and Kumar (2008)]. Besides, the more stringent rules are, the more incentives governments have to circumvent them and not comply with them. On the other hand, the more lax they are the more the government can undervalue fiscal discipline. Moreover, if simple, rules tend to be ineffective and if complex, they tend to be difficult to follow.

For rules to be optimal they have to be continuously and independently adapted to the economic context [Krogstrup and Wyplosz (2009)]. If, on the contrary, they are set once and not revised thereafter, in cases where the government is affected by deficit bias problems, rules will not allow for the necessary short-term flexibility to face unexpected shocks. In addition, fiscal rules may fail to promote the quality of fiscal policy since they do not indicate when and what fiscal adjustments are required. Hence, as Blanchard and Giavazzi (2004) suggest, when rules are binding and impel governments to improve their fiscal positions, governments may be tempted to cut the funding of strategic investments or other pro-growth expenditure instead of executing more innocuous – although more complex – cuts in other over-expensive budgetary items.

There is a wide range of different rules governments can adopt. Their design must bear in mind the country's specific fiscal policy breaches or insufficiencies. Besides, different fiscal rules can be applied to the general, central, regional or local government or even to other government's sub-sectors like public enterprises or social security systems. Indeed, several developed countries throughout the world have adopted some of the most diverse sets of fiscal rules.

Sweden and Chile have both adopted budget balance rules. Budget balance rules aim to bring revenues and expenditure to equilibrium within a pre-specified timeframe. They can be defined in a variety of ways; for example, a rule may oblige the government to assure that the public finances are in equilibrium over the economic cycle. For these rules to be effective they have to be cyclically-adjusted; otherwise, they may encourage procyclical behaviours [EC (2010b)].

The path that Sweden has been following towards fiscal discipline and sustainability since the mid-1990s results from a broad institutional reform that includes fiscal policy rules. After the deep economic crisis in the 1990s, with deficits reaching 11% and public debt approaching 70% of GDP, Sweden launched a consolidation program to rebalance its public finances. The program consisted of introducing two budget rules: a rule that made it compulsory to have an average budgetary surplus of 1% of GDP over the cycle, and the introduction of a system of annual expenditure limits, namely a system that obliges the government to determine a mandatory spending cap to be set in place three years later. Thus, each year, the budget approved by the government is constrained by the cap set three years earlier. This latter rule was accompanied by the adoption of a general policy principle focused on creating a budget margin to prevent the spending cap from being too rigid and to assure government compliance with it [Dolan (2011)].

The Swedish rules intend to allow the government a sufficient margin to run countercyclical policies, that is, to be able to increase budgetary deficits during economic downturns and later compensate for them with the adequate surpluses throughout the subsequent upswings. However, other countries that implemented budget balance rules did not benefit from them as much as Sweden did. Chile, for example, adopted a similar rule in 2000, although not adjusted for the business cycle. The rule imposes a 1% of GDP surplus target on the government to be achieved every fiscal year. As a consequence, the rule mostly eliminates the possibility of using the business cycle to equilibrate public finances or, relatedly, to conduct countercyclical policies to stabilize the economy [Dolan (2011), Fiess (2005)]. The problem when budget balance rules are not cyclically-adjusted is the risk of excluding important productive and growth-enhancing public investments from the budget – e.g., R&D spending – merely in order to comply with the imposed ceilings. Therefore, the quality of public expenditure may be harmed by budget balance rules.

In order to avoid the mentioned drawbacks, the United Kingdom was one of the first countries to introduce an alternative solution that excludes investment expenditure from the restraints imposed by rules. This solution is commonly known as a golden rule. The legal text of golden rules is usually comprised such that borrowing is only allowed for investments and not to finance current spending. This rule, however, may be not easily operationalised because investment is not a straightforward concept, opening space for policymakers to misuse it in order to circumvent the rule. Besides, the golden rule, by itself, does not limit debt or borrowing. These former two aspects are the likely reasons why the British government has also adopted a complementary rule, called the sustainable investment rule. This second rule obliges the public sector net debt to be held at a stable and prudent level, which is understood as being a maximum of 40% of GDP over the business cycle.

As in the UK, other countries too, mainly in Europe, have established debt rules. Debt rules may be formulated according to the debt repayment capacity of the borrower, or as a numerical ceiling to debt in percentage of GDP. The appropriate settings for such rules depend on the base on which one wants them to be applied to. For example, a debt rule may either restrain a sub-national sector or the central government. Nevertheless, it is not only debt that can be restrained by a rule; other elements of fiscal policy can be subjected to control too. Expenditure rules, for instance, may result in spending ceilings (sometimes in percentage of GDP, other times in percentage of total revenues or in various other forms) and/or may set up limits to the expenditure growth rate. These spending caps or limits are usually framed within the medium-term budgetary plans of the various levels of government. The goals of these rules are to address problems of procyclicality and successive expenditure overruns, and to assure a higher level of accountability and transparency in the spending process. Hence, in times of budget consolidation, these rules tend to be widely used, as they are perceived to be quite effective in promoting discipline. A similar concept is one of revenue rules: these can limit the allocation of revenues, determine what the tax burden should be (as a percentage of GDP) and/or place normative instructions concerning tax rates [EC (2010b)].

An important aspect that positively influences obedience to fiscal rules is whether or not they are legally or even constitutionally grounded. Germany, for example, has recently introduced constitutional fiscal rules to limit the structural deficit of the federal and the regional governments. The Federation is now constrained by a revised golden rule while the regions have to respect a zero-structural-deficit rule. The rules forbid any borrowing to finance public projects unless it is duly justified – mainly in cases where there are urgent investments that are significantly in the public interest – and only in the face of natural disasters or other emergency scenarios is the government exempt from complying with them. The aim of such rules is to ensure a sustained decline of the debt-to-GDP ratio in Germany. Paradoxically however, debt abolishment, *per se*, may not be a truly desirable fiscal policy outcome since debt continues to be an important source of funding and a useful tool for economic stabilization.

The new German constitutional rules are a remarkable political achievement and a step forward in providing the government with important commitments regarding fiscal policy. The rules signal a compromise towards fiscal discipline and consolidation, the soundness of public finances, the promotion of fiscal stability and growth, and the restoration of confidence in the economy [Blondy (2009)]. According to Campanella (2011), there are essentially three reasons for giving fiscal rules a constitutional status. First, it is a natural deterrence against governments caving into the temptation of simply changing the law, since the procedures of altering a national constitution are very complex. Secondly, inscribing a discipline-enhancing rule in the law is a clear signal of the importance fiscal sustainability has to a country's society. Finally, the reputational costs for a government wanting to breach the rules are considerably higher in case it is 'guarded' by a constitutional law. However, grounding a fiscal rule in the constitution will necessarily restrict the government's fiscal flexibility. Accordingly, the government's ability to adapt to changing economic environments, notably by using fiscal discretion at will, becomes considerably reduced with constitutional rules. In the end, it is essential to carefully design the rule *ex ante* so that it does not become a burden in the future.

The next section, after explaining the EU fiscal framework in detail, depicts the EU's recent experiences with fiscal rules, emphasizing the euro area case. It shows that, in reality, even after the introduction of fiscal rules, public finances in great number of euro area countries still suffer from severe imbalances. Additionally, the major drawbacks, challenges and insufficiencies inherent to rules are analysed, implying that they are a somewhat incomplete institutional solution to fiscal profligacy.

3.1 The case of European Union countries

In 1992, the European Union (EU) adopted the Maastricht Treaty. By that time, the EU was composed of the 12 countries from the former European Economic Community (EEC). However, since then, 15 new countries have joined the EU, which presently comprises 27 Member States. In terms of economic integration, the EU is a single market – notably, the EU allows for people, goods, services and capital originating from one of the 27 Member States to move freely throughout all the other Member States. The Maastricht Treaty has been amended three times, in 1997 with the

Amsterdam Treaty, in 2002 with the Nice Treaty and recently in 2007 with the Lisbon Treaty. Together, these form the Treaties of the European Union.

In 1999, an Economic and Monetary Union was established and, in a step towards greater economic integration, 11 of the 15 EU countries adopted a single currency, the euro. On the 1st of January, 2001, Greece also joined the euro area. Since then, five other European countries have joined the euro, making it the official currency in 17 countries.

Belonging to the euro area implies a number of rights and obligations for Member States as well as creates some perverse incentives. In this regard, three fundamental implications are worth noting since they directly affect all the Member States' economic policy powers. The first implication concerns the loss of control over national monetary policy. Euro area countries' national monetary policies are delegated to the Eurosystem, which is the group of all Member States' national central banks and the European Central Bank (ECB), the supranational entity that coordinates them. The mission of the ECB, and of the Eurosystem as a whole, is to assure and maintain price and financial stability within the euro area.

Secondly, another particularly relevant implication concerns euro area Member States not fully internalizing the costs of their debt accumulation, but rather sharing these with their fellow Members. In the literature, this phenomenon is often termed international externality resultant from fiscal policy. It results from the possibility of having highly indebted countries trying to seek relief from their debts by lobbying the ECB to use the inflation tax, despite the effects that would be borne by their partners. In the EMU, national economies are closely linked and share the same monetary policy, and so the costs of the monetization of debt (related to inflation) are not borne entirely by the undisciplined country but rather by all other Member States as well. Krogstrup and Wyplosz (2009) model this international externality as a 'partial international transfer of debt burdens'. Ultimately, this phenomenon, *per se,* creates incentives for the accumulation of debt beyond what is beneficial for welfare, that is, it causes deficit bias [Beetsma and Bovenberg (1999)].

The third implication refers to fiscal policy, particularly the set of fiscal constraints imposed on countries that adopted the euro (and also to the other EU

Member States that did not). Countries in the euro area have to agree to be fiscally disciplined by sticking to a Stability and Growth Pact (SGP). The SGP is a rules-based framework aimed at coordinating the national fiscal policies in the EMU, and its primary objective is to safeguard sound public finances, crucial to the smooth functioning of the EMU. The SGP, as part of the EU fiscal framework, is essential in ensuring, in the short and medium-term, that the Member States' national fiscal positions will be sustainable in the long run. The European Commission and the European Council (Council) are the main bodies monitoring the Member States' compliance with the SGP.

Article 126 of the Treaty of the European Union (TEU) (formerly article 104 in the Maastricht Treaty) lays the foundations for the EU concept of domestic fiscal discipline, establishing the legal basis for the rules in the SGP and for the procedure that operationalises their enforcement – the Excessive Deficit Procedure (EDP). The SGP formula has not been static over time; it suffered a major reform in 2005 and, nowadays, the political developments within EU economic governance are reshaping some of its elements. Thus, alterations in the SGP (particularly in its fiscal rules), in other EU arrangements or in the Treaty itself, are to be expected. For example, recently, on the 30th of January, 2012, 25 out of the 27 EU Member States formally agreed to adopt and incorporate a 'golden rule' into their national legislations aimed at restricting annual government deficits to 0,5% of GDP in order to maintain their domestic public finances structurally close to balance. This new rule aims to address structural budgetary deficits, namely deficits that are corrected from the cyclical component and that do not account for one-off or temporary measures. Notwithstanding any other developments that may emerge in the near future, it is worth explaining the SGP's existing core fiscal restraints that are compulsory to Member States.

In general, the SGP consists of two main impositions on Member States. The first requirement is to comply with a 3% of GDP deficit threshold. This limit restrains only conjuncture budgetary deficits and not structural deficits, unlike the 'golden rule' that has recently been approved. The second imposition is that government debt must not exceed 60% of GDP or, if it does, it must be approaching the debt limit 'at a satisfactory pace'. In 2010, though, it has been decided that the pace of the debt reduction has to be within a pre-determined numerical benchmark. The debt rule was recently made fully operational and put on equal footing with the deficit criterion [EC (2011)].

The SGP may be divided in two fundamental arms, a preventive and a dissuasive. The preventive arm of the Pact requires Member States to submit their annual budgets and medium-term stability or convergence programmes to the EC and the Council. This enables the country's government to demonstrate the way in which it is going to safeguard a sound domestic fiscal position and, in addition, is a helpful opportunity for the EC and other Member States – through the Council – to assess and comment on the country's domestic fiscal policy at EU-level. Traditionally, many of these EU-level comments, assessments and discussions on the Member States' fiscal policy have been made *ex post*, namely after the execution of the annual budgets and medium-term programmes. It was only recently, that this process was rescheduled to happen both *ex post* and *ex ante*, allowing some time for the EC and the Council to issue all the necessary recommendations and for the countries in question to incorporate the consequent adjustments before closing the budget bill. This new framework, proposed by the van Rompuy Task Force, will permit deeper fiscal coordination at EU-level [Council of the European Union (2010)]. Additionally, in 2010, the European Parliament and the Council adopted some proposals from the EC aimed at reinforcing the European economic governance. One involves the introduction of Medium Term Objectives (MTOs) for the Member States' budgetary balances, underpinning the preventive arm of the SGP. These objectives are set in structural terms, that is, they are cyclically adjusted in order not to be altered by the estimated economic cycle or by one-off and temporary measures [EC (2011)]. This permits both the EC and the Member States to assess the latter's domestic fiscal position in order to, in a dynamic fashion, periodically adjust the relevant budgetary items and ensure that the MTOs are met. Besides that, in order to accompany the introduction of MTOs, the adoption of a multi-annual perspective in national fiscal planning was also made compulsory. Another recent policy measure that fits in the preventive arm of the Pact was to make it mandatory for Member States to adopt a set of minimum requirements and standards with the purpose of improving the quality of all administrative levels within national budgetary frameworks.

A more muscled arm of the SGP, the dissuasive arm, is operationalised by the Excessive Deficit Procedure (EDP). The EDP is triggered whenever a Member State is in non-compliance with the rules in force, and it follows a sequence of steps. The first step happens even before an excessive deficit has been completely diagnosed. Thus, before likely unconformities between domestic fiscal policy and the SGP's mandatory thresholds, i.e., if the country's fiscal position is outside the perimeters imposed by SGP rules, a procedure is formally opened and an 'early warning' is issued for the undisciplined country. The subsequent steps of the EDP may include recommendations, requests of adjustments and/or mandatory corrections on the Member State's fiscal policy. Eventually, if the required measures are not implemented in time, the procedure may then comprise of sanctions or pecuniary fines (only for euro area countries), although only under a joint decision of the EC and the Council. The sanctioning and fining process can be thought of as being part of a third arm of the SGP, the most muscled of the three: the corrective arm. The corrective arm derives from the dissuasive arm and is operationalised when, even after all the steps took along the Procedure, the country remains incompliant with the rules. The process of sanctions has been strengthened in 2010 by the introduction of a sequence of progressive financial sanctions kicking in at an earlier stage of the EDP. In addition, nowadays, the euro area countries may also be required to make a non-interest-bearing deposit of 0,2% of GDP in case they do not comply with the deficit or debt rules in force. Lastly, as a sign of renewed economic governance at the EU level and in order to prevent and correct Member States' macroeconomic and competitiveness imbalances, the EC has recently implemented other new surveillance and enforcement mechanisms [EC (2011)].

It should be noted that the recent developments in EU economic governance have been, in part, the consequence of a history of ineffectiveness of the European fiscal framework. For instance, the 2005 SGP reform took grasp of the relatively undefined EU fiscal framework up until that point. One can divide the history of the Pact in two: before the 2005 reform, and after. The pre-2005 SGP had several flaws that some Member States took advantage of. For example, the implementation of the EDP was too complex, and was thus ineffective. The debt rule was not enforced, as it had no sanctions associated with it, which meant that in practice it was not considered binding. The incentives for the pursuit of healthy domestic fiscal policies were thus poor [EC

(2004)]. Nonetheless, even before the introduction of the Euro, there were, in the literature, suggestions of measures for establishing sound incentives to national fiscal discipline that would have increased the degree of effectiveness of the SGP. For example, regarding the effectiveness of deficit constraints, Inman (1996) suggested they should be exceptionally costly to amend, must use *ex post* deficit accounting and be constitutionally grounded, should be enforced by open and politically independent review panels or courts with sufficient powers to apply significant sanctions for violations, etc. Ultimately, the line of reasoning was that, in the absence of these features, the SGP would be hardly enforceable which, indeed, proved to be right. Despite meeting the criteria of a good fiscal rule, fostering the adoption of time-consistent policies (which helps to remedy deficit biases), and contributing to the promotion of fiscal discipline across the EU, in practice, the pre-2005 SGP record denies its putative beneficial effects. Annett et al. (2005) argue that there were key problems with the enforcement and national ownership of the rules. The EC (2004) viewed the problem from a different angle, arguing that the Pact suffered from excessive stringency, which eventually led some Member States to ignore it. The SGP's disproportionate rigidity was also criticized by Wyplosz (2005), who suggested that the pre-2005 SGP underestimated the necessity of Member States being able to adapt to unforeseen contingencies if and when its rules became counter-productive.

The fact is that before 2005, fiscal behaviours were not at all improved but, instead, deteriorated with the introduction of the Monetary Union and the SGP [IMF (2004)]. In fact, the tipping point of the EMU's SGP occurred in November 2003 when, disregarding the recommendations of the Commission, the European Council decided to 'suspend' the sanction procedure where France and Germany, incompliant with SGP rules, were both facing an EDP. Numerous economists labelled this suspension ruinous and deadly to the effectiveness of the Pact mainly because it set a dangerous precedent that gave leeway to other countries to also breach the SGP rules[1]. In this regard, De Haan et al. (2004) suggested that making the decision to deploy the excessive deficit procedure (EDP) dependent on political will has, *per se*, constituted one of the main causes for the discredit of the SGP. This conclusion was confirmed by the results of Beetsma and Debrun (2007). Hence, it is believed that the suspension of the sanctions

[1] See, for example, De Haan et al. (2004).

helped provoke the EU 'fiscal failure' which in turn, to some extent, boosted the deterioration of public finances of many euro area countries that culminated in the current sovereign debt crisis some of them are facing.

At any rate, a major reform to the EU's fiscal framework arrived in 2005. It consisted of some revisions in the Pact's regulations and reformulations of interpretations of the Treaty. Ultimately, both the preventive and the corrective arms of the SGP were relaxed[2]. The reform thus addressed the EC (2004) and Wyplosz's (2005) worries about the Pact's excessive stringency. In a lucid analysis, Eichengreen (2005) pointed out that while the 2005 SGP reform was a step towards more flexibility, it eliminated the existence of enforcement powers. For that reason, it was easily predictable that the EC's influence on national fiscal policies would be more limited after the reform and that most of the necessary mechanisms to ensure compliance with the SGP's fiscal rules would be absent thereafter. Eichengreen (2005) thus refers to the Euro project as a monetary success but a fiscal failure. Counting the cases where euro area countries disrespected the deficit ceiling of 3% of GDP imposed in the SGP demonstrates this so-called fiscal failure. Accordingly, Table 3.1 shows us how many times Member States had excessive deficits between 1999 and 2011, based on reviewed and updated data.

There are some disturbing post-EMU trends one can identify. For instance, since 2008, the year of the world financial crisis, most euro area economies have experienced successive public finances imbalances and thus breached the 3%GDP deficit threshold. This indicates that the crisis, at least to some extent, provoked a decrease in their public revenues and/or expansions in their domestic public expenditure. In practice, most EMU Member States have had to 'feed' their domestic economies and financial systems while facing diminishing revenues due to their poor output growth since 2008. In addition, a remarkable number of breaches of the deficit ceiling also happened before the 2008 crisis. For example, in 2003 and 2004, half of the euro-zone member countries had excessive deficits. One has to bear in mind, though, the effects of the world economic slowdown after the events of September 2001 in the USA, which affected Europe as well. In any case, all the breaches to the Pact observed in Table 3.1 cannot be simply

[2] See Loureiro (2008) for a review and criticism of the 2005 reform of the SGP.

justified by external factors. Instead, they are the consequences of the continuous fiscal imbalances – partly due to structural aspects but largely resulting from governmental misuse of fiscal discretion – of many European countries. Nevertheless, given their participation in the EMU, the question is: how have they managed to breach the rules so often? As suggested earlier, perhaps the rules were not binding – at least not binding enough – and/or the rules were not properly enforced.

Table 3.1 – Excessive deficits (> 3% GDP) in euro area countries, 1999-2012

	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Austria						X					X	X	X	X
Belgium											X	X	X	X
Cyprus											X	X	X	X
Estonia														
Finland		X	X	X				X	X	X				
France				X	X	X				X	X	X	X	X
Germany			X	X	X	X	X				X	X		
Greece			X	X	X	X	X	X	X	X	X	X	X	X
Ireland		X								X	X	X	X	X
Italy			X	X	X	X	X	X			X	X	X	
Luxembourg	X	X	X						X	X				
Malta										X	X	X	X	X
Netherlands					X						X	X	X	X
Portugal			X		X	X	X	X	X	X	X	X	X	X
Slovakia											X	X	X	X
Slovenia											X	X	X	X
Spain										X	X	X	X	X

Sources: European Commission / AMECO

Notes: Crosses show that, in that year, the country had a fiscal deficit exceeding 3 percent of GDP. Crosses relative to 2012 are EC forecasts. Grey fields indicate that the country, at the time, was not a member of the euro area.

In view of these facts, the ineffectiveness of the SGP is clear. Indeed, the Pact has been overly reliant on politics rather than on independent/automatic procedures, namely enforcement mechanisms and sanctions. As emphasized by Burda and Gerlach (2010), a major determinant for the failure of the Pact was the lack of consequences for countries that broke the fiscal rules. The SPG has been feeble, for a number of years, in enforcing rules and sanctioning undisciplined Member States, and has given too much leeway for undisciplined governments to circumvent it, note Beetsma and Debrun (2007).

However, besides the procedural and political reasons, fiscal rules may also have contributed to the ineffectiveness of the Pact.

In economic terms, the efficiency of rules remains highly debatable. Especially in the EMU, numerical fiscal rules have some weaknesses and problems that may have helped undermine the success of the SGP. The first problem is that rules may encourage procyclicality. This is typically the case of simple deficit or debt ceilings as those in the SGP [IMF (2004)]. The EC (2006a) itself acknowledges the existence of a 'certain trade-off' between fiscal rules and stabilization in good times. The reason is that deficit and debt rules are not able to deter major expansions in upswings since they have no way of forbidding procyclicality in 'good times'. On the other hand, during downturns such rules lead to procyclical contractions, which, apart from helping compliance, may have a negative effect on the economy as well. Thus, rules are more binding in bad times than in good times - exactly the opposite of what they should be in order to promote countercyclicality. In this way, such rules continue to allow overspending and under-saving or, in other words, excessive budgetary deficits like those observed throughout the last decade in euro area countries. However, not all types of rules encourage procyclicality and deficits; the EC (2006a) stresses that budget balance rules applied 'over the cycle' and instrument-specific rules may contribute to reducing the risk of procyclical bias.

Rules may not be easily enforceable either, mainly because there are not feasible mechanisms of surveillance and enforcement (at least independent ones), and also because there are ways for governments to effectively evade them by, for example, utilizing strategies of non-transparent and/or distorted public accounting practices. On the one hand, fiscal opacity allows politicians to escape democratic control, opening the path to harmful overspending and growing debt. Opacity may be divided into three dimensions: deficient information on budget documents and government accounts, no clear rules about whom in government is responsible for what in the budget process and vague economic assumptions underlying budgetary decisions [von Hagen (2010)]. On the other hand, governments often use other strategies in order to uncover the real situation of public finances, such as creative accounting and off-budget operations. Koen and van den Noord (2005), von Hagen and Wolff (2006), Kappeler and Nemoz

(2010), Rogoff and Bertelsmann (2010) and von Hagen (2010) are among the works that focus on these subjects.

Creative accounting refers to the unorthodox treatment of general government operations that actively affect the fiscal balance or public debt without these appearing in the public finances data as government expenditure. A type of creative accounting that has recently proliferated amongst European governments is to remove some overly resource-consuming items off the general government budget in order to make the domestic economic scenario seem more appealing. One classic example is the one of Public-Private Partnerships (PPPs); since the 1990s, these partnerships have proliferated in some countries and have changed the way public investment is traditionally accounted for (England, Spain and Portugal are examples). In a PPP a private entity substitutes the government in buying and operating an asset at the cost of the former selling the corresponding services to the latter for a predetermined period. This may seem efficient but, in practice, what happened in many of the countries that invested through PPPs was that their governments only adopted this channel in order to reduce the initial budgetary deficit/public debt associated with the investments in public infrastructures. It seems obvious that being over-reliant on PPPs is comparable to credit-dependency. In this way, in practice and at least to some extent, such governments have constrained their public finances. Along the same vein, governments routinely have hidden liabilities. For instance, some governments have guaranteed risky debts of State agencies and large companies that did not account for the deficit thus contributing to a deterioration of their fiscal positions.

Related to creative accounting is the use of one-off measures. In several countries these are joint practices. One-off measures are non-recurrent government decisions that affect net lending or borrowing for one or a few years, but not permanently. For instance, the privatization of a public company represents a one-off measure, as all the financial flows and other proceeds resulting from the sale operation are unique, i.e., they only happen once. Another example is the incorporation of private pension funds into the public social security system. This operation allows the government to have a massive one-off intake in exchange for the responsibility of paying the associated pensions from then on. For an anxious government worried about complying with the ceilings imposed by the SGP, the attractiveness of this operation lies in having welcome oxygen supply today that only has to be paid for over the subsequent years. The EC (2004) recognizes some sizeable one-off measures in a number of countries of the EU. Oftentimes, these measures have served to divert the scrutiny of the EU institutions and other Member States. At any rate, the key problem with using one-off measures is that they do not solve the structural problems of the economy.

Having explained policy gimmicks, it is important to realize the extent to which numerical fiscal rules are exposed to and evaded through them, in order to understand how they contribute to fiscal indiscipline. The literature on the subject states that if a government is myopic and impatient so that it values its present consumption more than the long run maximization of the society's welfare, then a numerical rule will only tempt the government to better hide its borrowing and not to incur less debt. Thus, the general idea is that the more binding numerical fiscal rules are – especially deficit rules – and the weaker their enforcement mechanisms, the more likely an undisciplined government is to engage in non-transparent practices and opaque accounting strategies. Besides, as noted by von Hagen and Wolff (2006), in the scenario of a clear absence of political will for discipline and where rules are the only disciplinary mechanism over fiscal policy, creative accounting and off-budget operations will probably flourish, undermining transparency and diluting democratic control over the budget. There is in fact evidence of creative accounting in EMU Member States and of a clear overlooking of SGP rules. Further confirming this observation is the fact that, historically, the deficits of Member States only partially explain the evolution of public debt levels. Hence, this corroborates the hypothesis that governments attempted to circumvent fiscal rules through creative and other highly non-transparent accounting practices. The implication then is that the lack of transparency allowed politicians to freely pursue their own interests rather than those of the country. Consequently, the levels of spending grew higher and imbalances surged in many EMU countries.

3.2 Institutional reform

The limitations inherent to rules prevent them from being a complete solution to fiscal profligacy and, in particular, to reverse the situations of deficit bias. This applies to any country and, of course, to euro area countries. Yet, not only rules but also the current institutional fiscal framework as a whole has proved unsuccessful. It reflects deficient economic governance both at national and EU levels. Eventually, fiscal performance and fiscal discipline in the euro area will only be enhanced with stronger and better-designed fiscal institutions, able to improve the incentives of policy-makers [Ter-Minassian (2002)]. In a nutshell, both the national and the EU-level fiscal frameworks must be strengthened on fronts other than fiscal rules and, therefore, a sizeable institutional reform is required.

Before detailing what an institutional reform involves, however, it is important to dismiss any other potential alternative.

Sometimes cited in the literature, the only available alternative to institutions enforcing discipline within public finances is financial market regulation. This type of regulation concerns the disciplinary effect on fiscal outcomes that markets have via interest rates. The reasoning behind is that markets price the debt of a country in accordance with its perceived ability to repay. Typically, therefore, when it comes to borrowing money in the markets, an undisciplined country will be penalized through its interest rate in comparison to a disciplined one. It thus follows that when the fiscal position of a country deteriorates, it will have to bear a higher interest rate than in the case where its fiscal position is stable or is perceived as healthy by capital markets. Furthermore, an important notion related to the markets' expectations is that investors typically believe that as long as the debt-to-GDP ratio of a country increases, its ability to pay its debt decreases. Accordingly, capital markets are expected to signal the deterioration of a country's fiscal position with an increase of its interest rate, which, indeed, is confirmed by recent evidence. Even so, the problem lies deeper, in the fact that market pressures may not be sufficient to deter undisciplined countries from pursuing profligate fiscal policies – a fear confirmed by the historical records of interest rates of those EMU countries that are now dealing with sovereign debt crisis. The explanation then, as in Hauner and Kumar (2006), is that most of the time the increase in interest rates applied to undisciplined countries is far from what is necessary to force the country to improve its fiscal position, for example. This, in itself, reduces the role of financial markets as an alternative to institutions. Nonetheless, the mark-ups in markets interest rates usually allow sharp-eyed market spectators to distinguish disciplined from undisciplined countries.

It is also worth noting that market discipline is likely to be weaker in the EMU, where credit spreads and ratings may not substantially penalize Member States' fiscal profligacy [Hauner and Kumar (2006) and Balassone et al. (2004)]. This is well illustrated in Figure 2.2 of the previous chapter, which displays minimal mark-ups in long-term interest rates of some EMU countries until 2008. There, it is crystal clear that the differences in the public finances of the four countries were not duly reflected in interest rates. Even so, in 2009/10, at the peak of the sovereign debt crisis, long-term debt interest rates eventually boomed for Greece, Ireland and Portugal – just before their request for EU/IMF rescue – reaching unimaginably high levels (in the Greek case, the interest rate hit figures close to 30%). What happened? Evidence lead to the conclusion that only in the face of extreme scenarios in which a country will definitely not be able to service its debt (or when most investors believe so) and when no financially healthy third-party country is firmly willing to back the sinking country are the markets prone to applying a risk premium that is sufficiently high to pressure the government into correcting its fiscal conduct. At this time, the risk premium is largely unaffordable to the already over-indebted country, and it may give rise to situations of imminent or actual bankruptcy. In summary, market discipline over fiscal policy works indeed, but it works much too late [Bayoumi et al. 1995]. Thus, the upshot is that, given the fickleness of capital markets, market regulation is of little help when it comes to creating permanent mechanisms to foster fiscal discipline.

An institutional reform can be defined as the creation of new and/or a reorganization of existing institutions in order to enable them to deliver a set of projected objectives. However, there are various types of fiscal institutions, which makes this concept difficult to define. The list of bodies, procedures and rules that match the possible concepts of fiscal institutions is considerable. Besides, the nature of fiscal institutions also varies according to the role one wants them to have. For example, they may be established at the EU level and nationally, as well as regionally or covering any other relevant domain. As a result, talking about fiscal or budget institutions in general may be vague and imprecise. Thus, it is worth further clarifying the range of budget institutions.

Traditionally, in the literature, fiscal institutions involve rules, procedures and independent bodies. Nevertheless, other budget institutions are often referred to by a number of authors. For instance, in Fabrizio and Mody (2006) budget institutions are defined as forms of self-imposed control by fiscal actors in view of improving the quality of decisions. They can be defined as different mechanisms and rules of the budget process united by the same objective: influencing fiscal outcomes. Institutional structures of the budget process may influence outcomes by helping to determine the strategic choices and behavioural incentives of politicians. Ter-Minassian (2002), in turn, considers that the main institutional components of a fiscal framework are fiscal rules, transparency, fiscal laws and fiscal councils. Lienert (2010) also emphasizes fiscal responsibility laws. The EC (2006b), on the other hand, refers to ‘domestic budgetary institutional settings’, which include the procedural rules and structures of the budgetary processes, the numerical fiscal rules constraining the discretionary powers of policy-makers (for both EU and national-level rules), and independent bodies or institutions providing input and formulating recommendations in the area of fiscal policy. In brief, in any discussion about the reform of fiscal institutions, one has to consider there is a wide range of institutions that may serve a wide range of purposes.

An institutional reform to promote fiscal discipline in an EMU will have to happen both in the Union as a whole and individually within each Member State. Nevertheless, reforms at a European level cannot be identical to reforms in domestic fiscal frameworks, although they should be complementary.

At EU-level, the weaknesses of the SGP and other fiscal framework insufficiencies mentioned above have recently triggered a process of comprehensive economic governance reinforcement. The European Commission acknowledged the necessity of strengthening the EMU’s fiscal framework in order to anchor macroeconomic stability and the sustainability of public finances, two essential preconditions for achieving growth and jobs. To achieve this, the SGP needs to exercise its role as the main catalyst of EU fiscal policy co-ordination. Particularly, SGP’s rules have to be strengthened and a more comprehensive macroeconomic surveillance has to be implemented in order to enhance the fiscal discipline of Member States. Nevertheless, the disconnect between European and national policy processes has to be addressed seriously, and all Euro-wide reforms will have to be complemented with provisions within national fiscal frameworks [EC (2010c, 2011)].

At a national level, fiscal frameworks should comprise of effective and well-designed institutions aimed at promoting a sound fiscal environment conducive to growth and prosperity. The European Commission defines these frameworks as: "*The set of elements that form national fiscal governance, i.e. the overall system of arrangements, procedures and institutions that underlies the planning and implementation of budgetary policies*" [in EC (2010a), p.73][3].

A strong fiscal framework enhances domestic economic governance. Therefore, in order to restrain governments' spending and overcoming deficit biases, there are some important factors to consider when reforming national fiscal institutions. First, fiscal objectives, targets and rules should be clear, measurable and must cover all levels of government comprehensively. For example, specific expenditure caps could be applied to all levels of government. Secondly, fiscal policy should be governed by a set of *ex ante* guidelines in line with the government's preferences. For instance, the government could specify how and when discretionary powers should be used for stabilization purposes and explain what fiscal instruments should be used in case of economic recessions and of booms. A third ingredient concerns the commitment to transparency. In order to be effective, a domestic fiscal framework needs to be based on fully transparent public accounting processes associated with free, timely and complete availability of transparent, reliable and independent fiscal information, data and statistics. Moreover, forecasting systems must work properly and be realistic. Fifth, it is vital to create sound incentives to avoid deviations from policy objectives, which may be achieved by creating mechanisms/channels that increase the political or reputational costs for governments that depart from those objectives. Finally, Member States should agree upon some standards for domestic fiscal frameworks. These include, for example, the use of top-down budgetary processes and/or the creation of public bodies mandated to provide independent analysis, assessments and/or forecasts on national fiscal policy [Council of the European Union (2010) and Calmfors (2010b)].

Above and beyond these factors, however, a reform of national fiscal institutions always has to focus on adopting or modifying rules and independent bodies.

[3] According to the EC, the main elements of a national fiscal framework are numerical fiscal rules, medium-term budgetary frameworks for multiannual fiscal planning (MTBFs), budgetary procedures governing the preparation, approval and implementation of the budget and independent public institutions intervening on budgetary policy issues.

Although rules have failed in the task of solving fiscal profligacy, they have some usefulness in restraining governments and they may have a role to play if some conditions are satisfied. Krogstrup and Walti (2007) argue that rules are still a useful policy tool for fiscal discipline in that they still do help to discipline budgetary outcomes. Moreover, national fiscal rules may be a useful complement to EU-level rules. If they are at least as strict, domestic fiscal rules may provide support for the SGP's fiscal commandments. Nonetheless, it is important that the introduction of domestic rules obeys proper criteria. In order to put them into effect, rules have to be well-anchored to domestic policy-making at all government levels, and have to provide clear benchmarks allowing the measurement of performance of the country's fiscal policy with respect to transparency and accountability. Moreover, it is also crucial to set out consequences in case of non-compliance. These may not necessarily be pecuniary sanctions but have to involve, at least, deterrent costs to reputation. Rules are defined by the costs one incurs when trying to evade them, argues Debrun (2007). Therefore, it is crucial to determine mechanisms that inflict costs on national policy-makers when they bypass, change or thwart rules. Further, if such rules are numerical, it would be highly beneficial to clearly specify their escape clauses in detail, along with a detailed list of circumstances that may trigger them and the procedures that relate to them. Complex escape clauses help ensure compliance in 'normal' times [EC (2011)].

Independent bodies are another key piece for fighting fiscal indiscipline. The concept of independent bodies is, *per se*, very wide. In the context of fiscal policy, these are often viewed as domestic or international institutions, to a large extent independent from the political sphere, that contribute by some means to the normal course of fiscal policy and the budget process. Their remit can vary and their mandated tasks differ widely from one another. So, bearing in mind that an institution is an element that somehow actively influences fiscal policy, one can apply the term 'independent body' to an array of entities ranging from a statistics production institute to a court of auditors or to an economic research department of a University, for example.

Each country's institutional environment depends on its culture and traditions, and includes rules, independent bodies and/or other elements. Consequently, reforming domestic fiscal frameworks is, to some extent, country-specific; there is no one-size-fits-all fiscal framework and, thus, the same bodies, rules and regulations will not solve every country's problems [Ter-Minassian (2002)]. Thus, each country must diagnose its own problems and come up with the necessary political will to solve them. Here, EU institutions must put in some additional effort to persuade Member countries that some reforms will *de facto* result in a healthier fiscal framework, both domestically and internationally. The EU political debate on institutions remains too sloppy, even as some Member States are struggling with sovereign debt crises. Historically, however, Member States have often proven to be receptive and even pro-active in adopting reforms, for instance on measures to enhance transparency and monitoring within the budget process [EC (2010a]. In contrast, there traditionally has not been as much political will when it came to centralizing the budget process or to adopting top-down budgeting, when in fact changes like these are likely to entail significantly positive disciplinary effects on fiscal policy.

Ultimately, the scenario of high and rising debts of some euro area Members, menacing risks of sovereign default in some of those countries, and great instability within financial markets has to be inverted, particularly through the action of policy-makers, both at European and at national levels, that have to react and (re)shape new or existent budget institutions. As rules alone are insufficient, a domestic institutional reform should also include the creation of national independent bodies in charge of providing inputs and formulating recommendations in the area of fiscal policy [Beestma and Debrun (2007) and EC (2006b)]. Besides, these institutions could play an active role in enforcing compliance with the SGP, thus becoming a useful complement to EU-level policies. A growing debate in the economic literature and within some decision-making instances at EU and national levels increasingly suggests that not all types of independent bodies are appropriate for these roles. Nonetheless, the introduction of independent fiscal agencies is one of the most popular suggestions for reform, and it has been frequently put forth as a must-have component in national fiscal frameworks.

Consequently, besides rules, decision-makers should focus on agencies. According to the EC (2006b), these can be designed to complement and/or substitute fiscal rules, which make them a possible key remedy to fiscal indiscipline. Therefore, the basis for sound and sustainable national public finances may be a rules-based fiscal framework complemented by some sort of independent fiscal agency. Hence, hereafter, the main focus of this dissertation will be on independent agencies – other budget institutions are beyond the scope of this work.

A growing number of economists believe that independent fiscal agencies can effectively address some of the causes of fiscal indiscipline and deficit persistence in many euro area countries. Importantly, the idea of independent agencies has been mentioned and endorsed by the EU institutions, the OECD, the IMF and a substantial number of renowned individuals in the field[4]. Thus, it is worth defining these agencies in order to know how they can enhance the existing fiscal frameworks. There are two main definitions one can use. The first is from Debrun et al. (2009) that divides independent fiscal agencies into Independent Fiscal Authorities (IFA) and Fiscal Policy Councils (FPC), and the second is from Wyplosz (2005) that divides independent fiscal agencies into a hard and a soft version of fiscal councils, corresponding to the Debrun's IFA and FPC, respectively[5].

A general definition of FPCs can be found on Simon Wren-Lewis' webpage devoted to publicizing FPCs: "*The term Fiscal Council is generally used to describe an institution, funded by but independent of government, which provides public advice on fiscal issues. (…)* [one may] *restrict the term to include only institutions that provide macroeconomic advice on the likely course of national budget deficits, but these same institutions may or may not also provide detailed microeconomic costing of the budgetary impact of particular projects or proposals*"[6].

One of the major differences between IFAs and FPCs is that the former are given decision-making powers over some fiscal variables. This means that IFAs have statutory powers, delegated by elected politicians, in order to control fiscal variables and/or to impose certain measures within specified contingencies. Some authors, such as Wyplosz (2005), call IFAs the hard version of FPCs.

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[4] There are a number of articles that endorse the idea of establishing national independent fiscal agencies. See, for example, ECB (2010), European Commission (2006a, 2009, 2010b, 2010c), Council of the European Union (2006, 2010), European Council (2010a,b), van Rompuy (2010), Hagemann (2010), Wyplosz (2002, 2005, 2008), Annett et al. (2005) and Debrun et al. (2009).

[5] Henceforth, and for the most part of this work, the definition/taxonomy given by Debrun et al. (2009) in regard of independent fiscal agencies, authorities and councils is going to be followed. Alternatively, the terminology in Wyplosz (2002, 2005, 2008) will also be mentioned.

[6] See http://www.economics.ox.ac.uk/members/simon.wren-lewis/fc/Fiscal_Councils.htm.

Among economists, independent fiscal agencies are commonly interpreted as functioning in parallel with rules. Thus, the general belief is that both rules and agencies can play their role against fiscal profligacy without overlapping each other. Some authors refer to a number of complementarities, including EC (2006a, 2010b, 2011), Debrun (2007), Beetsma and Debrun (2007), Calmfors (2010a), Calmfors and Wren-Lewis (2011a), Fatás and Míhov (2010) and Lane (2010).

A prior note before exploring the main areas of complementarity between rules and agencies, as discussed in Debrun (2007), is that even if a government do implement some restrictive fiscal rules, it may not be predisposed to setting up institutions to facilitate their enforcement, implying that it may have planned to never have to comply with the rules. Nevertheless, agencies are always able to contribute to a more effective enforcement of fiscal rules.

A possible contribution of independent agencies may be to monitor governments' compliance with rules in a timely and effective manner. As the effectiveness of a fiscal rule depends on its monitoring, the whole process may be improved if it is carried out by a third-party, non-politicized institution. This body could even issue suggestions in order to optimise the design of the rule itself. Hence, it could be possible to delegate the task of optimally creating, implementing, enforcing and/or monitoring compliance with fiscal rules to an IFA. In addition, a soft version of the agency (a FPC) could also report on and publicly inform voters about the cases in which the government was incompliant with fiscal rules, as well as stating in detail how they were circumvented and asking the government for explanations. FPCs monitoring the government's adherence to fiscal rules would reinforce the enforcement of rules. A council may also spot the government's attempts to dabble in creative accounting – which, as seen earlier, may be prompted by strict rules – and publicly denunciate them.

Additionally, rules give councils a benchmark against which to evaluate government policy. In this sense, numerical rules can define the country's fiscal policy objectives, thus facilitating the work of independent institutions. Among the possible features that could arise from this 'joint-venture', it is worth noting that, in the context of the preparation and implementation of a budget, an independent agency can assess whether budgetary plans and developments are in line with the rules.

Besides, the complementarity between fiscal rules and agencies is manifest as they potentially focus on different aspects of government finances and as their time orientation is different. While numerical rules tend to have a short or medium-term orientation and often apply to sub-sectors of government, agencies typically analyze government finances as a whole from a long-term perspective.

"*More elaborate monitoring by an independent institution can allow a fiscal rule to be more flexible*" [in Calmfors (2010a), p.13]. There are benefits in allowing FPCs to advise the government in the case of an economic shock. We know that a simple fiscal rule like a budget balance rule do not take into account that an economy has good and bad times since they are as binding in good as they are in bad times. However, during economic downturns, it would be positive to have a comfortable budgetary margin for the government to steer the economy back on to the right track. In this sense, some sort of 'constrained discretion' as to when rules should be adapted by independent fiscal bodies could be beneficial. The incorporation of an element of independent judgment into the fiscal framework would boost the effectiveness of rules by permitting a suitable management of the trade-off between fiscal discipline and fiscal discretion/flexibility. Hence, FPCs could be able to monitor whether economic shocks are the one and only motivation for deviations from fiscal targets and rules. Another possibility could be to institute complex rules that are explicitly contingent to economic shocks. However, these complex rules may not be easy to monitor. Nevertheless, an FPC could play a role in monitoring complex and sophisticated fiscal rules as well.

There are still a number of other situations where a fiscal agency can complement a rule or vice-versa. For one, an FPC may boost the effectiveness of national rules by providing independent analytical inputs, macroeconomic forecasts and other assessments. It may also issue penalties in case of non-compliance and it may control and decide on the escape clauses of the fiscal rules, namely by ensuring that these are only triggered in case of shocks of sufficient severity. A clear relevant example of a council's response to a real necessity of an escape clause is the one of the Swedish Fiscal Policy Council. After the 2008 recession, this council advised the Swedish government to depart from the rules in place in order to allow for more discretionary fiscal expansion and therefore fight the economic slowdown. This confirms that IFAs and FPCs may be designed not only to constrain fiscal policy-making but also to help manage the trade-off between long-run fiscal discipline and short-term fiscal flexibility. In other words, these agencies are useful in the promotion of long-run fiscal sustainability and solvency, allowing, at the same time, for the necessary flexibility to stabilize output in the short-term.

There are also some other proposals in the literature related to complementarity between rules and independent fiscal institutions. One of them is from Inman (1996) who, within the EMU context, suggests the delegation of judiciary power to the European Court of Justice (ECJ) to monitor compliance with the Balanced Budget Rule. The author argues that, in this way, the rule would become absolutely compulsory for all Member States. Additionally, the ECJ would also have statutory power to impose sanctions and severe penalties on the incompliant countries. Krogstrup and Wyplosz (2009) make a different type of proposal, this time regarding optimal fiscal frameworks. They argue that the social optimum would be achieved if the optimal annual deficit ceiling could be externally estimated and set every year. In this case, there would not be a fixed fiscal rule. Instead, a fairly sophisticated, domestic, and non-partisan fiscal agency would ensure that the government commits to applying public spending to productive investments only. This would guarantee success in eliminating the common-pool problems related to unproductive spending. No country has adopted these original ideas yet but they are further confirmation of the perceived complementarity between rules and independent fiscal agencies.

Finally, an interesting finding is that the majority of the already-established councils work alongside national fiscal rules [Calmfors and Wren-Lewis (2011b)].

4. Independent fiscal institutions

Among economists, there are different perspectives about what the design and remit of independent fiscal agencies should be, and the literature comprises proposals often only slightly different from one another[1]. In order to simplify the analysis, some of the articles have offered different ways of categorizing proposals. For our purposes, the main focus will be on the conceptual definition given by Debrun et al. (2009) – IFAs and FPCs.

Delegation of power over some aspects of fiscal policy to agencies is likely to improve their ability to influence fiscal outcomes. Thus, as happens with the delegation of monetary policy to an independent central bank, an Independent Fiscal Authority in control of a part of fiscal policy-making may effectively promote transparency, depoliticize the macroeconomic policy framework, and/or help ensure long-run sustainability and solvency while allowing for some fiscal flexibility to stabilize the output in the short-term. On the other hand, if decision-making powers are not delegated to agencies, their capabilities of restraining the government are diminished. Even so, FPCs may be able to exert their influence through a range of other channels. It should be noted here that all currently established agencies are fiscal councils and that no IFA solution has passed from theory to practice yet.

The rest of this chapter is divided into two parts. The first section explores the fundamentals of delegating fiscal policy, notably in analogy with monetary policy and independent central banks. A survey of the literature behind the proposals for IFAs and an explanation of why they have not been adopted by any country so far are also provided. The second section is devoted to explaining FPCs, namely their goals, remit, mandate, composition and others. It also offers some considerations related to the important determinants of a council's success, such as ways of assuring independence, and explores the proposals in the literature, also including fiscal councils at European level.

[1] For a survey see, for example: Debrun et al. (2009), European Commission (2006b), Debrun and Kumar (2008), Von Hagen (2010).

4.1 Independent fiscal authorities (IFAs)

In order to understand the usefulness of IFAs, one must first understand the fundamentals of policy delegation. Maskin and Tirole (2004) present an interesting model detailing circumstances in which it is beneficial to allocate decision-making powers to non-elected officials. Their main argument is that given the possibility that elected representatives do not maximize the average citizen's utility (social welfare) but rather their own preferences (or a mix of the two), there are cases where it may be socially beneficial to delegate powers to non-elected judges or bureaucrats. These cases include situations when the electorate is not properly informed and literate about policy, when it is costly for the electorate to acquire decision-relevant information, or when there is sluggish feedback about the quality of policy-makers decisions. Here, the delegation scenario may be desirable, namely by instituting a body that is not completely democratically accountable and placing some technical decisions under the control of a set of appointed bureaucrats. One should bear in mind, however, that the authority of non-elected officials would necessarily have to be more limited than that of elected ones.

Additionally, the delegation of policy is only justifiable when some criteria are met. Alesina and Tabellini (2007) explore how the socially optimal allocation of policy tasks between politicians and bureaucrats may be achieved. First, delegation to bureaucrats is preferable when the object of delegation is technical tasks that require more skills than effort, or when there is uncertainty about whether the policy-maker has the necessary abilities to perform the tasks. Nevertheless, it is to be expected that a politician will not be completely receptive to delegating redistributive policies to independent agencies. Given that a delegated authority can criticize the government's actions and inflict political costs, it is not obvious why a government would want to delegate policy in the first place. Nevertheless, assuming they do, a second question arises: what would prevent governments from withdrawing powers from a delegated authority in case of misaligned interests? As noted by Wren-Lewis (2011), under some circumstances, delegation may be sustainable from the governments' point of view. For instance, it is possible that the government chooses to delegate decisions as a commitment device (to a certain policy objective, for example). Furthermore, the political cost of overruling the previously created agency makes the commitment more credible. Therefore, in theory, if the agency rigorously follows its mandate, then the necessary conditions for its sustainability should be in place. Another criterion for the success of delegation is that there are socially harmful distortions in policies implemented by the political representatives. Otherwise, there is no gain from delegation whatsoever. Finally, delegation should not entail major policy coordination problems because if it does, the benefits created by delegation may be outweighed by the costs of non-coordination.

However, when it comes to fiscal policy delegation, different opinions often emerge in the literature, either in favour of or against it.

The idea of taking some fiscal policy-making decisions away from elected politicians in order to address the problems of excessive domestic fiscal indebtedness started to gain momentum in the literature in parallel with the success of monetary policy delegation to independent central banks (ICB). Before this success, though, the process of getting endorsement for the idea of monetary policy delegation had been long and windy. Nonetheless, the works on that idea proliferated along with the persistency of an inflation bias in the third quarter of the twentieth century. Eventually, the near-consensus was that monetary policy had to be under the control of an independent central bank and had to obey a medium to long-term rule (allowing, at the same time, for a minimal level of short-term discretion). Essentially, the success of this system is now widely acknowledged because low inflation rates have indeed been achieved, at least wherever an inflation targeting strategy was properly adopted [Krogstrup and Wyplosz (2006)]. As a result, when considering fiscal delegation, it is certainly useful to establish some of its associations with monetary delegation.

Firstly, a clear similarity between fiscal and monetary policies resides in the general goal that they must achieve: stability. Naturally, the delegation of monetary policy aims at price stability much in the same way that fiscal policy delegation ought to attain fiscal discipline. Nevertheless, there are also differences between fiscal and monetary policy delegation. One of these concerns the control over policy instruments. Wren-Lewis (2011) recalls that central banks have always conducted money market operations and have always had a consultative role with the government regarding interest rates. So, it was little surprise when the task of fixing interest rates was delegated to the – then independent – central bank. In contrast, in fiscal policy, given the huge amount of tax and spending instruments available, delegation is much more difficult. Still, it could be possible to mandate an independent body with the task of setting the government's annual deficit target. Even so, there is no analogous body for fiscal policy as there is the central bank for monetary policy, and thus there is not an institution to which these powers would naturally be delegated.

Furthermore, another criticism often aimed at fiscal delegation is the scarcity of democratic accountability and questionable legitimacy of independent agencies. In short, creating an IFA implies that some important policy instruments have to be taken, permanently or temporarily, from a legitimate democratic body and handed to an unelected one. Therefore, in a democratic regime, it can be questioned from whom an IFA is given the authority to carry out fiscal decision-making, especially if it encompasses fiscal distributive consequences. The words 'no taxation without representation' imply that even only delegating indirect control over some tax rates may be excessive. Even though this argument holds, it is not applicable to some proposals such as the one from Wren-Lewis (2003) of an IFA to which only limited powers to temporarily change a few fiscal instruments would be delegated. It remains to be assessed how much distributional impact this agency would exert in comparison with independent central banks in changing the interest rates. Moreover, there are mechanisms, such as the one von Hagen and Harden (1994) have proposed, that enable elected politicians to correct bad decisions and poor performances of IFAs. In such cases, the legislature, besides establishing the agency, may also have the right to dismiss it under pre-determined circumstances – that is, only when is truly justifiable and not because of political opportunisms. This is very important since it is probable that a conflicting relationship will arise between the IFA and the government, given that their objectives, incentives and judgment may tend to differ [Debrun et al. (2009)].

Calmfors (2003) provides another perspective, claiming that it is both possible and feasible to delegate a part of fiscal policy without giving rise to distributional and democratic legitimacy issues. If delegation mainly involves macroeconomic stabilization decision-making aspects, elected governments may maintain control over all decision-making that has distributional impacts such as decisions on the size of government, on the structure of long-run taxes and expenditure, and on the long-run debt path. One criterion, then, seems to be that some more sensitive areas of policy, notably areas that serve primarily distributive objectives or that are highly dependent on social preferences, must remain on political ground [Debrun et al. (2009)]. In the end, if only some selected decisions were delegated to an agency, the government would still be held accountable for all of its fiscal decisions and the electorate preferences would still be represented democratically.

In any case, some proponents of fiscal policy delegation suggest that whenever there is an underlying cause of deficit bias there may be a rationale for delegating fiscal policy. Here it would be useful to briefly review a few specific proposals in the literature.

Although it has not yet been implemented, the idea of IFAs is not new. One of the earliest works proposing the creation of an IFA was of Blinder (1997), arguing, essentially, in favour of a relocation of powers from the political sphere to independent non-elected committees of technical experts. Besides comprehensively analyzing important issues surrounding the delegation of policy decisions[2], Blinder (1997) argues that fiscal policy decisions of governments have become too political and have therefore discredited and weakened democracy. To overcome this problem, he argues that the experience of delegating monetary policy to independent central banks must be considered, notably by acknowledging that this delegation has often brought impartiality and independence to policy-making. Likewise, fiscal policy might be better situated on a less political ground. If some fiscal policy-making was to be made on non-partisan, technocratic grounds by 'appointed professionals', 'best equipped' to make some specific decisions, some malfunctions would be corrected, suggests Blinder (1997). Hence, an independent tax authority could be created. Yet, determining the objectives and goals of such independent agencies would necessarily be a political task. Ultimately, the best fiscal framework would be the one that could find the right balance between delegation of powers and political intervention. Ultimately, Blinder's central question is not if delegation of policy is desirable, but rather how many and to what extent fiscal decisions should be delegated.

[2] Blinder (1997) analyzes the problems of government myopia and short-sightedness, the democratic legitimacy of delegation, and the moral and distributive aspects of policy, among others.

Another early proposal for quite a substantial macroeconomic reform in terms of reshaping and redesigning economic institutions comes from Ball (1997) who proposes the creation of a national institution with power to control, to some extent, both monetary and fiscal policy. Much in the same way, Gruen (1997) discusses the possible benefits of establishing institutional mechanisms that are able to detach the 'determination of the overall stance of fiscal policy from day-to-day government'. Gruen (1997) puts forward as ideal an independent statutory agency that would control some tax-related tariffs as a function of a pre-set taxation parameter. This parameter would be the institution's instrument to attain the objective of budget balance over the business cycle.

Wyplosz (2005) has a slightly different view, proposing an IFA mandated by the government to set an annual fiscal deficit target that leads to compliance with a pre-specified long-run debt target. Wyplosz (2005) believes that there are time inconsistency problems arising from the tensions between the objective of long-run debt sustainability and the necessity of short-run fiscal flexibility to ensure macroeconomic stability. Therefore, as fiscal policy needs both short-term room for manoeuvring to counteract unexpected shocks and a binding long-term plan for fiscal sustainability, an institution capable of managing this trade-off without jeopardizing any of those two objectives would be truly beneficial: "*The challenge is to deliver on the short-run objective without giving up the long-run objective*" [in Wyplosz (2005), p.73]. Again, ICBs have proven their effectiveness in solving the time inconsistency in monetary policy – they now efficiently manage the trade-off between short-run monetary flexibility and long-run price stability by creating incentives that allow short-run discretion to be constrained by long-run discipline. Hence, in order to overcome the deficit bias problem, 'fiscal policy could be set in the same mould', argues Wyplosz. Specifically, with an IFA the short-run output stabilization objective could be effectively constrained by the long-run debt sustainability objective. It would allow the use of deficits for countercyclical purposes, guaranteeing, at the same time, fiscal discipline over the business cycle.[3]

[3] Wyplosz's proposal follows an earlier one – Wyplosz (2002) – which, similarly, argues in favor of the creation of fiscal policy committees mandated to impose a cap on the overall size of the budget deficit, while leaving the task of achieving the goal to governments.

In turn, Eichengreen et al. (1999), addressing the situation in Latin American countries, also suggest the creation of National Fiscal Councils with mandatory powers (such as FPCs in their hard version). This proposal was intended to solve some fiscal credibility and flexibility problems, notably by mandating the new bodies to control the maximum variability of public debt. Furthermore, National Councils would help ensure countercyclicality, serve as a pacifier for capital markets expectations, as well as create an environment of trust that would facilitate investment, borrowing and other macroeconomy-driven activities. Eichengreen et al. (1999) argue that such agencies would gain credibility from their record of political independence while retaining the flexibility characteristic of a people-based, as opposed to rules-based, institution. Besides, they could also help address the common-pool and commitment problems, as they would be able to rise above partisanship and to develop a reliable, long-term fiscal strategy.

In Europe too, IFAs may have an important role in promoting fiscal discipline. In the EMU, fiscal policy is a particularly decisive instrument given the scarcity of other effective policy means of tackling domestic economic imbalances in the short to medium terms. Even so, when governments' activities are only driven by stabilization objectives, their ability to ensure fiscal solvency in the long-term may be compromised. Therefore, giving the role of fiscal stabilization to an autonomous agency may be helpful. In this regard, Leith and Wren-Lewis (2006) suggest that when fiscal policy is used primarily as a tool to stabilize the business cycle, delegating fiscal decisions to independent agencies is not too different from delegating the control of monetary policy to an ICB. Also, Wren-Lewis (2002) finds some major advantages in delegation. First, as this case clearly mirrors monetary delegation, it should share the relative success of ICBs. Moreover, it seems easier to take fiscal stabilization out of the government's hands rather than taking debt control. Such an agency would only need to temporarily control a limited number of relevant tax instruments – e.g. consumption taxes – in order to achieve maximum leverage over the key macroeconomic variables. Wren-Lewis (2002) reckons that even though the changes to those selected instruments would only be temporary, they would still permanently impact public debt.

Moreover, Calmfors (2005) further proposes that, in the EU, the effectiveness of domestic fiscal frameworks is dependent on at least three components: well-defined policy objectives, transparency and incentives to avoid deviations of government policies from pre-set objectives. Thus, national councils of independent experts should establish these incentives. They can also be charged with checking if *ex ante* objectives and *ex post* government policies are uniform, providing evaluations of policies, issuing recommendations and/or preparing forecasts. The tasks that such institutions can be mandated with entail variable degrees of direct decision-making. *In extremis*, these domestic IFAs could be given some central powers: "*A far-reaching proposal would be to give the Fiscal Policy Council the power to veto political decisions on the annual budget balance, and possibly also on the size of government expenditures, when it considers them to constitute major deviations from the objectives pre-determined by the parliament*" [in Calmfors (2005) p.12].

IFAs may be designed to solve several political failures associated with fiscal policy. For example, delegation of fiscal policy to technocratic decision-makers may help avoid the *ad-hoc* – and often gravely short-sighted – methods sometimes used in the governments' fiscal decision-making processes. In fact, IFAs could fully focus their pre-set overall priorities on encompassing gains in efficiency [Calmfors (2003)]. Also, the delegation of (temporary) control over some specific taxes to independent agencies may be fruitful and preventive in the face of situations in which the current generation has a deliberate desire to exploit the coming generations. In any case, the upshot is that such institutions may help to better align fiscal policy with social preferences by constraining discretionary actions and eliminating some distortions in the political process.

All the proposals and perceived benefits of IFAs have to be contrasted with the fact that no IFA has been established in any country to date. Some authors argue that their introduction is unlikely, at least for now [see, for example, Debrun et al. (2009)]. The idea of delegating control over tax rates and/or some items of government expenditure to unelected bodies, even if on a temporary basis, is not only a highly sensitive and controversial topic within the political sphere, but is also often emphatically neglected by politicians. Besides, all the parallels that may be drawn with the (successful) case of monetary policy delegation still have their boundaries and limits. In this respect, one should be mindful that there are some aspects of fiscal policy that are completely different from monetary policy and, although some of the monetary policy associations may solidify the idea of fiscal delegation, these aspects generate obvious contextual differences between the two types of delegation. For example, the underlying causes of deficit and of inflation biases – i.e. the central motives for delegation – are fairly distinct. As a result, problem-solving in each case is also somewhat dissimilar since each problem needs a different remedy. For instance, an advisory ICB would, most likely not be able to eliminate inflation bias and time inconsistency in monetary policy, while a fiscal watchdog may be able to solve many informational problems by simply making information available to the public.

Furthermore, not all conditions for fiscal delegation have been satisfied yet. First, as emphasized in the criteria formulated by Alesina and Tabellini (2007), before delegating, a general consensus on what constitutes sound policy has to exist. This aims to ensure first, that the agency's mandate serves the best interest of society and, second, that the agency can be held accountable for achieving all its pre-set objectives by using appropriate policy-making instruments. Indeed, while this consensus in monetary policy has been achieved (the consensus being that sound monetary policy is reflected by low and stable price levels), in fiscal policy the only consensus currently found is that debt should be sustainable. Thus, the objectives of fiscal policy concerning debt are far from being as clear as the objectives of monetary policy. In fact, while most developed economies tend to have similar implicit or explicit national inflation targets, their debt-to-GDP ratios are far from similar.

Secondly, economists have still not decided on a number of political economy issues that remain uncertain, which raises problems when fiscal delegation is under discussion. For example, different opinions arise about debt policy: it is unclear if it is best to target debt – and if so, what the target should be or what the optimal level of sovereign debt is – or if debt should follow a random walk. Moreover, the speed at which some debt threshold should be achieved is also controversial. The central question, though, resides in fiscal sustainability, often appointed as the primary objective of IFAs. The fact is that sustainability, *per se*, is not enough to guide fiscal policy on an annual basis [von Hagen (2010)]. One may think of the intertemporal budget constraint as a threshold for measuring policy; however, the constraint only implies that public debt must not grow faster than 'the long-run rate of interest net of the long-run real rate of growth of the economy' forever. Anyhow, there are countless paths for debt that ensure the government's compliance with the intertemporal budget constraint, as Wren-Lewis (2011) points out. Hence, the constraint is completely silent about policy adjustments, that is, it does not lay out the path fiscal variables should follow in order to achieve a sustainable fiscal position.

However, monetary policy delegation is not a trouble-free solution either. Castellani and Debrun (2005) find that delegation of monetary policy to ICBs may include distorted incentives to governments. To some extent, in the face of output cuts driven from monetary restraints, governments may tend to use expansionary fiscal policy to stimulate output growth. This suggests that it is possible that, instead of being annihilated, the inflation bias is merely relocated from monetary to fiscal policy (in the form of a deficit bias). In this way, some time-inconsistency problems may be transferred, again to some extent, from monetary to fiscal policy, resulting, in due course, in enlarged deficits. Therefore, it is possible that a partial reform of macroeconomic institutions – both monetary and fiscal ones – only reshuffles policy distortions instead of correcting them, thus affecting the execution of macroeconomic policy, state Castellani and Debrun (2005). The remedy may be to impose effective limits on fiscal discretion, and an IFA can be mandated to do so.

Finally, despite all of the problems and limitations associated with it, complete absence of delegation of fiscal policy to independent bureaucrats is somewhat awkward. Four explanations for this stand out. The first is that there are real possibilities of fiscal delegation giving rise to some implementation problems [Wyplosz (2008)]. Secondly, the time devoted to the political economy debate about delegation is still insufficient. There is a need for a longer discussion in order to reach a broad consensus on the desirability of such an institutional reform before the delegation of (some) fiscal decisions to independent bodies can become a reality [Calmfors (2003)]. Third, in countries where monetary policy is already independent – or centralized in a supranational entity such as in the euro area – governments are usually particularly resistant to delegate control over fiscal variables as well. Finally, the major obstacle against the delegation of fiscal decision-making is the lack of political will. On this matter, Wyplosz (2008) comments: "(…) *the proposal* [for the creation of an IFA] *asks the culprits to put in place an arrangement that will not just bind them* [the elected governments], *but will also force them to take full responsibility for identifying a debt* *target and uphold the policy implications as set forth by the FPCs* [hard version]" [in Wyplosz (2008) p.29]. From that perspective, such proposals are indeed naïve.

At this point, one may ask if it is possible that the soft version (FPC) be a first step to the implementation of the hard version of agencies (IFAs). The answer seems to be yes. In fact, over the last decade, many governments have been committing to fiscal discipline and finding ways to eradicate the deficit bias problem. In this sense, is not unreasonable to expect that, eventually, these same countries will find the idea of an IFA more attractive in order to fight fiscal profligacy. Besides, some countries have recently established FPCs, which may indicate that they are moving towards IFAs. Similarly, Kirsanova et al. (2007) claim that if the council's assessments and positions are typically followed and are considered helpful, there should be a predisposition from both policy-makers and voters to delegate some fiscal powers to the FPC.

Ultimately, in spite of all their advantages, the barriers associated with IFAs imply that, at the moment, they do not represent a real institutional alternative/complement to rules fighting fiscal indiscipline. A less intrusive solution is probably more appropriate - fiscal councils could be a valuable and helpful alternative. Hereafter, the discussion will only focus on the soft version of agencies that do not involve delegation of control over fiscal decision-making. It should be noted, however, that in terms of effectiveness, having an advisory agency might be different from having a decision-making one.

4.2 Fiscal policy councils (FPCs)

In general, the basis for the establishment of FPCs has already been laid out in this essay. Even so, in order to underline their potential role in eradicating fiscal indiscipline, there is still a need to detail the form and content of the councils' solution to the problem.

A possible definition of an FPC is provided by Hagemann (2010): "*At its most basic level, a fiscal council is a publicly funded entity staffed by non-elected professionals mandated to provide non-partisan oversight of fiscal performance and/or advice and guidance – from either a positive or normative perspective – on key aspects of fiscal policy*" [in Hagemann (2010), p.5]. The primary objectives of a fiscal council are to promote fiscal discipline, notably condemning fiscal indiscipline, revealing its causes and pointing out the way towards a sustainable fiscal policy. Nevertheless, as fiscal councils are unable to directly solve the political failure that intrinsically causes fiscal indiscipline they cannot be considered complete solutions [Wyplosz (2008)]. Councils can only try to mitigate and possibly eliminate the implications of that failure. Without political failure, disciplined politicians would always conduct policy in order to maximize social welfare. Indiscipline would simply not be an issue and fiscal discipline would be compulsory within all levels of government. However, as the political failure persists, councils provide the possible solution. In this section FPCs will be characterized in detail and will be analyzed in order to provide an overview about when and how they can help tackle fiscal indiscipline and deficit bias.

The idea of FPCs is not new, although it has only recently gained momentum in the political communities of a number of countries. One of the first councils to be established was the Netherlands Bureau for Economic Policy Analysis (CPB), founded in 1945. Another example is the Congressional Budget Office (CBO) in the US. Established in 1974, it is the largest council to date, and is mandated to provide the Congress with: "(…) *objective, nonpartisan, and timely analyses to aid in economic and budgetary decisions on the wide array of programs covered by the federal budget and the information and estimates required for the Congressional budget process*" [from the CBO website[4]]. As in the CBO, independent evaluation of fiscal policy is the core task of a majority of the other already established councils. However, the form in which evaluation is conducted and provided to voters may vary from one institution to another. Depending on the economic, political and historical context of each country, there is a wide range of motives for establishing an FPC. There are as many motives as there are problems driving fiscal indiscipline, and so different councils in different countries may perform different tasks when working towards the objective of ceasing indiscipline,.

Right from the outset, the approach and methods the council should follow have to be explicitly and minutely defined and mandated by the government or Parliament. A clear and thorough statutory position and mandate are essential for the council's survival and success. In this sense, it should be determined if fiscal policy is going to be

[4] See http://www.cbo.gov/.

assessed *ex-post* and/or *ex-ante* and if in a positive and/or normative manner. In addition, if permitted by the legislature and in order to strengthen incentives for fiscal discipline, some FPCs may also be mandated to supply normative judgments and recommendations, for example by evaluating fiscal policy against the government's pre-set objectives. Sometimes, FPCs also actively participate in the budget process by helping to prepare the macroeconomic framework underlying the budget, giving advice of various types, issuing credible fiscal projections and macroeconomic forecasts, and providing assessments of specific policy measures (e.g., social security sustainability studies or analyses of the economic sustainability of the public healthcare system) [Annett et al. (2005)]. Notwithstanding, even when FPCs are mandated to deliver recommendations and analyses, all decision-making over fiscal policy – namely final decisions on budgetary targets and the fiscal stance – remains within the government's sphere. This ensures that governments alone are responsible for decisions on fiscal policy [see Calmfors and Wren-Lewis (2011b) and EC (2010b)].

Furthermore, it is worthwhile to shed some light on the goals councils want to achieve. Typically, councils evaluate whether the policies pursued (and/or projected) by governments are sustainable in the middle and long runs. Following this evaluation, councils use a number of channels to influence policy outcomes. If deemed credible and well-reputed by the public, a council has the ability to steer government fiscal policy to sustainability. For example, it can publicly highlight deviations of government policies from their optimal path, thus creating, *per se*, reputational costs for the government. Also, a council can be given a 'watchdog role' consisting of providing unbiased information to the electorate, helping them judge the government's fiscal policies with accuracy and impartiality [Kirsanova et al. (2007)].

Fiscal councils may also be of help in addressing problems of fiscal opacity, particularly by promoting transparency in fiscal policy and within the fiscal framework. Along a similar vein, independent agencies can help reduce the consequences of asymmetric information between voters and policy-makers by publicly explaining what the public finances look like and how the tax payers money is being used – namely on which projects and policies [Debrun and Kumar (2007) and von Hagen (2010)]. A mandate like this would allow the credible conveying of impartial information to the public about the economic outlook of the near and medium-term future. Hence, as privileged observers of economic and political developments, FPCs could detect and denounce non-transparent tendencies in the government and the budget process. This scrutiny creates incentives for governments to respect an acceptable code of conduct within fiscal policy. Besides, these institutions can also be effective in increasing governments' accountability towards voters by raising awareness – both in voters and politicians – of the long-run costs of current deficits. Thus, one of the FPC's greatest assets lies in media and public attention insofar as it is allowed to leverage its role of raising awareness. Also, an FPC's assessments may play an important role in enriching and informing the public debate about relevant fiscal issues, including within the national Parliament.

Foundationally, the usefulness of a council depends on a clear definition of what it is intended to do, notably its remit, the scope of its activity and its mandate.

The remit of a fiscal council concerns the issues on which the FPC will have to focus its attention and the economic objectives it should pursue and try to achieve. Usually, the remit of councils lies in performing advisory and/or monitoring tasks. Calmfors and Wren-Lewis (2011a) identify a set of four possible core activities of a FPC: '*ex-post* evaluation of whether fiscal policy has met its targets in the past'; '*ex-ante* evaluation of whether fiscal policy is likely to meet its targets in the future'; 'analysis of the long-run sustainability and optimality of fiscal policy' and 'analysis of fiscal transparency'. Notwithstanding, the scope of the remit can vary. Not only could it include aspects of fiscal policy – as in the Belgian and Canadian Councils – but it could also cover employment, growth and other areas – as is the case of the CBO in the USA. The mandate of an FPC, on the other hand concerns its specific and periodic tasks and role in the budgetary process. These tasks may include publications, reports, projected variables and issuance of recommendations, analyses and/or other inputs for the budget process. An FPC can also have other formal obligations such as time-scheduled reports, regular hearings in the parliament, specific data production, forecasting activities, and considerations about the budget proposals, among others. A fiscal council must have a clear and unambiguous mandate, which should include the regularity with which the tasks assigned are to be performed. Importantly, whatever the council is directed to do – all of its tasks as well as the scope of all its activities – has to be widely recognized by politicians and voters in order to ensure the council is both accountable and protected [EC (2010b)].

In addition, as fiscal indiscipline can result from several different causes and varies by country, it must be ensured that domestic FPCs seek to address the particular problems that exist in their countries, notably by adapting their remits and mandates to the problems one wants them to solve. In support of this notion, von Hagen (2010) states that the design and powers given to a domestic FPC depend on what is causing fiscal indiscipline in each country. The experience of having a fiscal council cannot be transferred from one country to another unless their underlying problems are the same. Therefore, before anything else, a clear understanding of the individual fiscal problems of the country is vital. Only then is it possible to empower a council to perform the tasks that would properly address them. For instance, a country with an extensive record of biased forecasts and without any reliable institutional provider of forecasts and economic assumptions perhaps should call on its domestic FPC to provide forecasts. On the other hand, if the country already has a meritorious forecast provider but instead does not comply with fiscal rules and often undervalues fiscal sustainability issues, it should perhaps establish a council that would mainly highlight the importance of fiscal discipline and somehow monitor compliance with fiscal rules.

Moreover, the tasks an FPC can be assigned depend on other aspects too. When it comes to establishing a council, one has to bear in mind the institutional environment of the country in order not to duplicate responsibilities and tasks. The current fiscal situation, the culture, the tradition and the institutional arrangements that already exist in the country are specific features that influence the array of tasks a council may be mandated to perform. Additionally, the remit of a council must fill the country's need for quality research. However, if there is already a strong national academic tradition in producing high quality scientific content about domestic fiscal issues, it would probably be redundant for the FPC to do the same. Besides that, institutional frameworks usually vary from one country to another; even when they are similar there are always relevant differences that remain. The extent to which existing institutions are independent from the government, their reliability and perceived quality of their analysis, the fiscal history of the country and the institutions' past work, all contribute to the disparity.

Another central aspect of councils relates to the budget and resources that support their activities. When one estimates the resources a new FPC may need, it is important to consider first the scope of the activities the council is performing. First, we ought to anticipate what the regularity of the studies produced by the council is going to be (e.g. quarterly, semi-annual, etc.). Some existing councils, such as the Swedish FPC, publish reports at least twice a year but there is not a clear benchmark on what shall be the minimum/maximum regularity in which the council must produce reports. Then, one should consider the complexity of the tasks and analyses assigned. For instance, it is important to consider if the evaluations are of a general nature or instead, if they are more detailed and/or if the FPC is mandated to produce analyses upon request, etc. It should be acknowledged that these extra activities consume resources. Lastly, the variety of subjects under scrutiny is also important. Should the FPC have a unique focus on, for example, macroeconomic forecasts, or, on the contrary, should it also analyze employment, growth, and other fiscal issues? Thus, when establishing a council, policy-makers have to mindful that the scope of activities indeed influence the need for resources (human and financial), the composition, and the likely design of a council [Calmfors (2010a,c)].

The *modus operandi* of an FPC is also a crucial determinant for the success of its activities. As noted by the EC (2006b), three possible frameworks emerge: positive analysis, analysis against benchmarks and normative analysis. Councils that conduct positive analysis are usually forecasters of macroeconomic and budgetary variables, and statistics providers. Typically, their main aim is to improve the quality of the stream of information that underpins fiscal policy-making. Even though they cannot assess policy against benchmarks, they are still able to make positive assessments, carry out studies on a number of fiscal issues and/or perform costing analyses of policy initiatives. Sometimes, this kind of councils are able to somehow circumvent the limitation of not being able to assess policy against benchmarks by assessing the impact of two or more alternative policies thus leaving to the public the task of choosing the one they find best – as done by the CBO in the USA, for example.

Moreover, FPCs that deliver analyses against benchmarks are those that independently monitor fiscal developments besides evaluating a number of fiscal issues. These councils may perform *ex ante* evaluations of whether fiscal policy will meet its targets/rules or not. Alternatively, they can evaluate *ex post* if the policies have met their pre-set targets/rules**.** Lastly, in addition to normative analysis, some fiscal councils also issue recommendations and statements about the governments' policy.

One might ask which framework suits best, but the answer is not clear. Nevertheless, following Calmfors (2010b) and Calmfors and Wren-Lewis (2011a, 2011b), some useful considerations can be made. A first note refers to the minimum positive analysis that a FPC should perform: at the very least, a council must report on the economic consequences of the government's policy. The second is that there is a risk, which cannot be ignored, that the normative recommendations could compromise the positive analysis. Therefore, when defining the mandate of a council, one must be mindful of the fact that there are tasks that, when carried out together, are counter-productive as they may give rise to conflicting goals. For example, a council producing forecasts and, at the same time, making *ex post* evaluations and issuing policy recommendations, may produce biased evaluations of policy. Thirdly, existing FPCs differ in the amount of normative advice they provide, and about half only provide positive analysis. This diversity may reflect the multiplicity of countries' political environments, the differences in domestic institutional frameworks, and the range of problems and needs associated with fiscal policy among countries. Fourth, there is no consensus about what tasks a council should perform beyond engaging in policy evaluation and sustainability analysis. There is no obvious pattern for combining additional tasks. In the end, it is likely that normative evaluations and recommendations would carry more weight than positive analysis because with the former, the public has a clearer benchmark to judge policy against.

An additional question involving remits and mandates is the trade-off between a narrow and a wide remit. A broader remit has the advantage of producing valuable inputs for the conduct of policies. For example, it can cover growth, ageing, employment and development. Moreover, a wide remit helps to raise the general quality of the economic policy debates. Studying different fiscal subjects also results in synergies as it helps councils to reach more fundamental conclusions about policy as well as to be more aware of the overall fiscal scenarios. On the other hand, having too much to do entails a risk of subtracting crucial political and public attention (in addition to the human resources) from the primary objectives of the FPC. Ultimately, it needs to be remembered that these objectives were the ones that lead to the establishment of the council.

The quality of the activities conducted by a council is also directly dependent on the capabilities of those who carry them out. Therefore, the composition of an FPC is as important as its remit and mandate. A number of relevant conditions have to be met when deciding on the council's composition: the board of directors, their background and the background of the council's staff, the appointment procedures, the length of the term in office, the compatibility between the member's responsibilities and their political positions, the size of the secretariat, and the voting procedures are all aspects that deserve consideration. In this respect, the example of ICBs is valuable. Central banks provide an essential benchmark when it comes to strategies of ensuring independence of labour, and of reaching effectiveness in meeting policy objectives and fulfilling mandated tasks. In the literature, the majority of deliberations about the composition of councils are based on the examples of ICBs. Among the authors who have studied the composition and independence of councils are Fatás et al. (2003), Kirsanova et al. (2007), the EC (2006b, 2010b), Calmfors (2010b), Rogoff and Bertelsmann (2010) and Calmfors and Wren-Lewis (2011a). Some of the pertinent questions will now be discussed.

Which professionals should run the FPC? Typically, an FPC has a secretariat or staff (varying in size) and a board of directors (or executive committee) that aim to help and advise the Chairman in managing the council's internal and public activities as well as protect him from attempts of political capture or other interferences. Both the council's directors and staff cannot be randomly picked from the labour market; their recruitment and appointment, respectively, must respect a basic rule of independence, which is that they must not have been involved in politics (for at least some time).

One may identify five possible sources of people that may be integrated into an FPC. A first possibility is academic researchers because of their presumed independence and expected fresh research perspectives. They are probably the best choice. In turn, public finance experts from various levels of government administration may also be included when some expert knowledge about detailed assessments of budget bills is necessary. A risk with these specialists is that they may be focused on the prospects of a future career in government administration and thus, they may have some incentives to consider the government's preferences instead of the preferences of society as a whole. Alternatively, the council's composition may include analysts from the private financial sector. In this case, however, the catch is that they may have possible loyalties to their former or future private employers. In addition, the council could hire former politicians who benefit from widespread recognition of merit. The advantages are that ex-politicians know the system, and if the council combines people from different parts of the political spectrum, its credibility may be enhanced. In contrast, a major risk is that their analyses may be restricted by earlier positions they have taken in public. Finally, another possibility is to invite foreign personalities who may help assure the council's independence and impartiality towards the domestic political environment. The recently established Portuguese Council, for example, have included two foreigners within the five members that compose the board of directors, the German Jürgen von Hagen and the Hungarian George Kopits[5].

How should the members be appointed? The appointment of the Chairman and board members must follow some sort of specific and predefined procedure that ensures the board's functional independence. The appointment procedures must be grounded in guaranteeing professionalism as opposed to political preferences. In line with this, the parliament and/or other domestic independent institutions can recommend and/or nominate the governing body of the council. The government may also have a say in this process. For example, it may be asked to approve the appointed members of the council. Some authors argue that the appointment of members should be done by independent entities, such as the ICB, or by the council itself. Some degree of government involvement in the procedure may give rise to more political costs in case the government does not follow the council's recommendations afterwards. However, in terms of independence, too much involvement may be dangerous. In short, the appointment process must be designed such that it helps to guarantee independence, merit, technical expertise and credibility.

What is the appropriate length for the term in office? This is also variable. For example, in Belgium and in the UK the period in office is five years, in Denmark three,

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[5] See Barbosa et al. (2011) and Diário da República (2012).

and in Sweden it is currently one. In any case, as the elements of the council are to be completely independent from the political sphere, assigning the council's decision-making body long, fixed-term, non-renewable periods in office (as in central banks) may be an effective means of ensuring independence and impartiality.

How many people does a council need? The dimension of the staff of existing FPCs is diverse. While the Slovenian FPC has no permanent staff at all and its appointed members play their part in the council's activities in parallel with their current professions, the CBO has 230 members of staff. However, a council's secretariat usually comprises of 15 to 40 professionals. Moreover, the relationship between the size of staff and the remit is unclear. Nonetheless, the number of technicians needed tends to be related to the level of detail involved in the council's analyses and assessments. At any rate, it is vital to secure the absolute minimum of human capital needed to perform all the mandated activities. Therefore, it is crucial to introduce formal arrangements ensuring that the government will not reduce the council's staff or fire its members at will whenever it finds it 'politically convenient' to restrain the activity of the council. This kind of under-resourcing can compromise the soundness of the council's assessments, evaluations and/or forecasts and, eventually, can completely subvert the council's *raison d'être*.

Other concerns about councils' independence. When it comes to independence, there are some other important notes to take, namely some lessons that can be learnt from ICBs. A first basic rule for independence is that the council cannot take any directives from the government or any other institution. This means that the council has to be formally and informally insulated from all kind of government's interferences, especially backstage actions and/or non-transparent contacts. Thus, contacts between the FPC and the government should always be institutional and transparent, and not behind doors. Second, the independent development of frameworks, analyses and concepts has to be formally assured. Ideally, FPCs should be free to independently judge and question the governments' policies and assumptions. Councils should also have the freedom to initiate the studies and investigations they believe necessary instead of only responding to requests for information from the legislature. Finally, a last premise for reinforcing the independence of fiscal councils is to hold them accountable. Not holding a council accountable in the short-run may risk its long-run independence.

Given the likely conflicts the FPC and the government may have, it is prudent to ensure that the council's work is evaluated regularly so that the government is deterred from restricting its independence or reformulating its tasks.

The supervision of councils is not a subject of consensus among authors. The question of which body, if any, should supervise the national council by acting as principal in a principal-agent relationship, is not easily answerable. Nevertheless, a number of options have already been employed in different countries, denoting that this is a choice that greatly depends both on the countries' political system and on the countries' exposure to international organizations.

Accountability can be established in many ways. As noted by Calmfors and Wren-Lewis (2011a), a fruitful way of making FPCs accountable may be to establish international standards ruling their activity. This would also imply an added political cost for governments in case they wanted to attack the FPCs' independence. Similarly, Rogoff and Bertelsmann (2010) propose that councils could be monitored by an international agency – such as the IMF, for example. Such monitoring could assess and provide multi-dimensional ratings of the FPCs' performance. Alternatively, a more formalized international network of councils could be established. Further, in case international supervision is perceived as insufficient, Lane (2010) proposes an accountability framework based on a two-track process, where the council testifies and reports to the national parliament on a regular basis and is also periodically audited by an international expert group. Lane is not alone in endorsing the parliament supervision idea, as other authors also consider that having the parliament as the council's principal could enhance independence Notwithstanding, regardless of the type of supervision chosen, it always has to be carefully designed from the outset as limits and boundaries should be accurately defined and placed. For instance, it should be determined that the right of dismissing a council or any member of its board must only be made in very specific circumstances, and only if approved by a qualified majority within the Parliament. On the contrary, some disagree on having the parliament as a council's principal but, instead, suggest that the government could be a wiser choice. At any rate, the supervision of some types of councils is less necessary. Von Hagen (2010) believes that for councils that are only mandated to improve transparency, for example, the accountability of its members to their peers may be sufficient given that their peers' evaluation may affect their future career prospects.

A recurrent argument from fiscal council sceptics refers to effectiveness. As previously mentioned, the effectiveness of a council depends on its ability to create reputational costs to the government in case it does not follow and/or consider the council's widely publicized recommendations and/or assessments [Calmfors et al. (2010)]. Notwithstanding, it is worth explaining in detail how a council is able to influence and steer fiscal policy-making towards sustainability. A few simple logical steps help explain the reasoning: first, the government's deviations from the optimal path of fiscal policy will be noted and condemned by the FPC. The government, which is rational, will anticipate this. Hence, the government, *a priori*, has to choose between being disciplined by following the correct policies from society's standpoint, i.e., those that lead to sustainability, or being undisciplined and pursuing its own personal and/or other private interests. If it chooses discipline it will be backed by the council and probably rewarded with the voters' appreciation; otherwise, it will be publicly condemned by the FPC and is likely to face voters' disapproval. This anticipation from the government, *per se*, will restrain the pursuit of its own interests rather than those of society.

Nonetheless, a number of other factors are crucial to a council's effectiveness. Autonomy from the government, active public dissemination of analyses, visibility, credibility and a record of impartiality and objectiveness are some important conditions for its success[6]. In this respect, Calmfors (2010a) notes that in the long-term, the council's impact on policy depends on the quality of its work. On a daily basis, it is the reputation of the council that will grant it media attention in order to create pressure on the government, forcing it to pay attention to the council's assessments and recommendations. Thus, for fiscal councils, the media (and the internet) is a very important channel for feeding information to the public. In addition, FPCs must be credible, well-reputed and highly visible to the eyes of both political actors and the general public. Only a credible and well-reputed council would be able to influence public opinion and promote the debate. Besides, the more credible an agency is, the

[6] See Hagemann (2010).

more the government will pay attention to its assessments and analysis. As governments are usually not obliged to follow the councils' recommendations or to use its forecasts, if they still do, it is in part due to the trust they have in the institution. At the end of the day, a visible, credible and media attention-catching institution is more likely to influence budgetary outcomes and the quality of public finances than one that does not show those features.

There is also a belief among economists that the effectiveness of councils is to a considerable extent conditioned by the government's cooperation and commitment to fiscal discipline. As noted by Hagemann (2010), the mere existence of a council is not sufficient. Instead, a 'strong and sustained political commitment to a medium-term fiscal goal' and to the mandate of the FPC is critical. Fiscal councils are not 'silver bullets' that eliminate fiscal profligacy forever. Without this commitment from the government, and lacking the necessary political will, the ability of a fiscal council to improve fiscal outcomes is uncertain. Conversely, when there is commitment and political-will towards fiscal discipline, one may think that the presence of a council is superfluous. Nevertheless, as governments come and go, a credible and durable council can still become an impartial and objective voice in promoting fiscal discipline across the legislatures. Good fiscal institutions are the key to achieving a healthy fiscal performance, and one of the FPCs' major tasks should be to constantly remind politicians and voters of the value of fiscal discipline and the costs of fiscal profligacy [von Hagen (2010)]. Besides, as argued by the EC (2006b), a high degree of ownership seems to be a key condition for the success of councils. The fact that the political forces have established the council, *per se*, increases the reputational costs for politicians of ignoring or bypassing the institution's analysis, recommendations or forecasts. Hence, a final upshot is that general support from most political parties for the activity of the FPC, especially before the establishment and during the first years of the council, is a determinant of the council's success [Mihályi (2010) and Calmfors et al. (2010)].

Also, when it comes to access to data and relevant information, councils will always depend, to some extent, on government's cooperation. In this respect, at the outset of the council, it is crucial to have the government/parliament explicitly declaring that, within the scope of its activities, the FPC will have complete access to true, reliable and timely information and data about public finances at all times. In addition, when the council's mandate includes tasks such as forecasts and policy assessments, it should be given full access to internal information from the national statistical office, ministries and other governmental bodies [EC (2010b)].

Furthermore, the effectiveness of councils is necessarily measured by correlating their activities with policy outcomes. It is worth explaining these correlations. Debrun (2007) studies the channels through which FPCs may be able to impact budgetary outcomes. An interesting finding is that these impacts are mainly achieved through improving incentives for fiscal discipline. Besides that, the greater the council's strictness with government's indiscipline and the larger the guarantees of independence from political interference, then the greater the likelihood is of actual impacts. Also, there seems to be a positive relationship between the 'index of legal restraint' and the 'guarantee of independence'. This may indicate that when countries instituting these agencies are seriously committed to fiscal discipline, the council's effectiveness is increased, confirming the importance of the 'strong political commitment' idea from Hagemann (2010).

In general, existing independent fiscal institutions have been successful in influencing fiscal policy in their countries. In this respect, the EC (2006b, 2010b) confirms that many existing independent institutions – FPCs and others – seem to have influenced the public debate and are benefiting from large media coverage. The forecasts, analyses, recommendations and other policy advice from independent fiscal institutions are, indeed, influencing the conduct and developments of fiscal policy and thus contributing to fiscal discipline. According to the EC, this is the case at least in the Netherlands, Belgium, Austria, Slovenia and Sweden. In these countries, fiscal policy councils have earned a good reputation among voters and are highly respected by the political establishment.

This latter example confirms that informal independence, namely a council's reputation, is vital for making both the public and politicians aware of the councils' activities [Calmfors and Wren-Lewis (2011a)]. Mihályi (2010) argues that, from the outset, councils must demonstrate total independence from the government while building a highly technical team of experts to gain the necessary credibility from political leaders, financial markets, the press and the public at large. However, this process is usually slow, and a large amount of time is needed to build a good reputation. Therefore, a wise suggestion would be to delegate the tasks to older, well-reputed institutions sufficiently capable to perform them, instead of creating a new council from scratch. However, the risk with such a solution would be to have a council designed and shaped to fit within an existing institution, along with its traditions and governing structures already consolidated, instead of a council specifically designed and shaped to respond to the specific domestic fiscal policy problems in an unambiguous manner.

Rivlin (2010) states that, for young councils, establishing trust is difficult. It may be necessary to survive an inter-party change in government for a council to gain the trust of the politicians, the media and the general public. Until this happens, the FPC risks being seen as the government's political opposition rather than an impartial and independent body concentrating on fiscal policy only. For instance, the CBO – in which Alice Rivlin was the first Director – had to survive that change before being able to prove its (now widely recognized) impartiality. An interesting proposal in this respect is from Calmfors (2010a), who says that in the short-term, a government can help a new FPC get a 'flying start' by publicly committing to build on its analyses and heed its advice. Likewise, the government can include or mention the council's recommendations or analyses in the budget bill and other policy documents. Nevertheless, it is to be expected that the government's appreciation of the national FPC tends to be greater before rather than after its establishment.

There are some other noteworthy questions that directly influence the effectiveness of councils. The first issue is if councils really need an official status. It has been argued that academics and individuals from the public are able to play the same role as FPCs. This criticism is countered by three main arguments. First, having an official status enables more influence over policy; it is a way of getting an edge in media attention since there are many 'competitors'. Second, an official council can be given an official role in the budget process. However, the third and strongest argument is that a council commits independent academics and other economic experts to 'a sustained and consistent participation in the public discussion about fiscal policy' [Calmfors (2010a)]. In fact, the reality in most developed countries is that it has become very difficult to get academics to actively and regularly participate in the public economic policy debate, particularly due to their increasing specialization in specific areas of knowledge. Hence, an FPC can fill this void by re-directing ‘academic talent in the direction of fiscal policy evaluation’. Moreover, the direct involvement of an FPC in the budget process may be a positive factor and may allow it to convey messages in a direct and efficient way. This involvement could occur in various degrees. For example, the council could attend regular hearings in the parliament during the preparation of the budget, or the government could be obliged to justify departures from the council’s recommendations. A bolder arrangement would be to make the use of the council’s forecasts mandatory in the budget process or even to make the council’s approval of the draft budget mandatory [EC (2006b, 2010b)].

Another aspect of FPCs worth discussing is their democratic legitimacy. In fact, the legitimacy of councils to evaluate elected representatives is sometimes questioned. Nevertheless, the reality is that the council’s job is to further rationalize economic constraints and bear closer in mind the preferences of the majority of voters. In addition, FPCs might substantially increase the government’s accountability for its policies. This can be achieved by increasing the amount of reliable and impartial information made available to the public. On the other hand, when an FPC evaluates policy and makes normative recommendations, the risk of misusing its powers and defining its own policy agenda becomes, indeed, real. This is why it is highly advisable to have councils not setting their own economic-policy objectives but, on the contrary, base their activities on objectives previously set within the political system, notably on those inscribed in their Statutes. Then, the recommendations and evaluations issued by councils will only focus on the possibility of reaching the pre-set political objectives [Calmfors (2010a)].

It is crucial to explain how FPCs are going to solve most of the problems exposed in Chapter 2, because such an explanation is indeed their rationale. In general, the aim of the proposals of specific councils is to tackle one or some of the underlying causes of fiscal indiscipline and deficit bias. Hence, such proposals and the extent to which they overcome those problems shall be presented here.

One of the most recommended types of FPCs is the one that assesses the budgetary impacts of fiscal measures and provides analytical inputs to the political processes, especially high-quality independent macroeconomic forecasts, policy evaluations and/or impact assessments. Such agencies may also be mandated to monitor the consistency between *ex post* government policy and *ex ante* objectives, which would allow it to effectively constrain discretionary fiscal policy-making [Calmfors (2005)]. In this respect, the EC (2006a) claims that these analytical fiscal councils would improve the effectiveness of national-level rules. In addition, they would address the deficit-enhancing problem of procyclical biases during upturns.

The tendency of governments to 'inflate the growth forecasts underlying budgetary plans' may also be reversed by introducing forecasting fiscal councils. There are some proposals designed to deliver independent macroeconomic forecasts [e.g., Jonung and Larch (2006) and Kirsanova et al. (2007)]. Jonung and Larch (2006) diagnose a problem of over-optimism in a number of governments' projections of macroeconomic variables. The central problem is that the bias affects fiscal performance and leads to larger deficits and a faster accumulation of debt, being one of the sources of deficit bias. Therefore, if a country's budget process is based on biased forecasts, a wise way of purging it is to create an authority that depoliticizes the production of economic forecasts (of growth rates and other variables) and that takes over the task of producing the mandatory forecasts that underpin budgetary plans. In order to guarantee independence, this agency would have to be shielded from external interference, especially from domestic political pressures, which could be achieved by giving it legislative protection. Similarly, Kirsanova et al. (2007) propose the creation of a Fiscal Monitoring Commission, funded by the government, which would be charged with producing the best available projections for the public sector finances. Hence, if projections indicated that there was a significant chance that the public finances were not sustainable or that the debt path were sub-optimal, the Commission would publish proposals for changes to aggregate spending or taxes. In turn, the government would be required to publish a response to these proposals.

Councils may also have a role to play when it comes to informational deficiencies, economic illiteracy of voters, or severe asymmetries of information between the government and the public. Voters are often unaware of the true costs of tax cuts and spending increases. An FPC can produce and improve the availability of information on this matter for the voters and so encourage them to make a more rational and informed judgment about the government's competence, argues Wren-Lewis (2011). Besides, there is evidence – for instance from the Dutch CPB – confirming that informationoriented councils effectively discourage both government and opposition parties from bribing and/or pandering to the electorate before elections. Rogoff and Bertelsmann (2010) adds that, to address the public lack of information and *naiveté*, FPCs can run educational and awareness campaigns, and increase the availability of economic studies explaining the costs of indebtedness.

Impatience is another related cause of indiscipline that councils may help counteract. When the electorate is impatient and does not understand the fiscal sustainability dynamics – like the need for procyclical policies – a fiscal council can play an informative role by raising awareness and consciousness within the public. This is a task not so easily played by a government preoccupied with elections. In addition, the government can be impatient too and, in this case, a fiscal council can be another source of political pressure. These possible tasks are indications of how a fiscal watchdog can go a long way in approximating the government's preferences with those of society [Calmfors and Wren-Lewis (2011a) and Wren-Lewis (2011)].

Calmfors (2010a) also refers to some possible tasks that a transparency-oriented council could perform. It could make analyses known to increase awareness of the future costs of current deficits as well as of the risks associated with hidden debts and liabilities[7]. In addition, it could maintain a vigilant monitoring of all off-budget items and attempts of creative accounting. In turn, Annett et al. (2005) see FPCs as part of the strategy to strengthen the SGP. These bodies could play a relevant role in the attainment of the EU fiscal framework's objectives. They could review the national Stability Programs and help address problems such as the reliance on one-off measures and misreporting problems. In effect, this kind of activity would be of help in implementing and enforcing the SGP as well as in fostering national ownership of fiscal rules.

Also important is the possibility of assessing the feasibility and the impacts of some governmental projects from a fiscal sustainability standpoint. Calmfors et al. (2010) argue that fiscal councils can be useful in predicting the need of structural reforms by alerting the government and the public to future fiscal risks and stress. Furthermore, councils can also help inform voters of what policies are and are not in their interest from an economic angle and remind the public of the government's

[7] See also Rogoff and Bertelsmann (2010).

intertemporal budget constraint, particularly by highlighting the possible consequences of non-compliance with the constraint. In addition, FPCs can also bring some issues – like the long-run effects of fiscal policy and debt sustainability – to the political agenda, thus promoting its debate and bestowing them with the importance they deserve. Besides that, they can improve the quality of the economic policy debate in parliament by providing impartial and objective macro-fiscal analyses.

Fiscal councils can also alleviate common-pool problems. FPCs may issue recommendations to strengthen the authority of the finance minister when he is negotiating the budget with spending ministers and other agents. It would promote the necessary adjustments between the benefits added and the costs inflicted by (greedy) agents. In addition: "(...) *in more fragmented political systems, the recommendations of a fiscal council could form the basis of contracts between political actors that in effect internalized fiscal discipline*" [in Wren-Lewis (2011), p.18]. Moreover, von Hagen (2010) and von Hagen and Harden (1994) also propose the creation of a body that would be able to counteract common pool problems. This agency would serve as a coordinating device for the budget by imposing an annual ceiling for the budget deficit. In order to implement the deficit ceilings, the agency would require delegation of enforcement powers and, so, it would be difficult for it to obtain the necessary political support. However, a fiscal watchdog would also be able to play such a coordination role, notably by encouraging spending ministers to respect the pre-set fiscal objectives [Calmfors and Wren-Lewis (2011a)].

Von Hagen (2010) also considers that a fiscal council can be more effective at addressing problems of fiscal opacity, informational problems or issues related to the common-pool of resources rather than the time inconsistency of preferences in fiscal policy. The reasoning behind is that resolving time inconsistency implies delegating policy in an undemocratic fashion to an independent council, since the council's decisions would have distributive consequences. However, Calmfors and Wren-Lewis (2011a) counter-argue that an FPC that guards fiscal rules and advises the government may indeed reduce time inconsistency of preferences and inflation bias. As fiscal rules deal with deficit bias arising from this type of time inconsistency, a fiscal council can thus safeguard such rules in case policy-makers have incentives to depart from them.

FPCs may also guard fiscal policy from being used for political reasons. Councils can reduce the strategic use of debt for electoral competition as well as restrain the presence of political budget cycles. If the parties in the parliament agree to implement a fiscal rule to counter deficit bias arising from electoral competition, then an FPC can act as guardian of the rule and raise the cost for politicians trying to breach it [Calmfors and Wren-Lewis (2011a)]. In addition, fiscal councils' macro-fiscal analyses help deter incumbent governments from signalling their competence to the electorate through deficit-increasing policies. Hence, as the electorate begins to be informed about these economic-related subjects, it would be harder for politicians to pursue their electoral interests by means of mesmerizing voters with deficit-consuming policies before elections [Calmfors (2010a)].

The proposals of fiscal councils do not solely address domestic institutions but also transnational institutions. For instance, some authors refer to the need of further discussing the possibility of establishing a council that cuts across the European EMU.

The Council of the European Union (2010) advocates for a stronger economic governance that may be attained by means of encouraging interdependence between the economies of the Union, particularly within the euro area. It is within the context of reinforced governance that it makes sense to talk about an FPC at the EMU's level.

One may ask why the EC, for example, cannot play the role of a European FPC. Kirsanova et al. (2007) argue that, even by regularly monitoring budget developments and issuing public recommendations, the EC falls short of what a council may be required to do. The reason is that EC activity is too tied up by requirements from the SGP. Nevertheless, even if it was not, monitoring by the EC would always interfere with the strategic position of other Member States, argue Kirsanova et al. (2007). To prove this, Stéclebout-Orseau and Hallerberg (2007) build a model testing if a European watchdog could act as a signaller of Member States governments' indiscipline. The authors assume that as the EDP depends on peer pressure to be implemented, the more undisciplined Member States are as a whole, the less that pressure is and the lower the probability of sanctions. They find that, given the peer pressure procedures of the SGP, the scenarios in which a European watchdog would have incentives to signal indiscipline are scarce. Therefore, it could be counterproductive for a watchdog to signal the Member State's indiscipline because it could encourage other peer States to raise their deficits as well.

Apart the aforementioned proposal of delegating evaluation and ratings of national FPCs to an independent international entity, there are other proposals worth noting. Calmfors (2010a) suggests that a European council could, based on macroeconomic risk considerations, decide in advance on appropriate haircuts in the event of future sovereign debt restructuring. Another consideration is from Lane (2010) arguing for the importance of some sort of international cooperation network between national FPCs to change impressions and develop best-practice analytical frameworks.

Even earlier, Fatás et al. (2003) had also proposed the creation of a sustainability council for the Eurozone. Its mandate would be to assess Member States' national fiscal sustainability, to publicly detail their analyses and recommendations, and to advise the Economic and Financial Affairs Council (ECOFIN) to initiate the EDP. Another proposal for an independent committee of European fiscal experts is from Burda and Gerlach (2010). Their 'fiscal stability board' would monitor fiscal developments in the Eurozone, vet governments' justifications of fiscal deficits, and assess – as well as publicly comment on – proposed consolidations. This board would be small and manageable, composed of legal scholars, former senior central bankers, members of academia from across the Eurozone (especially economists), and also some former finance ministers, so that it would be taken seriously in the political sphere.

Similarly, the ECB (2010) endorses the idea of a fiscal agency tasked to 'monitor and assess national budgetary developments and advise the Eurogroup and the Council'. This proposal would aim at strengthening European governance, notably through enhancing fiscal surveillance, increasing the enforcement of fiscal discipline and providing the right incentives for Member States to comply with EU fiscal rules. Also important are the arguments from Calmfors (2010a) who believes that an independent fiscal council at the European level could assure that national fiscal frameworks would meet certain minimum standards or, alternatively, could deliver macroeconomic surveillance of Member States within a more judgmental role. Its main justification is that it would be best to have an independent European body carrying out surveillance given the extraordinary exposure to political interference this task encompasses.

5. Experiences with FPCs

Having understood the underpinnings of FPCs, the natural next step is to scan existing councils, getting to know about their experiences. These may teach important lessons in order to start drafting good practices. For instance, analyzing the existing councils' experiences may be helpful to picture the likely challenges of integrating domestic fiscal frameworks and to learn how to actually influence fiscal policy outcomes. Therefore, this chapter offers a non-exhaustive overview of national fiscal councils, with a major focus on the European countries, gathering some considerations about their impacts on policy and other experiences.

After the establishment of some early FPCs in the third quarter of the twentieth century, such as the German Council of Economic Experts in 1963 or the CBO in 1974, other countries followed suit and created their own national FPCs. However, it was only recently – from the late 1990s to the present date – that the idea of FPCs has gained special momentum again. Accordingly, several countries have recently established councils while others reorganized existing fiscal institutions, widening their mandate in order to accommodate some of the functions and tasks that are commonly assigned to FPCs. All in all, for many modern economies, the establishment of FPCs became a viable solution, especially since many of them started to face unaffordable public indebtedness.

Before discussing the impacts and experiences of fiscal councils, it may be useful to have a clearer picture of the presence of Fiscal Councils within Europe, especially in the euro area. Table 5.1 provides an overview of the existing fiscal councils in euro area countries and in the UK, Sweden, Canada and the USA. This table only includes the fiscal institutions that are generally and explicitly identified as fiscal councils. However, one should be mindful of the existence of other fiscal institutions, more or less independent from governments, which may play important roles within national fiscal frameworks. Table 5.1 includes information about the date of establishment, the composition and the functions each national council has to fulfil.

Table 5.1 – National fiscal councils in the euro area (and four other examples), 2012

Fiscal Councils												
				Functions								
Countries	Abbreviation	Est. Date	Composition / Staff	Macro-Fiscal Assessments	Forecasting		Monitoring Compliance		Sustainability assessments	Advisory	Costing / assessments of initiatives	Website
					Prod. own forecasts	Eval. Gov. forecasts	With rules	With targets				
FPCs in Euroarea countries												
Austria	GDC	1970, reorg. in 2002	16 board members + ICB personnel	x				x	x	x		http://www.staatsschuldenausschuss.at
Belgium	HCF	1934, reorg. in 1989	aprox. 35 people	x					x	x		http://www.docufin.fgov.be/intersalgen/hrfcsf/onzedienst/Onzedienst.htm
	FPB	1994	aprox. 100 people	x	x				x		x	http://www.plan.be
Germany	GCEE	1963	16 people (5 board members + 11	x						x		http://www.sachverstaendigenrat-wirtschaft.de
Ireland	FAC	2011	8 people (5 board members + 3 people)	x		x	x				x	http://www.fiscalcouncil.ie
Netherlands	CPB	1947	aprox. 150 people	x	x		x		x		x	http://www.cpb.nl
Portugal	CFP	2011	5 board members (currently recruiting)	x		x	x		x			http://www.cfp.pt
Slovenia	FC	2009	7 board members + government	x		x	x		x			
FPCs in other countries												
Canada	PBO	2006	14 people (3 board members + 11	x		x		x			x	http://www.parl.gc.ca/PBO-DPB/
England	OBR	2010	22 people (5 board members + 17	x	x			x	x		x	http://budgetresponsibility.independent.gov.uk/
Sweden	SFPC	2007	11 people (6 board members + 5 people)	x		x	x		x	x		http://www.finanspolitiskaradet.se
USA	CBO	1974	aprox. 240 people	x	x				x		x	http://www.cbo.gov/

Sources: European Commission, Fiscal councils' websites and Kopits (2011) [see EC (2012) and EC fiscal institutions database in http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/independent_institutions/index_en.htm].

From Table 5.1, one may notice that 7 out of the 17 Euro area countries have established fiscal councils. The eighth country in the list is likely to be Slovakia, since it intends to establish such an agency in the near future. Cyprus, Finland and Italy, do not have anything resembling fiscal councils, whereas fiscal governance in the remaining countries comprises of some independent fiscal institutions that, despite not being fiscal councils, are bodies that perform some of the tasks that could be mandated to fiscal councils. For instance, Estonia has a National Audit Office that was formed in 1990 (and reorganized in 2005) and is mandated to audit public accounts and to produce advice to government on a number of fiscal issues. It has a staff of approximately 90 people. Further, Malta has a Council for Economic and Social Development (MCESD) that works with and advises the Maltese government on relevant socioeconomic issues. Luxembourg, France and Spain all have Courts of Auditors. Besides, France also has the *Commission Economique de la Nation* and Spain has the National Committee of Local Administrations (CNAL). Greece constitutes a different case, as it has the KEPE, the Greek Centre of Planning and Economic Research, but no longer has any active FPC. The fiscal council GPK – the Greek abbreviation for the State Budget Execution Monitoring Office – that was formed in 2011 became inactive in the same year. After publishing a report highlighting the fact that the Greek sovereign debt was 'out of control' and that the government's budgetary targets for 2011 would not be met, the new council had to deal with an immediate and fierce reaction from the Greek government discrediting the council's and the council members' work. This episode took place in August 2011 and led the head of the agency, Stella Savva-Balfousia, to resign, leaving this agency of independent analysts on hold.

Slovenia instituted its fiscal council in 2009. With only seven members (backed by government staff), and limited financial and technical resources, the council has not yet managed to establish a strong reputation. Nonetheless, its wide remit allows its members to address the Slovenian major fiscal policy problems. So far, the council has delivered its annual reports, although these have not been able to provide an in-depth analysis of the country's public finances.

In contrast, the German CEE has a narrower remit than the Slovenian FC but, since its establishment in 1963, has had the time and spirit to provide politicians, institutions and the electorate with impartial, independent and valuable analysis, allowing it to build a strong reputation. It is composed of academics and is intended to advise German policy-makers on economic policy and to assess the macroeconomic developments in Germany. It also aims at helping both the public and other relevant institutions to formulate informed judgments regarding fiscal issues. The council's perceived professionalism has granted its reports and assessments an important role in German economic policy-making, notably influencing several political decisions.

In Canada, the Parliamentary Budget Officer was established in 2006 and is mandated to provide the Parliament with assessments of the nation's finances, to evaluate the government's estimates and to comment on the trends in the economy. It also performs cost analyses – i.e., it estimates the financial cost of proposals – upon request from parliamentarians or official committees. The PBO is a parliamentarian agency created in order to bridge the access-to-information gap between the Canadian government and parliament. The appointed Officer together with a staff of 13 form a genuine fiscal council. The remaining councils listed in Table 5.1 are presented below. However, before further reviewing the individual experiences of councils throughout Europe (and the US), it may be useful to look at these experiences in aggregate in order to figure out if these institutions are *de facto* influencing policy and fostering discipline.

When considering the impacts that fiscal institutions have on policy outcomes, some factors should be taken into account. In spite of the complexity associated with quantitative analyses of fiscal agencies, Debrun and Kumar (2008) conducted an econometric study to assess these factors. They use a broad definition of fiscal institutions, including councils, courts of auditors, wisepersons committees and other. Therefore, its conclusions apply to councils only to a limited extent[1]. Yet, it is important to note the study's key findings. First, well-designed institutions increase the costs faced by policy-makers in case of departures from sound policies. One can deduce then that institutions can indeed help counteract fiscal profligacy. Also, a positive relationship between the stringency of rules and the role of independent institutions is noticed. Such a correlation validates the complementarity hypothesis discussed in Chapter 3. Also,

[1] For instance, as noted by Kopits (2011), although the study of Debrun and Kumar (2008) is methodologically rigorous, its conclusions are highly questionable since they are drawn from a comparison of very different entities from different countries, which, thus, are not comparable.

Debrun and Kumar (2008) find a strong correlation between budgetary institutions and fiscal performance. However, although the direction of causality one wants to look for is from institutions to fiscal outcomes, there is some evidence of a reverse causality. This may mean that well-behaved governments adopt strict rules and institutions to reveal the true nature of their preferences, rather than that undisciplined governments adopt institutions that self-impose some necessary fiscal constraints. The authors called it the signalling hypothesis. In this regard, von Hagen (2010) underlines the difficulty of judging the councils' effectiveness except over long time horizons. Only time will allow the discrediting, or not, of the signalling hypothesis. Still, doubting a council's success if it faces an uncooperative government, von Hagen (2010) corroborates the view that a reverse causality can apply between fiscal institutions and outcomes. At any rate, one conclusion seems to be consensual, a fiscal council can indeed be effective at contributing to the soundness of fiscal outcomes when governments are minimally committed to fiscal discipline: "(…) *if a certain degree of commitment exists, it can be bolstered by an FC*" [in Debrun et al. (2009), p.66].

Another attempt at measuring the extent to which the existence of independent fiscal agencies can be linked to budgetary outcomes is from the EC (2006b). Its analysis is based on the answers to a questionnaire sent to all independent fiscal institutions established within the EU, and on other internal analyses. One of the findings is that whenever forecasting was delegated to an independent body, a real correction of the bias towards over-optimism was observed[2]. Moreover, even though appearing only to capture, on average, moderate media attention, fiscal institutions were perceived to be credible and to create a 'positive and significant' impact on the public debate. Another insight is that governments seem to follow recommendations issued by these institutions in more than half the cases. However, this tends to be highly linked to the credibility and recognized quality of the institutions. Ultimately, the main message from the study is that independent institutions indeed contribute to more fiscal discipline.

In spite of the difficulty of running regressions and conducting econometric analyses to assess the effectiveness of FPCs, one can still learn from the experiences and testimonies of existing councils. Some considerations are pertinent.

[2] Those results are consistent with Jonung and Larch (2004) and Hallerberg et al. (2001).

A first important insight is from Kopits (2011) who argues that FPCs must be completely home-grown and home-owned. They must address local needs and smoothly integrate local cultures and traditions. There is no recipe one can import from abroad given that credibility is not transferable. In addition, councils must be independent, non-partisan, technically competent and accountable to the legislature. Their governing body must be appropriately remunerated and free from conflict of interest. Lastly, the speed in implementation of a council is crucial because its non-partisanship has to be quickly proven and its role has to be understood by the public and by politicians; its benefits have to be revealed promptly. Thus, it is important for the council to create an identity for itself and start operating according to its terms of reference right away.

Also, some important reflections about the mandates and tasks of FPCs are necessary. The first refers to the complementarity between councils and rules. There are some cases, such as the one of the USA, where rules and councils do not coexist and/or work in parallel. Nevertheless, the vast majority of countries that have already established FPCs have fiscal rules. Thus, it should be natural to mandate national councils to monitor their government's compliance with fiscal rules. In fact, this is the reality of a considerable number of councils. Secondly, it is worth noting that very few fiscal councils, apart from the Slovenian and the Swedish ones, are mandated to analyse how the medium-term fiscal objectives conform to higher-level, more fundamental objectives. The absence of this task from other councils' remit can indicate that 'most governments shy away from potential criticism of their chosen targets', observe Calmfors and Wren-Lewis (2011a). A last reflection relates to the inclusion of the production of analyses upon request in a council's mandate. Some argue that this could remedy the commonly perceived idea that councils politically 'favour' the opposition parties (especially before elections when parties are trying to win votes), as they typically point out the flaws of governments and not of the opposition. One idea, practiced by the CPB in the Netherlands, is to let the FPC review the electoral programs of political parties before elections. This analysis enhances the comparability between the parties' electoral platforms, as well as broadens the public's understanding and explains the economic and financial implications of the parties' proposals. Alternatively, the council could be mandated to produce the costing of initiatives upon request – from the parliament or other official bodies, for example – as is done in the

CBO and in the Canadian PBO. For instance, the CBO produces cost estimates that show how specific bills would affect spending and/or revenues in the federal budget[3]. Hence, analyses upon request also help to increase awareness, among both politicians and voters, of the implications of policy-making.

In addition to the considerations above, it may be beneficial now to collect a handful of important lessons from the experiences of already established councils. The first lesson concerns the crucial importance of assuring total independence to councils prior to their establishment. Sufficient resources and budget have to be guaranteed in order to deliver effective, high-quality analysis. Independence is jeopardized if, instead of being appropriately provisioned with resources, the council has to 'draw on the resources of the ministry of finance' [Calmfors and Wren-Lewis (2011a)]. The incident between the Hungarian government and its national fiscal council illustrates this risk. As noted by Kopits (2011)[4], after the council published some critical views about the budget bill, the – then recently-elected – Hungarian government was able to restructure the national fiscal council, by substantially reducing its funding, narrowing its remit, limiting its access to information and altering its composition. These actions were widely condemned on multiple occasions. The chairman of the council eventually resigned, some of its international peers publicly expressed their opposition – e.g., the chairman of the Swedish FPC, of the Dutch CPB and of the English OBR[5] – and, across the world, several members of academia expressed their disagreement with those actions. One of the lessons to learn from this case relates to the stipulation of resources the council needs for its activity. The availability of resources, as well as the access to information, has to be sufficiently armoured from the very start of the council. In this respect, the EC (2006b, 2010b) recommends stipulating the financing of the FPC in a formal and sound legal text. Additionally, designing a long-term budget may also help to remove any temptations from the government of monopolizing the council through the size of its budget [Calmfors and Wren-Lewis (2011a)]. Another possibility is to delegate the funding of FPCs to another independent entity such as the ICB. In Austria, for example, it is the national central bank that bears the costs of the Austrian

[3] See http://www.cbo.gov/cost-estimates/.
[4] George Kopits was the chairman of the Hungarian Fiscal Council between 2009 and 2011.
[5] Lars Calmfors (SFPC), Coen Teulings (CPB) and Robert Chote (OBR) wrote a letter to the Financial Times on the 6th of December, 2010, condemning the "liquidation" of the Hungarian Council by the Hungarian Government.

Government Debt Committee, as well as provides for the necessary personnel and material expenses. Another example is the Portuguese council whose budget has to be appraised by the national Court of Auditors. In short, better mechanisms to eliminate the high vulnerability of FPCs to political interference have to be discovered, particularly in order to protect recently established councils. Again, central banks may provide useful insights about formal provisions for independence. The amelioration of these provisions would result in a higher council survival rate.

The inclusion of forecasting in an FPCs' mandate also deserves some reflection. Producing forecasts critically depends on three conditions: on a timely and complete supply of quality data, on the labour force, notably on hiring highly-skilled technicians, and on the availability of complex and costly working tools (e.g. software). When forecasting is included in a council's mandate, the amount of operational resources needed increases considerably. Therefore, forecasting may crowd out other possible tasks the council could perform. Besides, as the government usually provides the data inputs needed, the delegation of forecasting may precipitate breaches of independence and attempts of political manipulation. Accordingly, Bos and Teulings (2010) highlight the exposure to the government that forecasting brings to a council. For instance, not infrequently has the Dutch CPB been pressured from cabinet ministers to adjust its forecasts. In addition, even if made with credible data, forecasts do not usually manage to mirror the future with precision, turning out to be wrong *ex post*. Therefore, a real risk of including this task in the councils' mandate is that forecasting errors may weaken the councils' credibility in the public eye and within the capital markets and/or international bodies [Calmfors (2010a)]. Besides, governments may also use these errors and downturns in credibility as weapons to weaken the FPC. One possible way of circumventing this is to only mandate councils with the task of commenting on governments' forecasts, particularly by evaluating the macroeconomic overviews adopted by governments and their consistency with the budget projections. This task was mandated to the recently established Portuguese FPC[6].

Existing councils are divided about forecasting. Around half produce their own forecasts, while the remaining half does not. The English OBR provides a recent

[6] See Barbosa et al. (2011).

illustration of the difficulties related to forecasting. It was set up in May 2010 with a mandate to provide the official forecasts to the British government. Nevertheless, to produce fiscal forecasts a council must have detailed knowledge of government spending plans and tax receipts. The council either chooses to do it alone and expends a huge amount of resources, or it requests the government's assistance and expertise. The OBR chose the latter[7]. The council assumed the risk of having the government's officials try to strategically influence its activities, thus endangering its independence. Besides, as the budget is usually prepared in secrecy, and as forecasts are produced while policy decisions are being made, it is unavoidable that the public believes that non-transparent negotiations about numbers between the OBR and the government take place. Thus, it has also been unavoidable having the public (and the government's opposition) questioning the independence and credibility of the OBR from the very start of its activity. Hence, the council has been repeatedly criticized and publicly attacked within politics, in the media and by academics. The lesson in this case is more like an unanswered question: it is not clear if it is wise to delegate forecasting in a situation where governments control fiscal instruments, because the independence of the council may be severely compromised [Wren-Lewis (2011)]. Nevertheless, the OBR has made serious efforts to demonstrate its independence, especially when working with the government. Prominently places on its website are devoted to explain all of its interactions with the government as well as the measures undertaken in order to ensure transparency at all times in the council's activities.

The Dutch CPB started operations in 1945 and was formally instituted in 1947. Not without some difficulties, the CPB built its reputation over the years and presents itself within the country as a very well-reputed technical body providing objective and sound economic policy analyses, forecasts and models. Bos and Teulings (2010) draw on the CPB's experience and provide some lessons about the relationship between FPCs and politics. They believe councils must present the economic consequences of the governments' policies as well as their alternatives – and consequent trade-offs – but still 'refrain from becoming an active player in the political arena'. All relevant topics deserve to be targeted by the independent experts' impartial opinions, even the more

[7] Notwithstanding, the CBO, for example, produces fiscal forecasts itself. The difference is that the CBO needs to assess spending plans and tax receipts for other purposes (mainly for costing of policy initiatives) and so the resources would be spent anyway.

politically sensitive ones. Nevertheless, it is advisable to adopt a technocratic and objective attitude, language and presence, especially in media appearances. Moreover, fiscal councils should refrain from interfering in the political debate, especially during periods of electoral competition. The authors' argument is: "*This rule of conduct implies that CPB has a greater freedom in putting forward arguments in the initial stage of the debate on a certain topic, when political parties have not yet taken a strong stance on the topic*" [in Bos and Teulings (2010), p.22].

The experience with the CPB is a solid example that newly-formed councils must consider. In the Netherlands, it plays a unique role in fiscal policy-making by providing GDP growth projections, sustainability analyses and other macroeconomic forecasts. Moreover, the EC (2012) states that it has a central role in correcting and giving credibility to the implementation of the Dutch Medium Term Budgetary framework.

Another case that deserves to be cited is the one of the Austrian Government Debt Committee. Founded in 1970, it had its mandate extended in 2002 to include a number of budget advisory tasks. Its mission is to independently monitor and evaluate the financial situation in Austria. Since the mandate extension, the Committee's activities encompass the analysis and measurement of the impacts of fiscal policy on the economy according to sustainability criteria. It also monitors compliance with fiscal rules, notably with the SGP, assesses the debt dynamics, and issues normative analyses and recommendations. This committee is composed of a number of experts in financial/budget issues who are appointed by the federal government as well as by the Austrian Federal Economic Chamber and the Chamber of Labour.

The fields of action of the Austrian Debt Committee may be a good target for other FPCs to consider. One of those fields refers to structural developments in all levels of government. For instance, it closely follows the dynamics of both revenues and expenditure of not only central government but also of provinces and municipalities. In addition, its analyses also include a vast number of budget items such as pension systems, public health services and education. This transversal analysis of the public sector gives a clearer overview of the country's public finances situation than otherwise. It allows the council to produce advice, not on concrete measures, but on the structural reforms the country may need to undertake, especially regarding expenditures with investment character. It is worth noting that, since 2002, almost all of the Committee's recommendations have received unanimous approval by Austrian governments. At the same time, the attention of Austrian decision-makers, media and citizens towards these recommendations have grown considerably since 2002 [Chaloupek (2011)].

Also interesting is the recent Swedish experience with its FPC. Following the consolidation program Sweden made in the 1990s, notably after the introduction of the two budgetary rules of 2007 mentioned in Chapter 3, the Swedish FPC was established as a complement to this effort. It was mandated to assess the consistency of government's policies with fiscal policy targets, as well as to monitor compliance with the cyclical 1% budgetary surplus requirement and the annual spending caps. Accordingly, the chief objective of the council is to ensure that, during recessions, there is sufficient room of manoeuvre within fiscal policy to help as a stabilization tool. Notably, the SFPC is required to promote countercyclicality in fiscal policy. Therefore, it has some freedom to emphasize the subjects it thinks are appropriate and to present its analyses *ex ante* or *ex post* relative to policy actions by the government. One of the lessons this council can offer is that councils' analyses cannot afford to be perceived as mechanically recommending the government with more fiscal discipline and restraint; rather, they should be genuinely open-minded and considering the peculiarities of each situation [Calmfors (2010c)]. For instance, the council must evaluate whether discretion is needed for stabilization purposes or not, i.e., the council has to manage the trade-off between restraint and flexibility of fiscal policy. Along this line of thought, in 2008 the SFPC recommended to the government that it would be best to increase fiscal stimulus to counteract the recessive effects that came with the world crisis[8].

Another case worthy of note is Belgium with its two active FPCs. Both Hagemann (2010) and Coene (2010) refer to the Belgium FPCs (the forecaster – Federal Planning Bureau, and the normative analysis provider – High Council of Finance) as being fairly effective in their missions and in achieving reasonable impacts on policy-making. The fact that there are two and not only one council working on both missions – forecasting and issuing normative recommendations – is indeed the basis of one of the lessons Belgium has to teach. As Bogaert et al. (2006) suggest, institutions providing positive

[8] See Swedish Fiscal Policy Council (2009) and Calmfors (2010b).

and normative analysis should be completely separated from each other, and responsibility should be shared between ‘several strong independent institutions so as to minimize political pressure’.

Both Belgian councils are institutions with good reputation among policy-makers and the public. The HCF is divided in two sections, one that assesses the public sector borrowing requirements (including local governments) and another that focuses on taxation and social security contributions. In addition, since 2001, the council also includes a study group in partnership with the FPB, which annually analyses the budgetary and social consequences of ageing. In general, the HCF activities consist of publishing reports (mainly on an annual basis), assessments and opinions on these fiscal issues. The EC (2012), in a commentary on the functioning of the HCF, stated that, to date, the council’s budgetary recommendations and its role on fiscal policy coordination have ‘worked broadly satisfactorily’. Moreover, the FPB, having a wide remit including economic, social and environmental policy issues, contributes to the democratic debate by extensively propagating its activities. Besides collecting and analysing data, this council also ‘explores plausible evolutions, identifies alternatives, evaluates the impact of policy measures and formulates proposals’[9]. In addition, its mandate allows it to be requested by the government, the parliament, social partners and by national and international institutions to produce specific analyses.

The last focus will be on the countries which recently asked the international community for financial bailout: Greece, Ireland and Portugal. As put forth by von Hagen (2010), Greece would greatly benefit from establishing an FPC focused on improving transparency and predictability. The serious transparency and accountability problems within the country came to light after the financial crisis in 2008. Therefore, among other tasks, a fiscal council in Greece would have to somehow guarantee the reliability of the information about the Greek government finances to the public, the markets and other stakeholders. Accordingly, the memorandum of understanding between Greece and the EU/IMF has required the creation of a non-partisan fiscal agency to provide independent and expert scrutiny of government finances, and so in

[9] See http://www.plan.be.

early 2011, the Greek State Budget Execution Monitoring Office was formed. Unfortunately, its activities have stagnated since the incidents in August 2011.

Ireland and Portugal were also compelled to establish their own national FPCs[10]. Consequently, the Irish Fiscal Advisory Council was established in June 2011 with the tasks of independently assessing government compliance with fiscal policy targets/rules and of evaluating the soundness of the government's macroeconomic and budgetary projections[11]. It formally reports at least 3 times per year. Its second fiscal assessment report was made public on the 3rd of April, 2012, and addresses the Irish government's macroeconomic and budgetary projections as well as the government's estimated overall fiscal stance until 2015.

In Portugal too, the national FPC – *Conselho de Finanças Públicas* – has been established, having its Statutes approved by the Parliament on October, 2011, and its board appointed on January, 2012. In Portugal, several years of fiscal indiscipline has led public finances to a breaking point. A mix of persistent deficits, procyclicality and procrastination in introducing some necessary structural reforms were the basis of a sovereign debt escalation that culminated in a request for an international bailout in April 2011. For these reasons, the recently established Portuguese FPC was mandated to monitor compliance with fiscal rules, as well as to assess the debt dynamics and sustainability, the fiscal sustainability of the various levels of the public sector and the impact of their financial situation on public finances. The Portuguese council will also comment on the government's forecasts and a number of other relevant fiscal issues[12].

In the end, having discussed some examples of national FPCs across Europe and America, a fair inference is that councils have and are contributing to the overturn of domestic fiscal profligacy and indiscipline. Several international organizations, such as the IMF, the EC, the ECB or the OECD, consistently recommend the establishment of fiscal councils, taking them as must-have solutions within the national fiscal framework of numerous countries. Therefore, the role of FPCs in national institutional fiscal frameworks will be increasingly straightforward from here on.

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[10] See EU/IMF (2010, 2011)
[11] See http://www.fiscalcouncil.ie/.
[12] See Diário da República (2011).

6. Final Remarks

The outstandingly high sovereign debts in a great number of the richest economies in the world must be a concern not only to policy-makers, but also to society in general. Instability in the capital markets lead to the anticipation that sovereign defaults may not be far off, and thus debt problems have to be quickly addressed. Besides, the stakes are high because globalization has brought great economical interconnectivity. Hence, procrastination in introducing mechanisms to effectively address the troubles of domestic fiscal policies will eventually negatively affect not only individual countries, but also many neighbouring countries. This is especially valid in euro area countries which, given their level of economic integration, face a wider economic systemic risk.

Hence, cultures of fiscal indiscipline within countries have to be subverted and substituted with one of discipline. Fiscal discipline, which helps to promote a growth-enhancing, macroeconomically stable environment, will allow policy-makers to honour the real preferences of the society as a whole. In addition, principles such as prudence, responsibility and transparency have to be comprehensively reinforced in fiscal policy-making. Economic governance, both at national and EU levels, has to be redesigned to remove, or at least minimize, the political failures underlying protracted deficits. Therefore, in the short-term, a reform of fiscal frameworks appears as the best path to take. A rules-based framework complemented by an independent fiscal policy council is a plausible option.

In this sense, the current sovereign crises, besides difficult times, are also crucial opportunities to introduce structural changes. For instance, the sovereign debt crises in Greece, Ireland and Portugal are being used to reshape their fiscal frameworks, in accordance with the recommendations of the IMF, the EC and the ECB. Notably, all the memorandums of understanding signed between these three countries and their financial rescuers required the establishment of fiscal policy councils.

This is only one example of the support international institutions grant to the idea of fiscal councils. The expectations surrounding FPCs are affirmed by the success of existing councils around the world, including those in Europe.

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