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Fiscal Policies in Crisis Mode: Has the Time for Fiscal Councils Come at Last?

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Fiscal Policies in Crisis Mode: Has the Time for Fiscal Councils Come at Last?

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Abstract. *The paper revisits the potential contribution of politically independent fiscal agencies (“Fiscal Councils”, or FCs) to improve fiscal performance. A simple theoretical model first illustrates that FCs cannot credibly exert a direct constraint on day-to-day policy choices. It is by contributing to the broader public debate on fiscal policy—through the provision of unbiased quantitative and qualitative analysis, forecasts, and possibly, recommendations—that these institutions can reduce informational asymmetries hindering voters’ ability to reward good policies and penalize bad ones. The empirical part of the paper explores the relevance of this theory by looking at the media impact of FCs in relation to “real-time” fiscal developments. It appears that FCs activity and media impact increase in times of budget slippages or relative fiscal activism, a necessary condition for the validity of the theory. However, FCs’ media impact is only weakly correlated with subsequent policy changes.*

I. INTRODUCTION

The fiscal legacy of the 2008-09 economic and financial crisis brought to the fore serious concerns about the capacity of governments to meet their obligations in full. Several vulnerable countries came under severe market pressure, while government bond yields in countries considered so far as safe also started rising. In the euro area, repeated and increasingly acute bouts of panic seized sovereign debt markets, raising the specter of widespread self-fulfilling solvency crises in countries with otherwise manageable adjustment needs.

The need for improved fiscal governance quickly emerged as an essential part of any solution to the unfolding fiscal crisis. There is indeed solid evidence that good fiscal institutions combined with strong public financial management practices are associated with better fiscal performance (e.g. Debrun et al., 2008). Well designed institutional reforms could therefore anchor a credible commitment to sound fiscal policies in the future and reduce the short-term risk of a bad market equilibrium leading to insolvency. Stronger governance comes at an

¹ We are grateful to Petra Dacheva for excellent research assistance, and to Bat-el Berger for help in the case studies. The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF or IMF policy.

additional premium in the euro area, where the risk sharing implied by crisis management measures, calls for strict safeguards against moral hazard.

Fiscal institutions conducive to macroeconomic stability often come in the form of fiscal policy rules. Quantitative limits on debts, deficits or spending have long been used to contain fiscal profligacy (e.g. Fabrizio and Mody, 2006; and Debrun et al., 2008). Yet experience has revealed serious limitations often related to the rules' inflexibility in the face of adverse or unusual circumstances, or to the lack of supportive budget procedures. Inflexibility ultimately threatens the credibility of the rule itself, as the pressure of events can quickly lead to its suspension or even elimination. A prominent example is the 2003 European Council decision to put the Stability and Growth Pact in abeyance.

Since the mid-1990s, a small but growing literature has argued that non-partisan agencies could shape policymakers' incentives in a more credible and effective way than numerical limits on budgetary aggregates. Through independent analysis, assessments, and forecasts, such bodies would raise voters' awareness about the consequences of certain policy paths, helping them reward desirable options and sanction toxic ones. By fostering democratic accountability, these agencies could encourage policymakers to deliver more viable and more countercyclical policies. Hence unlike rigid rules, they could help shape an adequate policy response in practically any circumstances without risking the loss of the fiscal anchor. The argument gains particular traction in times of extreme shocks and crises, when policy discretion and credibility are both highly valued. The new EU Directive on national fiscal frameworks underscores the role of these agencies in strengthening fiscal performance.

Despite a fairly active debate in academic and policy circles, the economic analysis of "fiscal councils" remains sketchy and largely informal. No full-fledged theory has either established the desirability of such institutions or derived first-order principles underlying their effectiveness. Moreover, while existing studies cover a wide array of specific academic proposals and review a few existing institutions (Calmfors, 2010; Calmfors and Wren Lewis, 2011; Debrun, Hauner and Kumar, 2009), there is virtually no systematic empirical evidence exploring the link between these institutions and fiscal behavior. Absent theory and robust evidence, no definitive consensus exists as regards the tasks fiscal councils should be assigned, what institutional form they should take, and the complementarity or instead substitutability with rules-based frameworks.

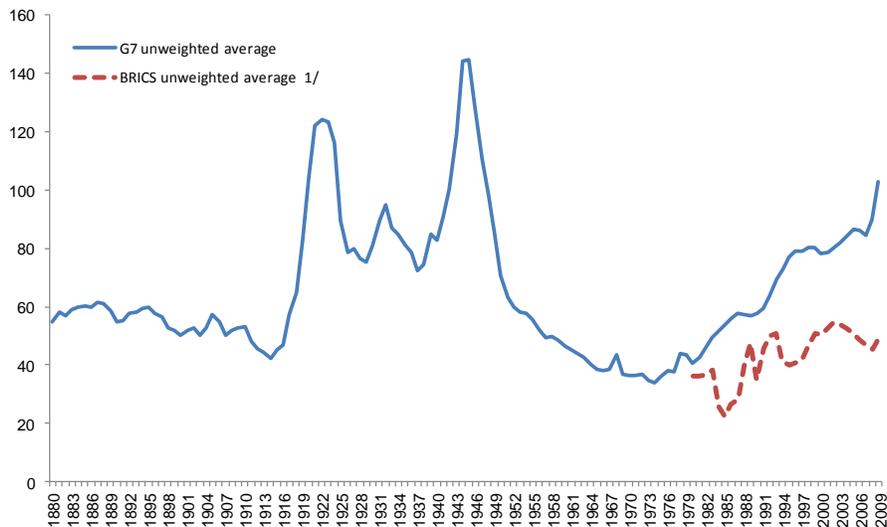
This paper proposes a coherent effort to fill some of those gaps. In Section II, we sketch a highly stylized theoretical model to anchor the debate on politically independent fiscal agencies. An important lesson from our purely illustrative model is that the effectiveness of fiscal councils rests on their ability to address the root cause rather than the symptoms of deficit bias. Section III gathers empirical evidence on the effectiveness of existing fiscal councils. Two testable propositions emanate from the theoretical model. First, councils can only credibly affect policymakers' incentives and actions if they systematically influence the

public debate on fiscal policy. We thus look at the media impact of fiscal councils at times where we would expect them to speak out, that is in the aftermath of budgetary slippages or policy shifts. Second, we test whether desirable policy changes follow peaks in media impact. Finally, the paper emulates other recent pieces—especially Calmfors and Wren-Lewis (2011)—by gathering more forensic evidence on what councils do and achieve. Concluding remarks form the fourth and last Section of the paper.

II. FISCAL POLICY, FISCAL COUNCILS AND DEMOCRATIC ACCOUNTABILITY

Since the late 1980s, a large literature has explored the reasons why macroeconomic policies tend to deviate from a well-defined social optimum. On the fiscal side, the hypothesis of a deeply entrenched deficit bias transpired from the seemingly inexorable rise in debt-to-GDP ratios since the mid-1970s. Today’s public debt levels are often unprecedented in peace time (Figure 1). While theories of deficit bias abound, empirical analyses have failed to identify a dominant explanation.² As this literature has been surveyed elsewhere (e.g. Calmfors, 2010, Debrun et al. 2008, and Hagemann, 2010), we limit ourselves to present a highly stylized two-period model of fiscal policy whose main virtue is to illustrate how fiscal councils can help improve fiscal performance without assuming the *delegation* of policy instruments inherent to the theory of central bank independence (Wyplosz, 2005).

Figure 1. Gross Government Debt in Selected Country Groups (percent of GDP)



Source: IMF Historical Public Debt Database (Abbas and others, 2010).

1/ Brazil, India, China, South Africa.

² Fragmented government coalitions (e.g. Fabrizio and Mody, 2006) and political instability (Debrun and Kumar, 2007) emerge as more robust causes of excessive deficit. This may reflect common pool problems—that is the failure to coordinate competing claims on finite budget resources—as well as the fear of not being re-elected (implying myopia for politician).

A. The Basic Model³

Consider the two-period model of Alesina and Tabellini (1990), assuming constant and deterministic income levels. Identical private agents maximize utility U , which is separable over time and types of goods (private and public).

$$U(c, q) = E_0 \left[\sum_{t=1}^2 \beta^{t-1} (u(c_t) + v(q_t)) \right], \quad (1)$$

where c denotes the per-capita consumption of private goods and q the per-capita consumption of public goods. E_0 symbolizes the expectations operator conditional on information available at the beginning of period 1 (time 0), and β is a subjective discount factor. A constant proportional income tax rate τ yields the following private budget constraints:

$$\begin{aligned} c_1 &= (1 - \tau)y + l \\ c_2 &= (1 - \tau)y - Rl \end{aligned}$$

with R , the interest factor and l , the stock of net private liabilities at the end of period 1.

Elected officials decide on public good provision. They belong to one of two political parties (C or L) indexed by Q . Preferences are identical across political parties and to those of the population, but officials only value public goods when in office. These assumptions avoid the needless complexity of a partisan cycle in the conduct of fiscal policy, leading to a simple and well-defined deficit bias.

$$U_Q(c, q) = E_0 \left[\sum_{t=1}^2 \beta^{t-1} (u(c_t) + \rho^{t-1} v_Q(q_t)) \right]; \quad Q = C, L; \quad 0 \leq \rho \leq 1 \quad (2)$$

with $v_C(q_t) = 0$ if party L is in office, and $v_L(q_t) = 0$ if party C is in office. Elections with uncertain outcome take place at the end of period 1, and the parameter ρ^{t-1} captures the probability of the incumbent party to be in office at period t .

The intertemporal budget constraint of the government determines the amount of public goods (per capita) delivered in each period:

$$q_t = \tau y + b - \delta_1, \quad (3a)$$

³ This section draws on Debrun (2011).

$$q_2 = \tau y - Rb - \delta_2, \quad (3b)$$

with b denoting the overall deficit at the end of period 1 (or equivalently, the principal of the debt to be repaid in period 2). The budget constraints are subject to random shocks affecting government efficiency. For a given amount of resources (tax revenue and borrowing), a positive realization of δ negatively affects public good delivery. Concretely, this could capture resource diversion by corrupt civil servants, the effect of poor administrative capacities, or unforeseeable policy mistakes. Of course, good surprises can also occur (more public goods being delivered with the same budgetary envelope). Hence, the shocks are non-serially correlated with zero mean and finite variance: $\delta_t \sim N(0, \sigma_\delta^2)$. Also, we assume that fiscal policy decisions have no impact on income, and thereby, on private consumption since R is given and independent of b .

In this model, a *deficit bias*⁴ emerges because elected officials are uncertain about re-election. This is immediately clear from a comparison of equations (1) and (2): any $\rho < 1$ entails policymakers' myopia (she discounts the future at a higher rate than a representative agent). While uncertainty is often exogenously given (e.g. Beetsma and Debrun, 2007), we argue that informational asymmetries between voters and policymakers are instrumental in making election outcomes uncertain and are therefore at the root of the deficit bias. Specifically, we make the rather plausible assumption that voters cannot know for sure whether a given policy slippage reflects an intrinsic lack of competence of the elected policymaker or an exogenous event outside her control. The shocks affecting public good delivery can thus lead voters to vote out (punish) competent officials or re-elect (reward) undeserving individuals.

B. Characterizing the Deficit Bias

The socially-optimal solution results from direct maximization of the representative citizen's utility (1) by a benevolent "social planner." To economize on notation, we set $\beta = R = 1$ (discount and real interest rates are equal to zero) and assume quadratic utility functions $u(x) = v(x) = -(x - \tilde{x})^2$. Decision-makers dislike deviations from pre-determined objectives denoted by a tilde. The Euler equation under the social planner yields a balanced budget:

$$q_1^* = q_2^* \Rightarrow b^* = 0. \quad (4)$$

Before deriving the political equilibrium—i.e. elected policymakers' choice—let us clarify the sequence of moves. First, "Nature" draws the governing party (C by assumption here). Then, party C officials prepare a budget setting the deficit for period 1, and by extension, the expected time path of public consumption over the two periods. Third, an efficiency shock materializes during period 1, and finally, elections take place. In period 2, the world ends

⁴ The term deficit bias means that a utility-maximizing policymaker delivers a fiscal balance that is systematically weaker than if a representative agent was directly in charge of fiscal policy.

after all debts have been paid off, and a new shock occurred. Solving this problem by backward-induction rules out time-inconsistency.

As noted above, the probability of re-election is a central determinant of the budget deficit in the political equilibrium, denoted by a $**$ superscript:

$$b^{**} = \left[\frac{1-\rho}{1+\rho} \right] \tilde{b}, \text{ with } \tilde{b} = \tilde{q} - \tau y. \quad (5)$$

Certainty about election outcomes defines two boundary cases. Certain re-election ($\rho = 1$) eliminates myopia, leading party C officials to opt for a balanced budget: $b^{**} \Big|_{\rho=1} = 0 = b^*$. By contrast, certain defeat maximizes myopia to the point that party C is not bound by the intertemporal budget constraint and chooses a level of public spending consistent with the expected delivery of \tilde{q} in period 1. The corresponding budget deficit is $b^{**} \Big|_{\rho=0} = \tilde{b}$. All other solutions fall in the $[0, \tilde{b}]$ interval. Myopic policymakers generate a deficit bias only if $\tilde{b} > 0$, which requires that the appetite for delivering public goods (parametrized by \tilde{q}) exceeds available tax money. This condition simply embodies the *common pool* problem inherent to budgetary decisions so that $b^{**} > b^*$. It is important to note that because voters' behavior remains purely exogenous, this deficit bias emerges in a political setting without formal democratic accountability.

C. Solving the Deficit Bias: Fiscal Rules vs. Councils

We now formally compare how fiscal rules and fiscal councils can affect policy outcomes. The analysis focuses strictly on fiscal councils (FCs), as opposed to fiscal authorities (FAs). As discussed in Debrun, Hauner and Kumar (2009), FAs involve a formal *delegation* of certain policy prerogatives normally in the hands of elected officials, a feature that makes FAs the fiscal analog to independent central banks. Absent meaningful historical precedent, FAs have little empirical relevance.

A Balanced Budget Rule

A straightforward solution to the deficit bias could be a balanced-budget requirement. A fiscal rule affects policymakers' decisions to the extent that violating it entails a certain cost measurable in terms of utility. The costs can be merely reputational or result from a formal enforcement procedure with explicit sanctions (see Beetsma and Debrun, 2007). Under a fiscal rule, the "constrained" utility of the elected official would be:

$$V_c = U_c - f(b - b^*). \quad (6)$$

Policymakers now maximize V_C instead of U_C , as they internalize the costs of exceeding the deficit ceiling b^* . The optimal fiscal rule is such that $f^* = (1 - \rho)\tilde{b}$ (the marginal cost of deviations), which implements b^* in the political equilibrium ($b^{**} = b^*$). The optimal rule requires harsher sanctions in a country where political instability and the propensity to spend are higher.

Showing that an optimal rule exists does not mean that policymakers have any incentive to set it up in the first place.⁵ In fact, it is straightforward to establish that the rule (f^*, b^*) violates the participation constraints of the policymakers as $E_0 V_C(q^*) < E_0 U_C(q^{**})$. Hence, even if policymakers inherit the rule from benevolent founding fathers, they will have an incentive to make it irrelevant or to scrap it altogether. Time-inconsistency destroys the credibility of the rule (Debrun and Kumar, 2009), which explains in part why these arrangements periodically come under intense pressure, are eliminated, substantially modified, circumvented, or temporarily ignored.⁶

Fiscal Councils

The main lesson from the above exercise is that any mechanism aimed at directly constraining fiscal discretion is bound to be resisted by policymakers and therefore, at a high risk of being weakened or dismantled as soon as the opportunity arises. Now the question is whether non-partisan fiscal agencies could at least appeal to policymakers (i.e. satisfy their participation constraint) *and* help to correct the deficit bias built into the political equilibrium.

The answer is positive if we think of the FC as an institution that can induce meaningful rewards for policymakers that pursue policies closer to the social optimum. To illustrate this, we need to incorporate in the model the basic requirement that elected officials are accountable to their principal (the voters). An immediate task is therefore to show that the deficit bias persists even if voters can credibly sanction inadequate policies. The failure of accountable governments to deliver the social optimum can be linked to informational

⁵ This argument is analogous to McCallum's (1995) second fallacy of central bank independence, stating that if governments have the discretion to set up an independent central bank with the right incentives, they also have the discretion to revert to a dependent central bank with inadequate incentives. Jensen (1997) formally demonstrates in the Barro-Gordon-Rogoff framework that delegation does not matter if the no-renegotiation assumption is lifted.

⁶ The problems have been documented and extensively discussed for numerical fiscal rules, but they also apply to independent fiscal agencies. The experience with the High Council of Finance in Belgium is a case in point, as noted by Coene and Langenus (2011). The recent abolition of the Hungarian Fiscal Council—created only two years earlier—is another vivid illustration of the inherent fragility of discipline-enhancing fiscal institutions.

asymmetries discussed earlier: voters' preferences may be hard to read, whereas the abilities and true agenda of those running for office are unobservable to voters. As a result, policy mistakes (successes) can be hard to detect, interpret, and adequately sanction (reward).

Thus, for the sake of the argument, let us make two basic assumptions. First, voters cannot observe the intrinsic competence of policymakers. Second, opaque public accounts prevent voters from assessing whether observable outcomes are the result of either pure luck or competent policy making. Formally, this means that the efficiency shocks δ_t and the true level of debt (deficit) are unobservable ex-post. Only tax revenues and actual output in terms of public goods are perfectly observed. (Voters only know for sure what they pay and what they get.) The combination of unobservable competence and observable outcomes implies that voters will naturally use the size of q_1 as a signal of competence.⁷ As a result, a favorable efficiency shock ($\delta_t < 0$) could be interpreted as a superior capacity to deliver public goods given fixed budgetary resources. Rational voters only observe a "notional" budget deficit reflecting a combination of shock (δ_1) and noise (ξ):

$$q_1^C - \tau y = \xi - \delta_1 \quad (7)$$

To identify the realization of the efficiency/competence variable at the end of period 1, voters solve a basic signal-extraction problem:

$$E_1[\delta_1] = -\frac{\sigma_\delta^2}{\sigma_\delta^2 + \sigma_\xi^2} (q_1^C - \tau y) \quad (8)$$

As voters' best guess of δ_1 embodies their assessment of the incumbent's competence, it amounts to treating δ as persistent: $E_1[\delta_2|Q=C] = \lambda E_1[\delta_1]$ with $0 < \lambda \leq 1$, while $E_1[\delta_2|Q=L] = 0$. Clearly, the incumbent will be re-elected if she is expected to deliver more public goods given the remaining budgetary resources (which are the same for both parties). Formally, re-election occurs if $E_1[q_2|Q=C] - E_1[q_2|Q=L] > 0$. At time 0 (budget preparation stage for period 1), the perceived probability of re-election is therefore:

$$\rho = \Pr\left(\lambda \frac{\sigma_\delta^2}{\sigma_\delta^2 + \sigma_\xi^2} (q_1^C - \tau y) > 0\right).$$

This shows that a deficit bias remains even after explicitly introducing democratic accountability in the model. The difference with Section II.B is that two offsetting motives for excessive deficits now coexist. With the probability of re-election depending positively on the (ex-post) realization of a notional deficit, policymakers face an *opportunistic* (ex-ante)

⁷ Cukierman and Meltzer (1986), and Rogoff and Sibert (1988) first introduced that type of conjecture in formal models of fiscal policy.

motive to run a deficit. Indeed, a deficit reduces the likelihood that voters will detect adverse efficiency shocks at the end of period 1, which they may erroneously interpret as a lack of competence and a motive to vote against the incumbent. Notice that as the opportunistic bias grows to boost re-election prospects, the myopic bias weakens.

What could be the role of an independent fiscal agency? It is intuitively appealing to conceive it as performing non-policymaking tasks that improve the interaction between voters and policymakers. For example, providing quantitative and qualitative analyses of fiscal policy (*ex ante* and in real time) could in principle help voters see through policymakers' incentives and fiscal accounts so as to better grasp the adequacy of the observed policy stance. For that reason, a broad remit that includes elements of judgment on the nature of shocks to the budget is likely to better address informational asymmetries in a mutually beneficial way for voters and elected officials. Specifically, detailed analysis and normative assessments of fiscal performance could prevent the confusion between bad luck and bad policies, reduce opportunistic motives, and directly reward competent governments with greater re-election chances.

In sum, a well-functioning FC should become the main source of information on the underlying quality of fiscal policy, allowing democratic accountability to play its role. Of course, placing such a considerable amount of trust in a fiscal council would require strict guarantees of independence from partisan influences, a clear definition of the policy objectives under the council's scrutiny (e.g. fiscal sustainability) and a *modus operandi* genuinely "owned" by voters.

III. FISCAL COUNCILS, THE PUBLIC DEBATE AND FISCAL POLICY

This section gathers new empirical evidence on the effectiveness of fiscal councils. The substantial heterogeneity among institutions qualifying as FCs seriously complicates the task because it prevents the establishment of a single metric capturing with reasonable precision the strength or *ex-ante* influence of FCs on fiscal policy. So far, the literature is limited to thorough country case studies (e.g. Calmfors and Wren-Lewis, 2011; Coene and Langenus, 2011) and largely illustrative correlations (Debrun, Hauner, and Kumar, 2009).

A. The Approach

Our approach is two-fold. First, we build on the theoretical sketch developed above to explore the influence of FCs on the public debate through direct measures of their media impact. Second, two short case studies analyze the media impact in greater details. The use of higher-frequency data (monthly instead of annual) allows for a more refined assessment of the noise-to-signal ratio of media reports.

Our media impact variable is based on the number of times the official name of the FC appears in a country's national press (either in English or in national language(s)). We use

simple panel regressions to detect a relationship between the intensity of media reports referring to the FC and two *real-time* fiscal policy indicators expected to be of interest for the fiscal council. The first is the planned change in the cyclically-adjusted budget balance (CAB) at the beginning of the year, which captures the degree of fiscal activism planned in the budget (stimulus or consolidation). The second is the first estimate of the deviation in the CAB with respect to plans. This variable is interpreted as a symptom⁸ of slippages (or over-performance) during the budget year although its signaling power is affected by possibly large revisions in estimated output gaps.

Clearly, the results reported in the remainder of this Section only constitute a first exploration, a potential “appetizer” for further research. One source of concern is the untested reliability of the underlying media data, which could create unwanted noise in the statistical analysis. For instance, it is difficult to assess whether the comprehensiveness of press coverage is comparable across countries. Another potential issue is that our straightforward measure of media impact could capture events only loosely related to the national budgetary debate, for example political bickering about the appointment of a new FC member.

B. Data, Notation and Testable Hypotheses

Data Sources and Notation

All media data are from the Factiva database. Real-time fiscal and economic data are collected from the European Commission’s assessments of Stability and Convergence Programs (SCP)—typically discussed in early spring on the basis of data transmitted by national authorities. To save on the notation, we omit country indices and use time superscripts to denote the vintage of the Commission’s assessment of SCPs. As a result, X_t^t is the “real-time” forecasts of X_t at the beginning of year t , whereas X_t^{t+1} is the first estimate of the realization of X_t . The Δ operator symbolizes the first-difference of a variable over time. Hence, $\Delta X_t^t = X_t^t - X_{t-1}^t$ measures the planned “real time” variation in X between t and $t - 1$, while $\Delta X_t^{t+1} = X_t^{t+1} - X_{t-1}^{t+1}$ is the “first estimate” of the actual change. Finally, we define the “forecast error” of X as $ERRX_t^{t+1} = X_t^{t+1} - X_t^t$.

The sample only includes 7 continental European countries—Austria, Belgium, Germany, Denmark, the Netherlands, Sweden and Slovenia—over the period 2003-2010—years with comprehensive assessments of SCP by the European Commission. To maximize the time dimension, the main fiscal policy indicator is the cyclically-adjusted balance (CAB) instead of the more conventional cyclically-adjusted primary balance, which was not consistently reported in SCPs by all countries in the early years of the sample. The set of control variables

⁸ See Beetsma, Giuliadori, and Wierds (2009).

is necessarily parsimonious given the small size of the sample. It includes the gross public debt (DEBT) and the output gap (OG). The key indicator of media impact, NEWS, is the standardized number (z-score) of written press articles quoting the national fiscal council (in English and local language(s)). It reflects the intensity of the news coverage of the FC's activity in each country, and is thus taken as a proxy of its participation in the public debate on fiscal matters.

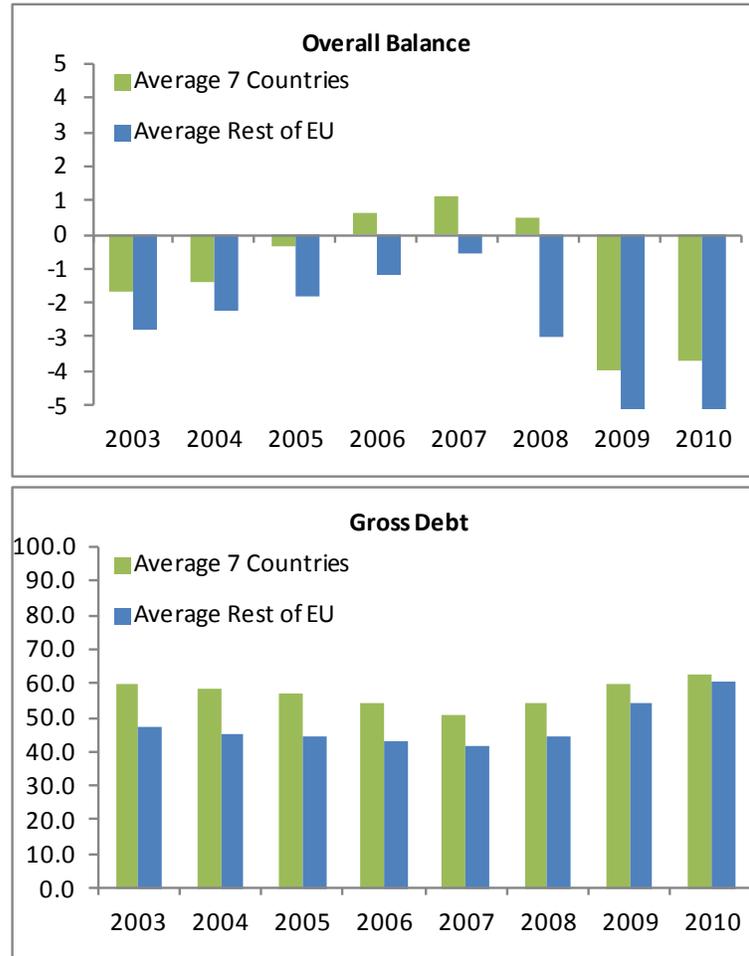
Testable Hypotheses

Theory points to two testable hypotheses. First, a necessary condition for the effectiveness of an FC is that it publicly *reacts* to fiscal developments either because they signal a policy shift with a notable bearing on the realization of policy objectives or because undesirable deviations from planned outcomes call for an analysis of the causes—bad luck or bad budget execution. To the extent that these reactions contribute to the public debate, the FC will enhance democratic controls. In that case, a change in the NEWS variable *follows* variations in fiscal indicators. Second, an effective council would be expected to make a difference in the conduct of fiscal policy. This would imply that changes in fiscal indicators would tend to *follow* peaks in FCs media activity. The analysis focuses on the planned change in the CAB—a proxy for deliberate policy action—and the forecast error—which could reflect unexpected shocks affecting the budget or policy slippages.

C. Results

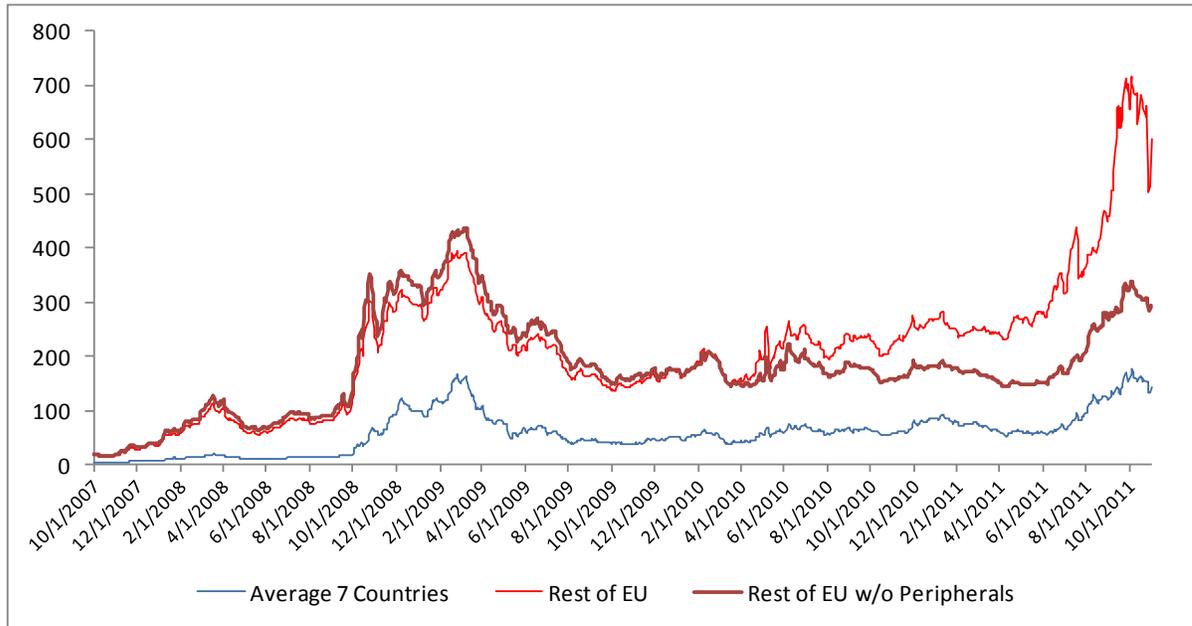
We first document systematic differences in key fiscal dimensions between countries that have and those that do not have FCs. The 7 countries in which an FC operates exhibit on average stronger fiscal balances than the rest of the European Union (Figure 2). By contrast, public debts are slightly higher—by about 10 percentage points of GDP—in countries with FCs, at least prior to the crisis. As the stronger fiscal positions may in part reflect greater concerns about debt stabilization, we also compare the two groups in terms of market perceptions of sovereign risk. Again, countries with FCs enjoy much lower spreads on average than other EU countries, even after excluding the euro area periphery.

Figure 2. Public Debts and Deficits in Countries with or without Fiscal Councils
(percent of GDP)



Sources: European Commission and authors' calculations.

Figure 3. CDS spreads (5-year) in Countries with or without Fiscal Councils
(basis points)



Sources: Markit and authors' calculations.

Do the Watchdogs Bark When Needed?

The underlying regression is as follows: $NEWS_t = c + d_t + \alpha FISC_t^{t+1} + \varepsilon_t$, where $FISC$ is a fiscal indicator, d_t , time dummies, and c indicates the use of country fixed-effects. The fiscal indicator is either the planned variation in the CAB at the beginning of year t (so $i = 0$) or the first estimate (in early $t + 1$) of the forecast error ($i = 1$), while $NEWS$ captures the intensity of citations in the press *during* the entire year t .

⌘

The regressions reported in Table 1 detect a statistically significant correlation between our two fiscal indicators and the media impact of FCs. On average, the fiscal watchdogs seem to bark louder when large fiscal policy changes are planned and they seem to be heard in the press. The fiscal councils in our sample also tend to make more noise during years when forecast errors end up being greater, suggesting that they publicly reveal policy slippages or express concerns when unexpected shocks send budget plans off track. Interestingly, the negative signs obtained for the first differenced CAB and the raw forecast error suggest that deteriorations in the CAB leads to increased media attention to FCs' messages. This is consistent with the role of FCs in primarily promoting fiscal responsibility.

Table 1. Media Impact of FCs and Magnitude of Fiscal Developments
(Dependent variable is NEWS)

	ΔCAB	$ \Delta\text{CAB} $	ERRCAB	$ \text{ERRCAB} $
FISC	-0.392*** (-4.96)	0.721*** (4.68)	-0.217* (-2.25)	0.453** (3.42)
Const.	0.113*** (5.17)	-0.246** (-2.47)	0.207*** (58.47)	-0.176 (-1.51)
Adj. R2	0.08	0.16	0.05	0.13
N. obs.	51	51	51	51

Note: All regressions include country fixed effects; robust t-statistics are in parentheses, with ***, **, and * denoting statistical significance at the 1 percent, 5 percent and 10 percent threshold respectively.

While these results provide an indication that FCs may be effective in sending the right messages at the right time, the limited size of the sample and the unclear signaling power of media activity call for caution. In particular, fiscal developments explain only a small fraction of the quantity of news reports referring to the FCs. Also, the introduction of time dummies severely reduces the precision in the estimated impact of fiscal indicators on FCs presence in the media, suggesting that the results in Table 1 may capture developments—such as the crisis—that jointly affect the budget and FCs reported activity.

Do FCs Influence the Conduct of Fiscal Policy?

Following our earlier discussion, the underlying regression is as follows:

$|\Delta CAB_t^f| = c + d_t + \delta NEWS_{t-1} + \beta_1 DEBT_{t-1}^t + \beta_2 OG_{t-1}^t + \varepsilon_t$. In contrast to the first set of regressions, we introduce a few control variables known to be related to fiscal developments, namely the cyclical position of the economy (lagged output gap), and the (lagged) public debt level. As regards the left-hand-side variable, we could only detect meaningful correlations between the absolute value of the planned change in the CAB for year t and FCs media presence in year $t - 1$.

As Table 2 shows, stronger media presence of the fiscal council in any given year is correlated with greater planned “fiscal activism” for the following year, regardless of whether the plans envisage a more ambitious fiscal consolidation or a greater stimulus. The results are fairly consistent across alternative regressions (fixed-effects or pooled) and to the inclusion of the only two statistically significant time dummies (2007 and 2008). The control variables display the expected signs: a reduction in the output gap (less positive or more negative) encourages fiscal activism, whereas high public debts are less conducive to activism.

While it may be tempting to conclude that more intense FCs involvement in the public debate pushes governments to do the right thing, the paucity and quality of the data and the fragility of the results call for caution. In addition, simultaneity problems loom large, as the plans for year t are prepared and discussed intensively in the second part of the preceding year. The results may thus reflect the fact that FCs are simply taking an active part to the debate surrounding budget preparation, particularly when significant policy shifts are discussed. While this would be welcome and supportive of the evidence in Table 1, it might not necessarily reflect the council’s actual influence on policy choices. Taking two lags to the NEWS variable did not help, suggesting that the distance between the council’s message and actual decision making would then be too large.

Table 2. Do Fiscal Councils Shape Policy Outcomes?
(Dependent variable: absolute value of the one-year-ahead Δ CAB)

Estimator:					
	LSDV	LSDV	LSDV	Pooled OLS	Pooled OLS
NEWS	0.110 (1.62)	0.146* (2.03)	0.153* (2.14)	0.108** (2.36)	0.108** (2.37)
OG	-0.347** (-2.63)	-0.271 (-2.27)*	-0.229* (-2.08)	-0.324*** (-3.93)	-0.325*** (-3.96)
DEBT	-0.010 (-0.59)	-0.022 (-1.28)		-0.001 (-0.17)	
i2007	0.510* (1.99)			0.492*** (3.30)	0.498*** (3.33)
i2008	1.687** (3.46)	1.306** (2.93)	1.193** (2.75)	1.601*** (5.10)	1.605*** (5.22)
Const.	0.665 (0.67)	1.534 (1.67)	0.339** (2.90)	0.178 (0.92)	0.147* (1.70)
Adj. R2	0.61	0.57	0.56	0.55	0.56
N. Obs.	44	44	44	44	44

Note: Robust t-statistics are in parentheses, with ***, **, and * denoting statistical significance at the 1 percent, 5 percent and 10 percent threshold respectively.

D. Going Forensic: Fiscal Councils and the Budget Process

While promising, the preliminary evidence on a link between FCs media presence and fiscal indicators—which only convey a clear policy signal at annual frequency—calls for a much more detailed analysis that goes beyond the scope of the present paper. Insights can nevertheless be gained from a more “forensic” analysis, involving higher frequency data. We look at two case studies of long-lasting fiscal councils generally thought to have been fairly successful in terms of impact on the public debate and positive influence on policy making: Netherlands’ CPB, and Belgium’s High Council of Finance. In contrast to more comprehensive case studies of fiscal councils (e.g. Calmfors and Wren-Lewis, 2011), we maintain a strict focus on the link between certain fiscal episodes and FCs media visibility.

Case Study 1: The Netherlands

The Netherlands Bureau for Economic Policy Analysis—known under its old-days acronym of CPB, for Central Planning Bureau—is a veteran among fiscal councils, beginning operations in 1945. It has been preparing economic forecasts since the 1950s, publishing reports on the state of Dutch public finances since the 1960s, undertaking election commitment costing since the 1980s, and preparing long-term scenario analyses since the 1990s. The CPB also has a number of other roles, including cost-benefit analysis, and a fairly broad research agenda.

The CPB is formally a branch of the civil service within the Ministry of Economic Affairs (MEA) and it is funded from the budget. Despite the lack of a separate status for staff and the financial dependency on the budget, several elements contribute to the independence of the CPB, including a supervisory committee, whose members are appointed by the cabinet for 5 years, and 5 yearly independent evaluations (usually by academics, many of whom are not Dutch nationals).

Like most FCs, the CPB cannot bite: it has no explicit mandate or instrument to directly influence fiscal policy. Also, it does not provide strictly normative assessments, not even against the government's own commitments and objectives. That said, the CPB evaluates quantitatively the effect of government policies on public finances. Clearly, a positive statement saying that the continuation of a certain policy is bound to threaten fiscal sustainability is not materially different from a normative judgment that such policy should be changed.

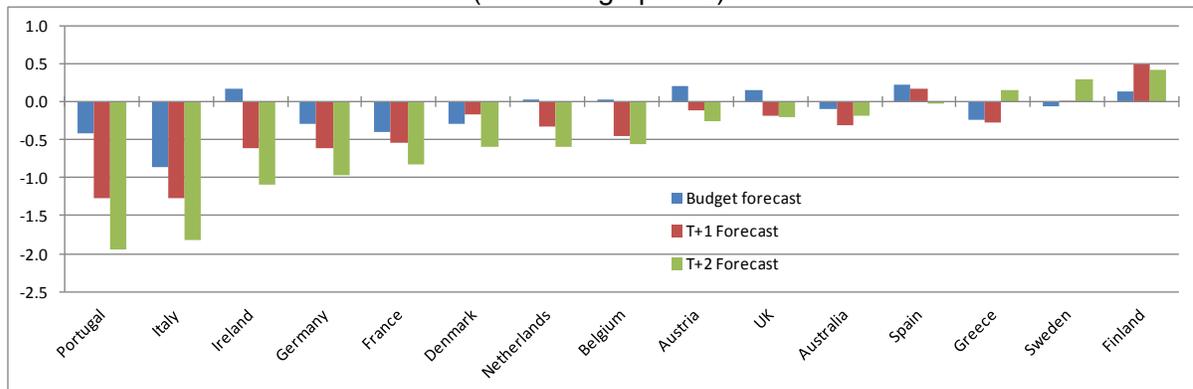
Another positive way for the CPB to enter into normative territories at politically critical times relates to its role of costing electoral platforms before, and coalition agreements after elections. That function has arguably improved the quality of public information and influenced the debate around elections, encouraging parties to tighten up their commitments in advance (in order for costing to be undertaken) and to avoid making commitments to unaffordable policies (see Bos and Teulings, 2011).

The CPB is an insider working within the budget process. It provides the macroeconomic forecasts used for the budget. Those forecasts are produced behind closed doors, and discussed with the government (initially through the Ministry of Finance, and later through the cabinet) prior to being released. While this means that the budget relies on independent forecasts, private discussions with the cabinet give an opportunity to the latter to put pressure on the CPB (Bos and Teulings, 2011). For the same reason, the CPB provides little public information regarding the evolution of the fiscal outlook during the year, allowing the government to change course, if necessary, without raising public awareness. Following meetings with cabinet, the CPB publishes its forecasts four times a year, with more extensive updates in March and September than in June and December.

Overall, this set of attributes, combined with a long history of well regarded analysis and forecasts have given a considerable degree of public credibility to the CPB. While its specific contribution is difficult to identify, the Netherlands' fiscal performance over the past 15 years has been relatively sound. In particular, there has been no apparent bias in macroeconomic forecasts, ex-post compliance with ex-ante targets has been satisfactory.

Let us look at each of these three aspects in greater details. Using data from the SCPs, we calculate the real GDP growth forecasting errors (at 1, 2 and 3 years horizons) across countries over the period 2000 – 2008. In the Netherlands, the average errors for the budget year have been, if anything, pessimistic; and while they appear slightly optimistic over the out-years, they remain well within one standard deviation of GDP growth in the sample. The same is true for the other countries, whose fiscal councils received the remit of providing independent macroeconomic forecasts into the budget (Austria and Belgium). This is in line with earlier results by Jonung and Larch (2006) showing that independent forecasting help prevent an optimistic bias in GDP forecasts (Figure 4).

Figure 4. Real GDP Forecast Errors (Actual minus Forecast): 2000-2008
(Percentage points)

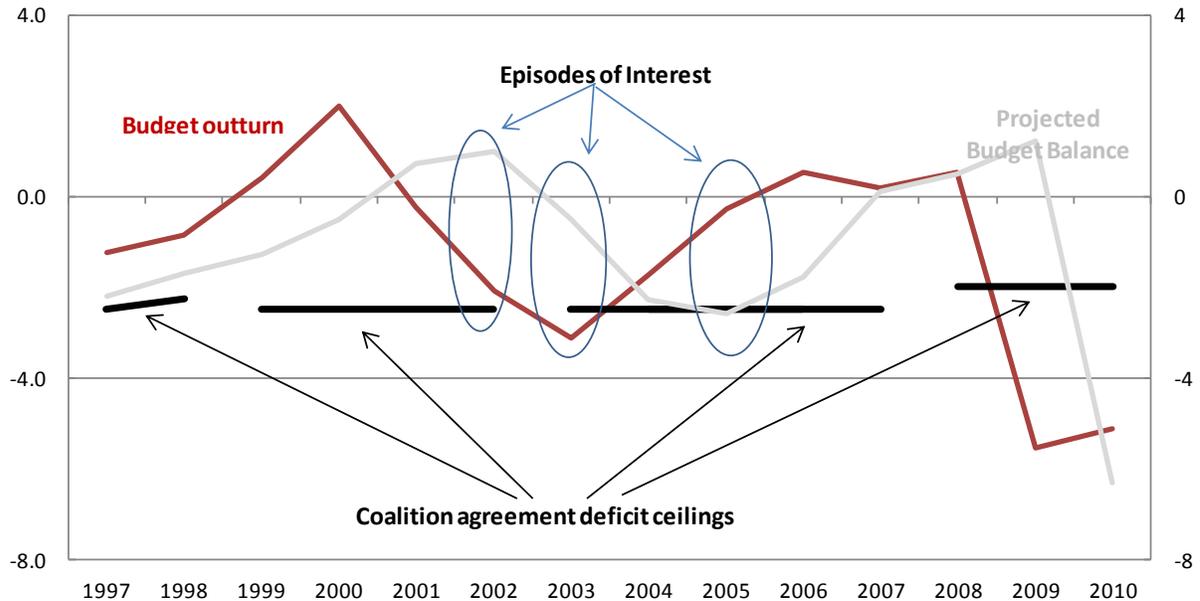


Sources: European Commission (SCPs) and authors' calculations.

We now turn to the compliance with ex-ante targets set over the political cycle. The Dutch budget system is governed by the coalition agreements reached at the beginning of each parliamentary term. These agreements specify, among other things, a deficit ceiling for the remainder of the term: bold black lines in Figure 5. The Figure also displays yearly forecasts for the budget balance (light grey lines), and the final budget outcome (red line).

This comparison allows identifying episodes of interest characterized as follows: (1) either the budget forecast or fiscal outturn is exceeding the deficit ceiling, or (2) the fiscal outturn is significantly worse than the budget forecast. In either of these cases, we would expect the fiscal council to raise the awareness of these outcomes, and make recommendations or suggestions to rectify the situation. Using the same media information as above (now at monthly frequency), we examine whether this did in fact occur.

Figure 5. The Netherlands: Fiscal Targets, Forecasts and Outcomes

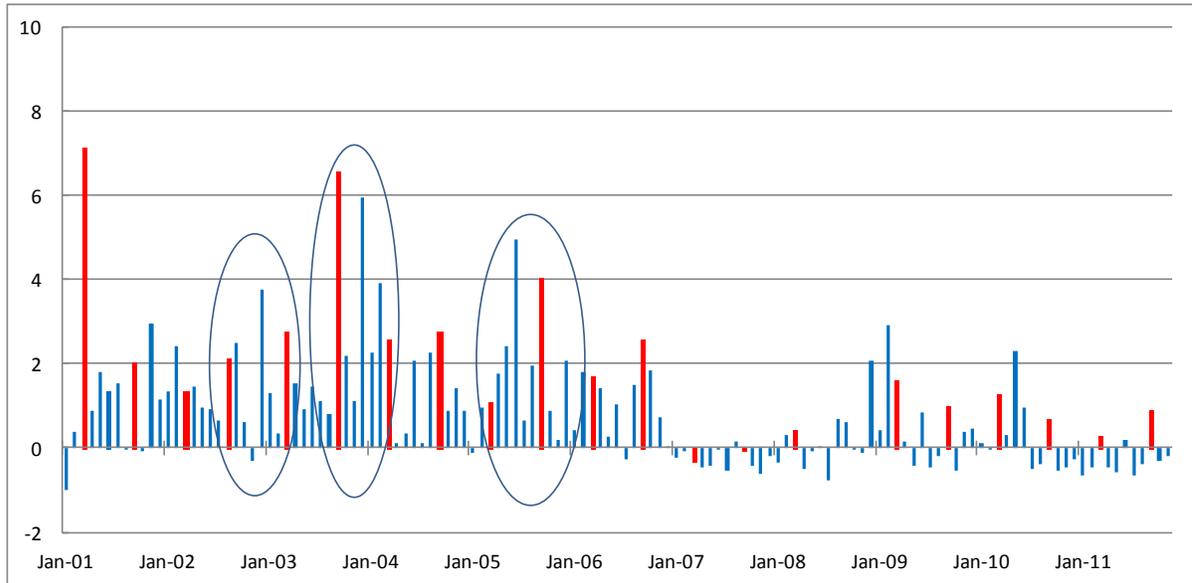


Sources: CPB and authors' calculations.

The first episode was in 2002, when the fiscal outturn came out significantly worse than the budget forecast, and was in fact approaching the deficit ceiling set in the coalition agreement. The second episode occurred in 2003, when the outturn was again significantly worse than forecast, but this time actually breached the deficit ceiling. The third and final episode was in 2005, when the budget forecast exceeded the ceiling, even though the outturn ended up comfortably inside the ceiling. The events related to the financial crisis are excluded, because they represented a more significant, exogenous shock, with less control available to policy makers.

We now map these episodes in Figure 6, compiling the media presence of the CPB calculated as the number of newspaper articles containing a reference to the CPB. We have adjusted and corrected that series for trend, looking at the number of articles relative to a four year rolling average. The columns highlighted in red refer to the months were the CPB releases its public forecasts and fiscal assessments. Some of the spikes observed in the series refer to election periods, where the CPB features heavily in the news.

Figure 6. Media Presence of the CPB
(Number of press articles relative to 4-year rolling-average)



Sources: Factiva and authors' calculations.

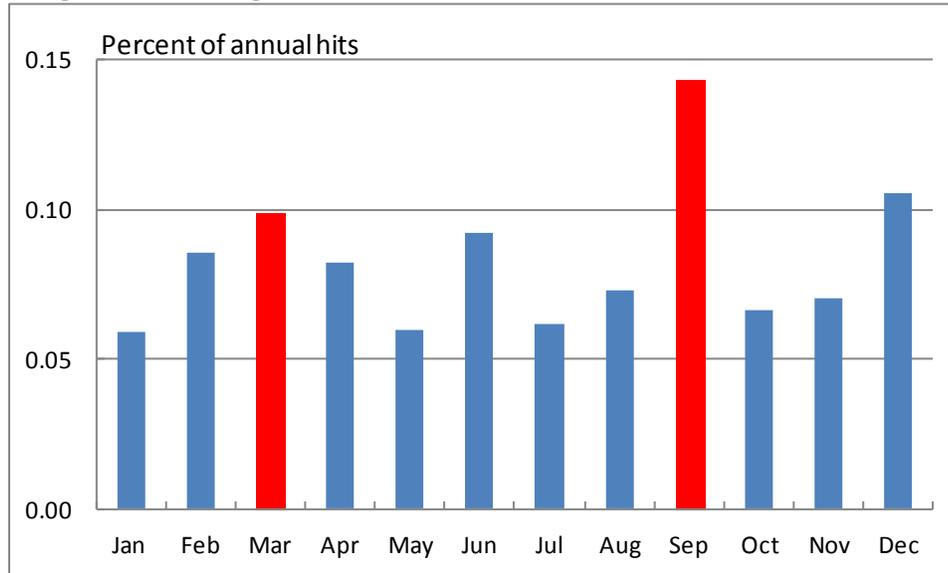
The three episodes identified above coincide with a marked increase in media reports. It is useful to note that the major spikes, particularly in 2003 and 2005 relate to the timing where the CPB released its public assessments.

An examination of the contents of CPB reports at those times confirms this interpretation. In 2002, the slippage became apparent towards the end of the year, and the CPB noted in its December report that due to the worsening economy, the small surplus achieved in 2001 would turn into a deficit of 0.8 percent of GDP in 2002. In 2003, this continued deterioration was noted in the March report, where the projections in the Central Economic Plan of that year were revised downward and the CPB noted that “additional deficit-reducing measures are necessary to comply with the rules from the SGP.” In the December 2003 report, the deficit forecasts were further revised upward, with the CPB noting that “even though the 3.35% deficit will be just above the 3% SGP ceiling, this does not mean that Brussels will determine this deficit to be “excessive”. Netherlands will probably be able to call on exceptional economic conditions”. In 2005, the forecast for the year exceeded the agreed deficit ceiling, which prompted the CPB to warn in its December 2004 report that: “Regardless of the austerity measures of the government, the [2005] deficit stays dangerously close to the 3% SGP deficit ceiling”.

Beyond individual episodes, the CPB’s ability to communicate to the public when it has something important to say and when it matters most during the budget process is important every year. Indeed, a fiscal council constantly out in the public with a running commentary, disconnected from important parliamentary budget preparation deadlines would raise doubts

about its ability to add something important the debate. We can assess this “noise-to-signal” ratio by plotting the average monthly seasonal patterns of media presence of the council (Figure 7). The spikes suggests that the CPB times its media intervention in a fairly systematic way, taking full advantage of the publication of its most extensive reports in March and September to influence the public debate.

Figure 7. Average Seasonal Pattern of the CPB Media Presence



Sources: Factiva and authors' calculations.

The message emanating from this analysis is consistent with the broader correlations detected earlier in the panel of seven countries. While it is difficult to identify a robust causal link between the activities of the CPB and improved fiscal performance in the Netherlands, the CPB's media visibility supports the idea that it actively contributes to the quality of the public debate, and reduces information asymmetries between decision makers and the public. There is indeed no significant forecast bias, the messages of the council appear relevant, and they are communicated in an effective and timely manner.

Case Study 2: Belgium

Two bodies provide independent fiscal inputs into the budgetary process in Belgium. Their responsibilities are split between the normative recommendations and assessments of fiscal policy from the High Council of Finance, and the positive, forecast input role of the Federal Planning Bureau (under the umbrella of the National Accounts Institute)—see Lebrun (2009). The case of Belgium is of particular interest because it is one of the only countries where a fiscal council makes normative recommendations. Over the last two decades, the High Council of Finance (HCF) has gone through periods of being highly influential, followed by a period where that influence has waned (Coene and Langenus, 2011).

The HCF dates back to the 1930s, when it was formed to provide advice to the Ministry of Finance. It only converged on its current role in 1989 when it started issuing recommendations on public sector borrowing requirements. The main objective of Belgian public finances at the time was to reduce the high budget deficit and public debt ratios, which stood at 7 percent and 125 percent of GDP respectively in 1988. Much of the Council's recommendations focused on monitoring and coordinating the fiscal effort across the different levels of government. Belgium's commitment to meet the Maastricht criteria provided an opportunity to expand the Council's normative role with recommendations to comply with these criteria as well as medium-term objectives.

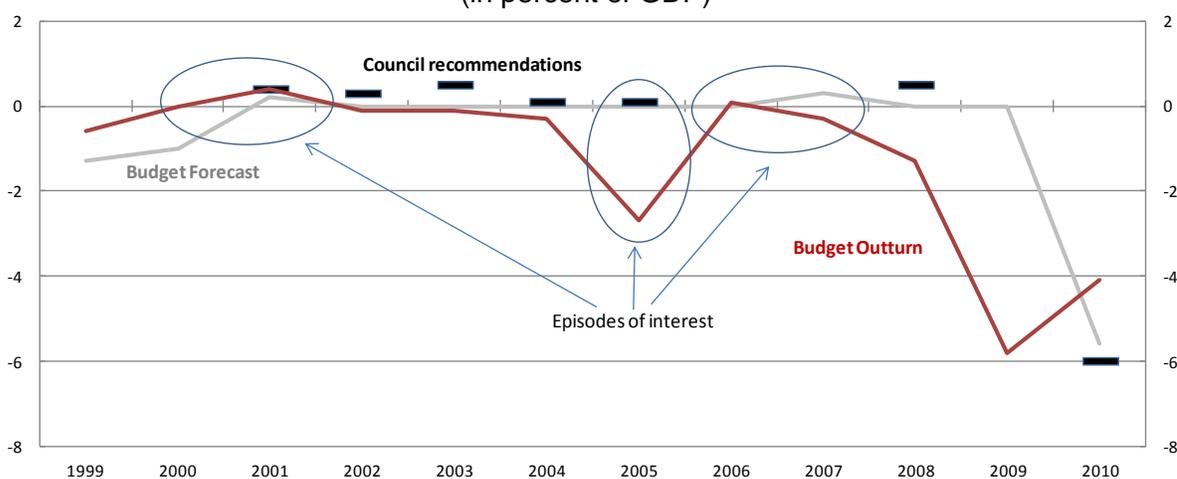
While the Council does not have any direct instruments to shape budgetary choices, its recommendations, compiled in two reports, have in general carried significant weight. The first report is published at the beginning of budget process (June/July), when the Council provides *ex ante* recommendations for fiscal targets. The second report provides an *ex-post* assessment of the extent to which the government followed the recommendations, and the implementation of the stability/convergence program of the previous year.

Unlike the CPB, the institutional set-up governing the HCF is more that of an outsider looking into the budget. Its recommendations are developed in a fairly independent manner, for the government to take on as it sees fit, rather than being worked out and negotiated behind closed doors. The Council is staffed with experts from ministries, the National Bank, the Federal Planning Bureau and academia. The Council's members are appointed by the Minister of Finance for a 5 year renewable mandate running across electoral cycles, which helps preserve independence. The chairperson is often an academic, although ties with political parties often exist. In addition, the political principal has at times deliberately weakened the Council's independence. Over the mid 2000s, for instance, after a number of unfavorable assessments, the Minister of Finance allowed the chairman's mandate to lapse without appointing a successor, which prevented the Council from providing fiscal recommendations. This resulted in a significant loss of influence for the HCF (Coene and Langenus, 2011).

Overall, the performance of the Council can be broken down into two periods: pre and post euro adoption (Coene and Langenus 2011). In the pre-euro adoption period, the Maastricht convergence criteria led to a good alignment of policymakers' objectives with the Council's recommendations, which were largely followed. During that period, the structural primary surplus increased by 5 percent of GDP, public debt started falling and the budget moved towards balance. After euro adoption, the weight of convergence criteria in fiscal policy formulation was lost, and the appeal of the Council's recommendations eroded. The primary balance deteriorated sharply, as most of the savings on the interest bill benefits were used to fund tax cuts and expenditure growth.

Due to data constraints, only the post-euro-adoption period can be subject to a similar analysis as the one performed for the CPB. In Figure 8, the Council's budget year recommendations for the fiscal balance are displayed in black, the budget forecast, in gray and the outturn, in red. A number of interesting episodes stand out. The first is the two years that follow the adoption of the euro in 1999, when outcomes were broadly in line with the Council's recommendations. The second episode is in 2004, when increasing divergences with the council's recommendations led to critical assessments of government policies. Finally, in 2005 and 2006, the Council could not produce reports or recommendations as its chair was deliberately left vacant.

Figure 8. HCF Budget Balance Recommendations, Forecasts and Outturns (in percent of GDP)

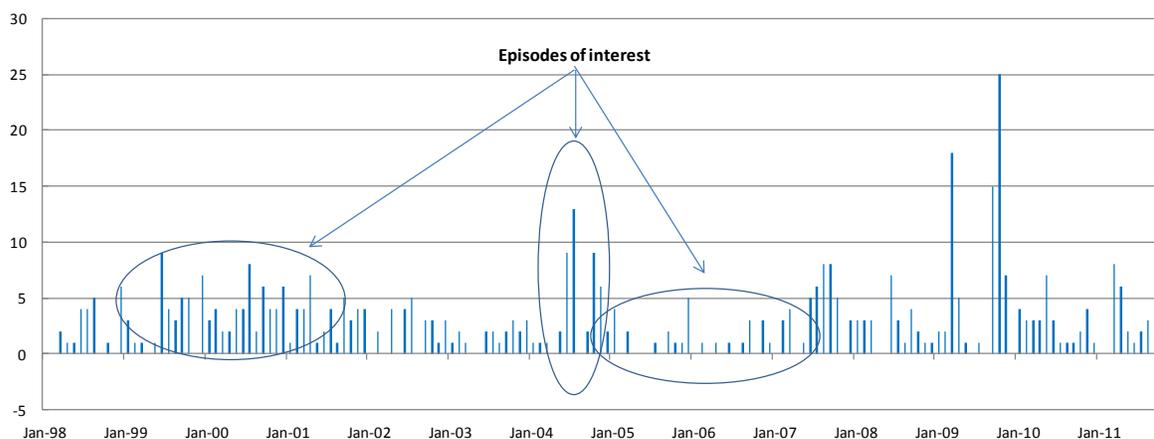


Sources: High Council of Finance and authors' calculations.

We now map these episodes into our measure of media presence of the HCF (Figure 9). In the initial period leading up to and during the euro adoption, there was a strong and sustained coverage of the Council in the Belgian press. This tails off as the 2000s progress and the Council clearly begins losing its influence. In 2004, the Council turned openly critical of government's policies,⁹ leading to a surge in media reports. Finally, during the period when the Council had no formal head and stopped reporting, its media footprint diminished substantially, despite emerging discrepancies between plans and outcomes in 2006.

⁹ The large deficit in 2005 was almost entirely due to a one-off debt assumption, related to the restructuring of the national railway company, which was attributed after the event.

Figure 9. Media Presence of the HCF
(Number of press articles relative to 4-year rolling-average)

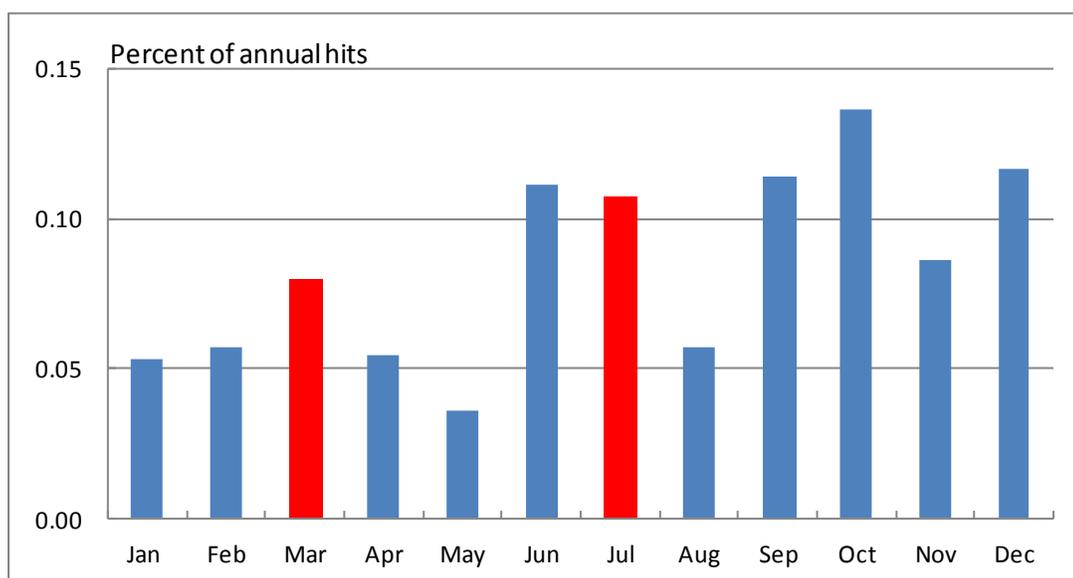


Sources: Factiva and authors' calculations.

Again, a more detailed analysis of the Council's reports and press citations support our reading of the data. In the early 2000s, when public finances were on track, press articles were relatively benign and the HCF reports noted with a fairly neutral tone minor deviations with respect to recommendations. For instance, the October 1999 reports observes that "The deficit of the central government for 2000 is projected at 1 percent of GDP, which is 0.2 percent higher than recommended by the HCF." The tone of HCF reports changed drastically in 2004. In July of that year, the Council launched a stern warning in these terms: "The High Council considers these fiscal scenarios unrealistic in the medium-term" and "The High Council wants to point out that the deteriorating fiscal position is [not only] due to cyclical factors but also—and mainly—due to discretionary measures such as lowering taxes and a major growth in government spending." Of course, there is no report to quote for the last episode.

The monthly pattern of media reporting on the Council is less clear cut and incisive than in the Dutch case, pointing to a weaker ability to shape the public debate on fiscal policy (Figure 10). In particular, media presence spread out more evenly over the year, and is less concentrated around the times when the Council publishes its key fiscal reports (in March and July). Such a pattern could also reflect a greater persistence of the Council's message, for instance because the media use the recommendations as a constant benchmark when discussing budgetary matters. Supporting that conjecture is the fact that despite less pronounced monthly spikes than in the CPB case, there is a concentration of press articles citing the Council in the latter half of the year, the period during which the budget is being negotiated and passed through parliament.

Figure 10. Average Seasonal Pattern of the HCF Media Presence



Sources: Factiva and authors' calculations.

IV. CONCLUDING REMARKS

The paper is a first attempt to provide a unified treatment of the role and effectiveness of independent fiscal agencies (“fiscal councils”) in enhancing fiscal discipline. From a theoretical perspective, the influence of such institutions depends on their capacity to deal with the root cause of deficit bias, including informational asymmetries between voters—the only legitimate principal in the policy game—and politicians. As a result, the delegation of fiscal powers is bound to suffer from the same time-inconsistency problem as binding fiscal rules. Turning to the empirical evidence, the heterogeneity among independent institutions themselves complicates cross-country comparisons based on summary measures of their strength or ex-ante influence on the budget process. In line with the conclusions of the theoretical model, we thus quantify FCs’ impact through their capacity to influence the public debate. We propose to proxy such influence with direct measures of media presence.

While our exploration of the statistical link between media presence and fiscal policy is promising, drawing robust conclusions requires a much more data-intensive work that is beyond the scope of this paper. Case studies of largely successful FCs nevertheless support the statistical findings, with two main messages emerging. First, fiscal councils tend to successfully deliver important fiscal policy messages in a timely fashion. This is a necessary condition for such institutions to credibly affect the conduct of fiscal policy. Second, there is no robust evidence that a high media impact of FCs is encouraging stronger fiscal performance.

Overall, this leads to a number of practical implications:

1. *Theory* suggests that the delegation of fiscal policy prerogatives to unelected officials is unworkable from a positive perspective, reinforcing the normative argument against fiscal delegation emanating from Alesina and Tabellini (2007). The theoretical sketch proposed in Section II indeed illustrates that the very decision to delegate macro-relevant dimensions of fiscal policy—such as the level of the deficit, as suggested by Wyplosz (2005)—violates participation constraints of elected decisionmakers. In *practice*, existing FCs have no direct policy-making powers.
2. In *theory*, an independent fiscal agency is more likely to credibly enhance fiscal discipline if a broad mandate allows it to address the various manifestations of the deficit bias (from creative accounting to masking policy slippages or biasing revenue forecasts). This includes having the discretion to make normative assessments. In *practice*, the case study of Belgium’s High Council of Finance suggests that this requires considerable guarantees of independence from partisan politics.
3. In *theory*, the council’s effectiveness works mainly through its impact on the public debate. By becoming a reliable source on the overall quality of fiscal policy, the FC can help voters identify ex-post deviations related to “bad policies” (as opposed to “bad luck”) and hold policymakers accountable. This is a task that rules-based fiscal frameworks—bound to remain simple to be operational—cannot by themselves deliver. Indeed, mere deviations from preset benchmarks do not always signal policy mistakes. In *practice*, existing FCs seem to deliver their messages in an effective and timely fashion, but there is little evidence such messages trigger policy changes, except when objectives/preferences of the FC and the government are perfectly aligned.

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