What should fiscal councils do?

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1. Introduction

The international financial crisis which erupted in the autumn of 2008 gradually changed into fiscal crises in a number of countries. While this partly reflects the impact of the recession, there is a fear that it might also mark a return to an earlier trend. The period from the early 1970s up to the mid 1990's was characterised by rapidly increasing government debt in most OECD economies. It then became customary to talk about fiscal policy being subject to *deficit bias*. This helped change attitudes to fiscal policy. Discretionary policy fell into disrepute. Instead *fiscal rules* designed to discipline policy makers were emphasised. At the EU level, the stability pact imposed ceilings on both deficits and debt as well as medium-term budget objectives. Several countries, such as the UK and Sweden, also introduced national fiscal rules.

The recent explosion in government debt suggests that the rules approach was not sufficient. One reason is that rules were not observed (Greece), another that, when deficit ceilings were respected, fiscal outcomes lay so close to them that there was no margin for contingencies (Portugal, France and the UK). In some countries there was an overoptimism about the sustainability of booms, such that when they came to an end, huge budget deteriorations resulted (Ireland, Spain and the UK).

These fiscal problems have led to a search for new ways of ensuring fiscal discipline. An idea that has received widespread attention is the establishment of independent fiscal institutions. Such institutions have recently been advocated by, for example, IMF staff (Annett *et al*., 2005; Kumar and Ter-Minassian, 2007), the OECD (in a number of *Economic Surveys)*, the ECB (2010) and the European Commission (2010a,b). EU finance ministers agreed in the van Rompuy Task Force (2010) to work out European standards for fiscal councils "tasked with providing independent analysis, assessments and forecasts related to domestic fiscal policy matters".

The recent interest in independent fiscal institutions was stimulated by a series of academic proposals starting in the mid 1990's.[1] The common motive is a desire to adapt the good experiences of independent central banking to the fiscal sphere. The proposals are of two types: some envisage delegation of actual fiscal policy decisions, others propose delegation of forecasting, analysis, evaluation and advising.

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[1] See, for example, von Hagen and Harden (1994), Blinder (1997), Wyplosz (2002, 2005), Calmfors (2003, 2005, 2010b), Wren-Lewis (1996, 2003) and Kirsanova *et al.* (2007). Debrun *et al*. (2009) provides a survey of proposals.

Independent institutions with the latter *fiscal watchdog* function have existed for a long time in some countries. They include the Central Planning Bureau in the Netherlands, the Economic Council in Denmark, the Congressional Budget Office in the US and the High Council of Finance in Belgium. Recently, similar institutions have been created in Sweden, Hungary, Canada, Slovenia and the UK. They are often labelled *fiscal councils*. New fiscal councils are being considered in a number of countries, including Ireland, Portugal and Slovakia.

We analyse what role fiscal watchdogs can play. Should they do forecasting or only evaluate the government's forecasts? Should they just undertake positive analysis or also give normative recommendations? Should they be complements to fiscal rules, helping to monitor them, or substitutes, allowing a more discretionary policy approach? Should fiscal watchdogs only evaluate the extent to which intermediate, medium-term fiscal objectives are attained or should they also analyse the appropriateness of these objectives? Should the remit be confined to fiscal policy or can it be broadened to other policy areas as well? How should independence from the political system be guaranteed? When is the establishment of a fiscal council time consistent, *i.e.* under what circumstances is a council likely to survive as an independent agent in the political policy-making process?

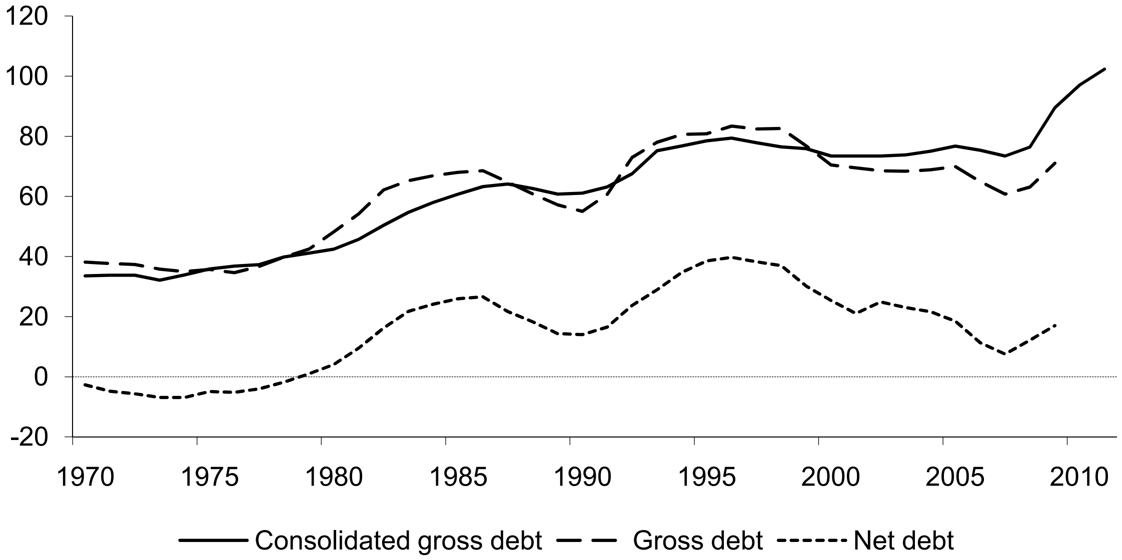
We discuss these issues theoretically and analyse the experiences of existing councils. Section 2 briefly reviews the development of government deficits and debts. To have a benchmark for the subsequent analysis, Section 3 discusses optimal debt policy. Section 4 surveys various explanations of deficit bias and their implications for fiscal councils. Section 5 discusses how they can be set up in practice. Section 6 surveys how existing councils function. This survey is complemented by two case studies in Section 7: of the Swedish Fiscal Policy Council and of the Office for Budget Responsibility in the UK. Section 8 concludes.

2. Trends in government debt

The current pace of increase in government debt is unprecedented in most countries. This is illustrated in Figures 1 and 2. Figure 1 shows that consolidated gross debt in the OECD area increased from 73 to 97 per cent of GDP between 2007 and 2010. Figure 2 shows developments in the euro area, Japan and the US.

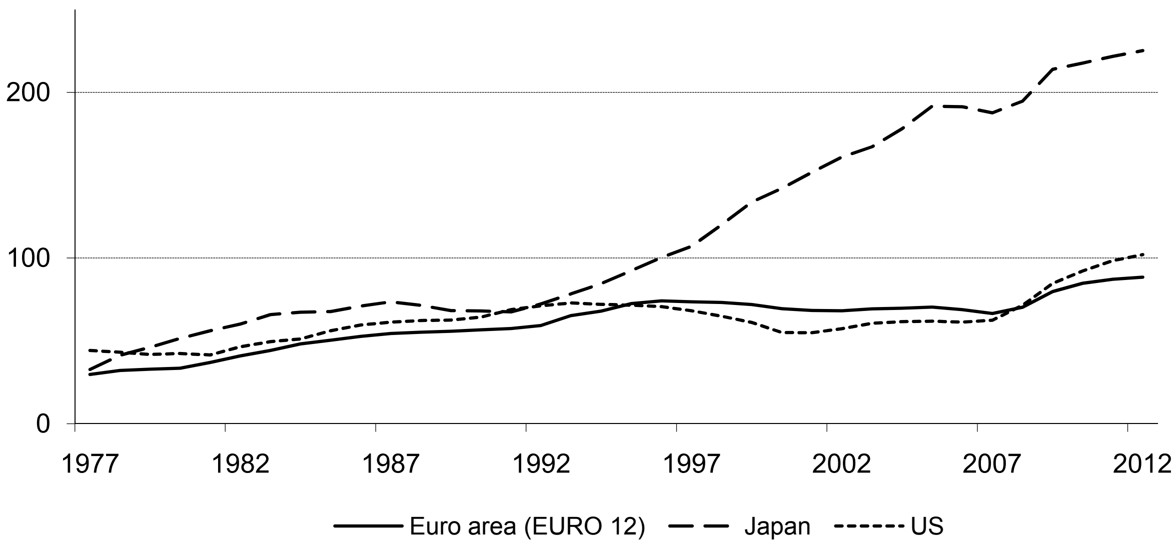
The recent sharp rise in government debt has resulted from a combination of automatic stabilisers being allowed to work in the recession, discretionary action to stimulate the economy and support to the financial sector in some countries. For the OECD area as a whole, the last years' increase in government debt stands in contrast to a stable or falling debt-to-GDP ratio in the preceding decade.

Figure 1 General government gross debt (OECD), per cent of GDP



Note: Gross debt is the sum of all financial liabilities in the general government sector without any netting between different parts of the sector. Consolidated gross debt is total debt in the general government sector after internal claims and liabilities in the sector have been netted out. Net debt is the general government sector's gross financial debt minus its financial assets.
Source: OECD Economic Outlook November 2009 and European Parliament.

Figure 2 General government consolidated gross debt (Euro area, Japan and US), per cent of GDP



Note: Euro area includes West-Germany up until 1991.
Source: European Parliament.

Looking further back, the secular rise in the ratio of government debt to GDP between the mid 1970s and the mid 1990's stands out. During this period, the gross debt ratio nearly doubled in the OECD, rising from around 40 per cent of GDP to about 75 per cent. These developments gave rise to a large literature on *deficit bias*, which we summarise in Section 4.

3. Optimal debt policy and the inadequacy of fiscal rules

There are two clear reasons for believing that deficit bias is undesirable. First, many governments have established fiscal rules designed to prevent it. Second, deficit bias is not consistent with existing ideas about optimal debt policy. This section begins by elaborating both points. It ends by using ideas about optimal debt policy to suggest why fiscal rules *on their own* are likely to fail, creating a potential role for fiscal councils.

3.1. Fiscal rules

Although studies of the effects of rules on fiscal performance are plagued by problems of interpretation (it may be that fiscally responsible governments signal their determination to exert fiscal discipline through the adoption of fiscal rules), there is some evidence that rules have had a causal effect (for example, European Commission, 2006 and OECD, 2007). But at the same time it is clear that fiscal rules have often been violated. This is probably most evident in the case of the EU's stability pact, agreed in 1997. According to it:

- government budget deficits shall not exceed three per cent of GDP; and
- consolidated gross government debt shall not exceed 60 per cent of GDP, or if the debt ratio is larger, it shall be approaching the debt limit "at a satisfactory pace".

Table 1 summarises the cases where at least one of the two rules was violated (the debt rule has then been interpreted liberally as being followed as soon as the debt ratio falls). What is remarkable is the large number of breaches before the recent crisis erupted in 2008 (44 out of 177 possible cases). This indicates that the rules were not binding.

3.2. Optimal debt policy

The starting point for any analysis of optimal debt policy might be the implications of tax smoothing (Barro, 1979). If we could choose our initial debt level, then in a very simple world without public-sector capital we would choose a negative level that could eliminate all distortionary taxation. However, if we instead inherit positive debt, it would be undesirable to eliminate it, because eliminating taxes in the long run would require substantial increases in taxes now to pay back existing government debt. This policy would therefore combine high taxes today with zero taxes tomorrow. In contrast, keeping debt constant at its current level involves a constant level of taxes. If tax distortions increase at the margin as taxes rise, and if we discount at the real interest rate, then the cost of high taxes today outweigh the benefits of zero taxes in the future, and keeping taxes constant (tax smoothing) is always preferable. An implication is that if a shock to public finances changes the debt stock we inherit, this shock should be accommodated. As a result, the long-run level of debt reflects past shocks. We will call this the random-walk debt result.[2]

Table 1 Breaches of the stability pact

	99	00	01	02	03	04	05	06	07	08	09	10
Austria	x		x			x				x	x	x
Belgium										x	x	x
Bulgaria											x	x
Cyprus						x					x	x
Czech Republic							x				x	x
Denmark												x
Estonia												
Finland												x
France				x	x	x	x		x	x	x	x
Germany	x			x	x	x	x			x	x	x
Greece		x	x	x	x	x	x	x	x	x	x	x
Hungary						x	x	x	x	x	x	x
Irland										x	x	x
Italy			x		x	x	x	x		x	x	x
Latvia										x	x	x
Lithuania										x	x	x
Luxemburg												
Malta						x				x	x	x
Netherlands					x						x	x
Polen						x	x	x		x	x	x
Portugal			x			x	x	x		x	x	x
Romania										x	x	x
Slovakia								x			x	x
Slovenia											x	x
Spain										x	x	x
Sweden												
UK					x	x	x			x	x	x

Note: The crosses show that a country has a government deficit exceeding three per cent of GDP, or a gross government debt exceeding 60 per cent of GDP that is not falling (or both). A grey field indicates that the country, at the time, was not an EU member state.
Source: ECB.

[2] Strickly, steady-state optimal debt follows a random walk, as was first shown in models with sticky prices by Schmitt-Grohe and Uribe (2004) and Benigno and Woodford (2003).

The rise in OECD debt prior to 2008 would only be consistent with random-walk debt if government finances had been hit by an unusual run of bad shocks. There is no reason to believe this to be so. Furthermore, potential qualifications to the random-walk debt result suggest declining, rather than rising, optimal debt (Wren-Lewis, 2011). In particular, if the interest rate exceeds the discount rate, either because of a default premium or because the current generation fails to internalise the welfare of future generations (as in overlapping-generations models), the benefits of reducing debt exceed the costs in terms of higher short-run taxes (Erosa and Gervais, 2001). There might also be precautionary motives for keeping debt low, such as the need to use expansionary fiscal policy to compensate for hitting a zero bound for interest rates (Wren-Lewis, 2010), which modify the random walk debt result (Mash, 2010).

While deficit bias appears sub-optimal, it may not even be sustainable. Sustainability is a much weaker criterion than optimality: there are many sustainable long-run levels of debt, and many paths towards that long run. An insight on sustainability is given by the European Commission's calculations of the so-called S2 indicator. It measures the annual, permanent budget improvement as a percentage of GDP which is required to meet the government's intertemporal budget constraint (*i.e.* for it to be able to pay the interest on the outstanding debt) given current tax and expenditure rules as well as projected demographic developments. The calculations imply that the fiscal balance must improve by 7.4 per cent of GDP compared to 2009 on a permanent basis across the EU as a whole (European Commission, 2009).

3.3. The difficulty with fiscal rules alone

Deficit bias appears to represent a significant departure from optimal policy, and may endanger sustainability. But at the same time optimality considerations might make fiscal rules problematic as a *sufficient* means of controlling deficit bias.

While it is fairly easy to overturn the random-walk debt result, the implication that sharp movements in fiscal instruments should be avoided is more robust. This has two implications. First, the optimal approach to any optimal debt target should be slow (Leith and Wren-Lewis, 2000; Marcet and Scott, 2008). Second, it is optimal to largely accommodate shocks to debt in the short run.[3] Government debt should be a short-term buffer rather than a

[3] This analysis is also likely to be compatible with using countercyclical fiscal policy when monetary policy is constrained by a zero-interest-rate bound, because the benefits of doing this will probably outweigh the costs of any delay to reaching the optimal debt target.

target. Simple rules involving *ex-post* targets for debt or deficits are likely to produce sub-optimal policy, which in turn reduces their credibility.

One possibility is to see fiscal rules as something to strive for *ex ante*, but not to achieve *ex post*. *Ex-post* evaluation could be done to learn about the risks of not achieving the objective in the future, but it would not require any policy reaction. The problem with such an approach is that the incentives to achieve targets *ex ante* become weak. Here, clearly a fiscal council could play a role in monitoring that *ex-post* deviations from *ex-ante* targets are motivated by economic shocks. Another approach to fiscal rules is to design them in a more complex way, so that they are *explicitly* contingent on shocks that might hit the economy. Unfortunately the contingent nature of such rules is likely to make them difficult to monitor, and they therefore may *on their own* be ineffective (Wyplosz 2005; Kirsanova *et al.*, 2007; Debrun *et al.*, 2009). A fiscal council could play a useful role of monitoring complex rules.

The conclusion is that fiscal councils could be useful *complements* to fiscal rules. The appropriate design of such councils, however, is likely to depend on the causes of deficit bias, which is an issue we now turn to.

4. Understanding deficit bias, and the implications for fiscal councils

There are a several reasons for deficit bias discussed in the literature, and that therefore could provide a case for independent fiscal institutions.[4] Below we try to isolate the key ingredients that may be involved, although in reality these may be interrelated.[5] We distinguish the following classes of explanation: (i) informational problems; (ii) impatience; (iii) exploitation of future generations; (iv) electoral competition; (v) common-pool problems; and (vi) time inconsistency. In each case, we ask what role a fiscal council might have, and what this might imply for its form.

4.1. Informational problems

One class of theories focuses on informational problems. An example is over-optimism about future growth, either by the electorate (who elect a government that reflects this optimism), or by the government relative to the electorate. Over-optimism can create deficit bias because tax revenues will be persistently below expectations. Politicians may overestimate their ability to influence growth, and may pressurise civil servants to produce over-optimistic forecasts. If

[4] Deficit bias is in practice closely related to pro-cyclicality. In principle, fiscal policy could be pro-cyclical without exhibiting deficit bias, but in general deficit bias results in large part from a failure to control spending and tax decreases ‘in good times’.

[5] This extends earlier attempts by, for example, Bertelsmann and Rogoff (2010) and Calmfors (2010b).

this is the source of deficit bias, then delegating just the forecasting process to an independent agency would be appropriate.

Maskin and Tirole (2004) talk about the danger of elected representatives ‘pandering to popular opinion’. Although this phrase is often used, it appears paradoxical, as we would normally want governments to reflect public opinion. But a key point about representative democracy is that the electorate normally delegates decision-making to representatives, whose job it is to take ‘good decisions’ that the individual has neither the time nor the competence to make. In this sense, representative democracy presumes a lack of information on the part of the electorate, and this lack can be exploited. Voters may be unaware of what the true fiscal position is. A government may argue that particular spending increases or tax decreases are affordable within existing fiscal plans, and it may be very difficult to verify this. This ignorance may allow the government to increase its chances of re-election, creating a political business cycle As there is no similar incentive to raise taxes or cut spending, this will lead to deficit bias.

Such lack of information might help explain the results in Alesina *et al.* (1998) that successful fiscal adjustments do not appear to jeopardise government popularity: if voters are made fully aware of the fiscal arithmetic, they may support short-term costs for longer-term gains. Alt and Lassen (2007), Broesens and Wierts (2009) and Lassen (2010) show that budget outcomes are more favourable in countries where fiscal policies were more transparent. If the electorate believe that politicians may spend money on prestigious projects or on particular interest groups, in ways that are hard to monitor, it may put pressure on governments to cut taxes to avoid money being wasted in this way (Alesina *et al.*, 2008; Andersen and Westh Nielsen, 2010).

If lack of information is a cause of deficit bias, a clear role a fiscal council could play is to provide better (*i.e.* unbiased) information. This would increase the probability that any rules to counter deficit bias are respected.

4.2. Impatience

Another possible explanation of deficit bias is impatience. This can work at the level of individuals or governments. An example of the former is where agents have hyperbolic discount functions rather than conventional exponential discount functions (Laibson, 1997). This makes individuals impatient in the short term, but more patient over medium- to long-term horizons, implying time-inconsistent preferences. Bertelsmann (2010), and Rogoff and Bertelsmann (2010) apply this idea to explain deficit bias.

An analogy is that we know we are overweight and should therefore eat less, but when a waiter offers us tempting desserts at a restaurant, we cannot resist. Just as the presence of a partner at the restaurant reminding us how we resolved to eat less can be effective in changing our decision, so a fiscal council may be useful in helping the electorate resist the short-term temptations of tax cuts or additional spending. Governments may not be able to play this role because it may generate short term unpopularity that could lose elections, while a fiscal council does not have the same concern.

A more common explanation for why impatience might lead to deficit bias involves governments discounting at a higher rate than the electorate, because individual politicians may lose office in elections. If optimal long-run debt follows a random walk, then a more impatient policymaker may allow debt to explode after an adverse shock to the public finances (Kirsanova *et al.*, 2007). The electorate may not be able to discipline politicians effectively, because elections are fought over a multitude of issues. Fiscal councils could provide an alternative source of political pressure in this case.

4.3. Electoral competition

Implicit in the impatient government story is that the electorate is unable to elect a more patient government. A similar story concerns competition between two political parties, but here government preferences are perfectly aligned with those of a section of the electorate. Parties can follow the electorate in having different preferences either over types of public goods or over the size of government. This set-up was originally formalised by Alesina and Tabellini (1990) and Persson and Svensson (1989), and later analysed in a sticky-price model with nominal debt by Leith and Wren-Lewis (2009).

In this theory, governments do not fully internalise the cost of debt, because those costs may be borne by an opposing party if the government is not re-elected. In addition, accumulating debt now has the *strategic* advantage from the point of the current government that it becomes more difficult for other future governments to pursue the interests of their constituencies, as the room for fiscal manoeuvre is reduced. In this framework, each party would show no undue impatience if it could be certain to be in power forever. Here, the apparent impatience entirely reflects the wishes of the section of the electorate that the party in government represents.

It is conceivable that parties under a *veil of ignorance* of who will govern in the future (or simply realising that they are likely to alternate in government) could agree on a fiscal rule to counter deficit bias arising from electoral competition. However, once in power a party has an incentive to violate the rule. A fiscal council, with the task of acting as a guardian of the rule, might act as a countervailing force by raising the reputation cost for politicians of reneging on the rule.

4.4. Common-pool theory

As public projects or tax cuts may favour small groups, those groups lobby for these with insufficient regard to the full budgetary costs now as well as in the future. Common-pool theories focus on the fact that many decision makers (*e.g.* spending ministers) may be involved in formulating budgets, and these decision makers fail to internalise the overall costs of higher spending and debt.

This theory suggests a direct link between different types of institutional set-up within government and the extent of deficit bias. Roubini and Sachs (1989) pointed to a tendency for more fragmented government coalitions to run larger budget deficits. This result found support in Fabrizio and Mody (2006), although they also concluded that arrangements that provide checks to these pressures can be effective. A number of studies of US states have found public spending pressures associated with political fragmentation (for example, Besley and Case, 2003).

Representative electoral systems are likely to be more subject to common-pool problems than those based on majority rule. Persson and Tabellini (2004) show that majoritarian systems are associated with greater fiscal discipline than are proportional ones. In countries with ideologically dispersed coalitions, Hallerberg *et al.* (2009) find that multi-year targets increase fiscal discipline. Hallerberg and von Hagen (1999) outline how a strong finance ministry can reduce deficit bias. However, over the last decade, the UK had a period when the finance minister (Gordon Brown) had unprecedented power and imposed fiscal rules, all within a majoritarian system of government. Despite this, the UK was also subject to apparent deficit bias.

Common-pool theory suggests how a fiscal council with no formal power might nevertheless reduce deficit bias. The recommendations of a council could strengthen the authority of a finance minister. In more fragmented political systems, the recommendations of a fiscal council could form the basis of contracts between political actors that in effect internalised fiscal discipline. (This is discussed in Section 6.2 in the context of the fiscal councils in Austria, Belgium, and the Netherlands.)

4.5. Time inconsistency and inflation bias

It is legitimate to ask whether deficit bias may be related to inflation bias. If fiscal policy is used as a stabilisation tool, then much of the inflation bias literature is directly applicable. In that literature, governments are often assumed to control output and inflation, and whether this is through monetary or fiscal means is not specified.

If fiscal policy can be used to raise output and inflation in the short run, this could lead to deficit bias alongside inflation bias. In Agell *et al.* (1996), a discretionary equilibrium exists with both inflation and deficit bias, and the government would be better off committing to inflation at target and budget balance. Castellani and Debrun (2005) show that institutional change that reduces inflation bias through monetary policy might encourage inflation bias through fiscal policy with an associated deficit bias.[6] If fiscal rules exist to deal with deficit bias arising from this type of time inconsistency, a fiscal council can act as a guardian of such rules when policy makers have incentives to depart from them. In addition, councils can also signal when countercyclical fiscal action is justified (see section 7.1). This might be particularly important for members of a monetary union, where frequent fiscal action may be required. For a fiscal council to advise on the extent of such action would represent a rather different role to advising on longer-term prospects for government debt.

4.6. Exploiting future generations

If the existing electorate does not care sufficiently about future generations, then they may elect governments that exploit future generations (Musgrave, 1988).[7] The exploitation of future generations may be direct or indirect. It is direct if taxes are cut today, and paid for by future generations. It is indirect when additional government debt crowds out capital.

Why would delegating fiscal decisions to unelected representatives help avoid this intergenerational transfer? Maskin and Tirole (2004) argue that officials want to leave a legacy. In that sense, they will care about what future generations will think of them. In this sense, a fiscal council could represent future generations. However, to do so effectively it would appear as if such a council would have to have actual power over fiscal decisions. It is not clear why a government would cede power in these circumstances.

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6 However, time inconsistency problems need not cause deficit bias in models of optimal debt policy. Leith and Wren-Lewis (2007) show that the time-consistent optimal debt policy can involve a rapid return to a debt target in a model with sticky prices or nominal debt.

7 Even in the standard Ricardian case, the welfare of future generations will still be discounted, which may not be ethically desirable (Stern, 2006).

4.7. The potential contribution of fiscal councils

Our discussion shows there is no shortage of explanations for deficit bias. One should expect that in reality different stories may apply at different times or in different places. This may be important in assessing what contributions fiscal councils can make. We will show below that such bodies differ substantially across countries. In some cases this clearly reflects views about what was important in generating deficit bias at a particular time.

4.7.1. Advisory or decision-making councils. Evaluating which explanations for deficit bias matter may be important for whether fiscal councils should have decision-making power or only be advisory. As shown in Section 6, all existing fiscal councils are advisory. But it has been suggested that such bodies could go a stage further, and take actual policy decisions. (Debrun *et al.*, 2009 describe such bodies as ‘Fiscal Policy Authorities’, and they are also sometimes referred to as ‘Fiscal Policy Committees’, with obvious parallels to the delegation of monetary policy.) Whether such a move is desirable may depend on the source of deficit bias.

Take, for example, the case where deficit bias involves *deliberate* exploitation of future generations based on complete information. If all a fiscal council does is to provide information about the extent of the exploitation and advice to the government, it would not change anything. Here there would be a strong argument for delegating decision-making power to an independent council that implicitly represented the welfare of future generations. With other explanations of deficit bias, an advisory role may be sufficient to affect policy, although one would always expect delegation of decision-making power to be more effective.

It is common to draw parallels to delegation of monetary policy decisions to independent central banks (see, for example, Calmfors, 2005; Wyplosz, 2005; or Debrun *et al.*, 2009). However, there are two important differences between fiscal and monetary policy here, beyond potential differences in the problem delegation is trying to avoid. First, while there is a general consensus about what the goals for monetary policy should be, there is much less consensus with fiscal policy. As we noted in the previous section, theory at present has very little to say about what constitutes an optimum debt target. Alesina and Tabellini (2007) suggest that widespread consensus about the goals of policy is a prerequisite for the successful delegation of decisions. If such a consensus is lacking for optimal debt policy, then this argues against taking decisions over debt and deficits away from an elected government.[8]

[8] A similar argument can be used to make a positive case for delegation of evaluation and advice. A fiscal council could play a useful role in both encouraging research on optimal debt policy and in evaluating this

Second, while there is generally only a single monetary policy instrument, there are many fiscal instruments. Issues over both individual tax policy, and over the overall size of the state, are clearly the provenance of elected governments and could not be taken by a fiscal council. Both arguments suggest a stronger case for fiscal councils with advisory functions than for councils with decision-making authority. The arguments also explain why fiscal councils are more suitable as complements to rules than as substitutes for them (see Wyplosz, 2002; 2005), since a rule determined by the political system gives an advisory council a clear, democratically decided, benchmark against which to judge policy.

4.7.2. Different types of advisory councils. The perceived cause of deficit bias should have implications for the tasks performed by an advisory fiscal council. The most clear-cut case is if the bias derives from deficiencies in information. If the primary problem is thought to be over-optimism by governments in making fiscal projections, then these forecasts could be delegated to the fiscal council. If the main information problem instead is insufficient understanding of the government's intertemporal budget constraint, *i.e.* of the future consequences of current deficits, providing fiscal sustainability calculations highlighting these consequences might alleviate the bias. These are two examples where the provision of positive analysis by a council may go a long way.

When the root cause of deficit bias is instead impatience on the part of governments, electoral competition or time inconsistency of the inflation bias type, the role of a fiscal council may rather concern the interpretation and implementation of fiscal rules. Then a more normative role providing explicit judgements on the consistency of government policy with the rules might be appropriate. This would serve to increase the *reputation cost* for governments of violating the rules.

If deficit bias is instead caused by common-pool problems, the role of a fiscal council might rather be to promote the *co-ordination* necessary to make individual agents internalise the effects of policies that benefit them on others. Presumably, this could be done both by providing positive analysis that can serve as a basis for political negotiations and by making normative recommendations influencing such negotiations.

As we noted earlier, the fact that fiscal rules may not be sufficient to prevent deficit bias could reflect the difficulty in designing rules that are both simple and optimal. This

research. (One of the striking features of delegated monetary policy is how well central banks network in processing academic research.) A delegated body may be preferable to government in this role because an independent body would be better able to take an objective view of research.

suggests a potential division of labour between a government and a fiscal council. A government can retain the power to establish the fiscal rule. A fiscal council can then either advise the government and electorate on whether the rule is being adhered to (if the rule is complex), or suggest when it is legitimate to depart from that rule (when the rule is simple), thereby helping to avoid distortions that simple targets might otherwise create.[9] A fiscal council might also advise on how rules could be improved.

4.7.3. The long-run viability of fiscal councils. Above we noted that under some explanations for deficit bias (*e.g.* exploitation of future generations) it was difficult to see why a government would establish a fiscal council. A related and important question concerns the long-run viability of a fiscal council. For the same reason that a government has an incentive to renege on a fiscal rule, it has an incentive not to heed the advice of a fiscal council or even to dismantle it if its critique of government policy becomes too embarrassing. The issue is in principle similar to the problem with central bank independence raised by McCallum (1995), which is that independence simply moves the time inconsistency problem to another level.

It is easy to see how this problem could arise.. Fiscal councils are sometimes proposed by opposition parties as part of a critique of incumbent governments. As can be the case with a fiscal rule, the prospective government may also wish to be seen to constrain its future actions. Once elected, and with a council established, the constraint begins to bind, which creates incentives to disregard the council's advice, to interfere with its remit and possibly even to shut it down. The position of the council may become even more precarious if the party that established it is no longer in power. Conflict between a government and a fiscal council is not inevitable: the fiscal council may help validate optimal departures from simple rules, or establish that a government was not unduly impatient. However, the experience of the newly established fiscal councils in Hungary and Sweden discussed in Sections 6.2 and 7.1.4. show that there are serious dangers here.

In principle, there are two ways to handle the political fragility of a fiscal council. One way is for the council to build up a reputation for impartial and competent analysis, so that the political cost of interfering with its activities outweighs the political gains. This is, however, likely to take time, since it presupposes that the council gets well-known among the general

[9] Krogstrup and Wyplosz (2010) examine how aggregate budget targets may allow productive government spending to be squeezed out in favour of transfers to specific interest groups. They suggest a fiscal council could have a role in allowing precommitment at the national level to desirable productive government spending, in the context of externally imposed deficit limits.

public, and may therefore not be enough for protecting newly established councils. The other way is to set up formal rules protecting the independence of the council. These issues are discussed further in Sections 6.2 and 8.

5. Issues when setting up a fiscal council in practice

The preceding section has analysed *theoretically* how independent fiscal institutions could strengthen fiscal discipline. Setting up such institutions, however, raises a number of *practical* issues. We focus on fiscal councils without decision-making power, as these are the only ones that have been established so far.

5.1. The remit of a fiscal council

A first question is how exactly to define the remit of a fiscal council. Our previous analysis suggests the following possible tasks:

- *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.
- Analysis of fiscal transparency.
- Costing of individual government policy initiatives.
- Macroeconomic forecasting.
- Normative recommendations on fiscal policy.

The first four activities can be seen as core activities of a fiscal watchdog. Fiscal targets are usually conditioned on cyclical developments, which means that there may be different interpretations of whether or not the targets have been met. This increases the scope for political manipulation. It gives a council an important role in verifying past fiscal behaviour. The risk of later being criticised by an official watchdog should strengthen the *ex-ante* incentives for governments to exercise fiscal discipline. These incentives are even stronger if a council also engages in *ex-ante* evaluation of whether fiscal policy is likely to meet its objectives in the future.

Long-run fiscal analysis should also be a core activity of a fiscal watchdog, since insufficient consideration of future consequences forms the core of the deficit bias problem. The European Commission and several EU governments produce regular sustainability calculations, but it is well-known that these are sensitive to small changes in assumptions (see, for example, Swedish Fiscal Policy Council, 2009; 2010). There is an obvious temptation for governments to make benign assumptions. A fiscal council can therefore exert influence either by making its own calculations or by careful monitoring of government calculations.

A key issue concerns the relationship between medium-term fiscal targets and long-term objectives. Medium-term targets can be seen as *intermediate* goals designed to achieve more fundamental, higher-level objectives. The latter could refer to social efficiency (giving an argument for tax smoothing*),* precautionary savings to deal with future contingencies or intergenerational equity (see, for example, Auerbach, 2008). A minimum assignment of a fiscal watchdog is only to evaluate the consistency of fiscal policy with the medium-term, intermediate targets. A more ambitious task is also to evaluate the consistency of the intermediate targets with the higher-level objectives. There is, however, a potential conflict between the two tasks. Should a fiscal council act both as a policeman for the intermediate targets set by the government and as a judge of the appropriateness of these targets? On one hand, the latter task could compromise the credibility of the council when policing the adherence to the intermediate targets if it is critical of them. On the other hand, given its expertise, a fiscal council is particularly well placed to analyse the relationship between higher-level objectives and medium-term targets.

Another contentious issue is whether a fiscal council should do macroeconomic forecasting. An obvious argument in favour is that overoptimistic government forecasts have often been used to mask profligate fiscal policy (Jonung and Larch, 2006). But forecasting increases the resource requirements for a council considerably. Forecasting may also crowd out other council activities. Moreover, forecasts are wrong most of the time – sometimes very wrong – so engaging in this activity could weaken the council's credibility and make it harder to fulfil other tasks (Wren-Lewis, 2010; Calmfors 2010b). An alternative is that the council only monitors the government's forecasts.

Should a fiscal council undertake only positive analysis or should it also do normative analysis? The minimum positive analysis is to set out the consequences of the government's policy only. A more ambitious approach is to spell out the consequences of alternative policies as well. Finally, a council could give outright policy recommendations. These issues involve difficult trade-offs. On one hand, normative recommendations could compromise the positive analyses. On the other hand, "consumers" of the council's reports may find it difficult to work out how a strictly positive analysis should be transformed into policy conclusions, thus lessening the impact of the council's analysis on actual policy (Debrun *et al*., 2009).

5.1.1. Broader tasks for a fiscal council? Could the remit of a fiscal council be broadened to other areas as well? Two possible candidates are employment and growth as these are also key macroeconomic objectives. Again there are arguments both in favour and against. A broader remit has the obvious drawback that the resources of the council are spread more thinly. Another risk is that the council's analysis of more concrete, short-run issues such as youth unemployment, specific tax proposals *etc.* could receive more public attention than less tangible fiscal sustainability issues. If so, the aim of strengthening the incentives for fiscal discipline may be achieved to a lesser degree with a broader remit.

There are also arguments in favour of broader tasks. One has to do with the strong interaction between fiscal sustainability and employment. Assumptions on future employment developments can be key to the results of fiscal sustainability calculations (Swedish Fiscal Policy Council, 2009). Deficit bias can also be seen as a manifestation of the more general problem of too little attention being paid to analytical input in the political process at large (Calmfors, 2009). In trying to increase the impact of such analysis, a fiscal council with a solid reputation might be more effective than a host of different evaluating agencies in various areas. At least in a small country, it might also be difficult to fill a multitude of independent evaluating institutions with sufficiently competent staff (Calmfors, 2010b).

5.2. Independence

There is a consensus in the academic discussion of fiscal councils on the need for independence from the political system. This follows from the presumption that deficit bias arises from distortions in the political system that a council should be designed to counteract.

Research on central banks has specified a number of ways through which independence for an economic policy institution can be achieved. These include:

- Appointment procedures that seek to guarantee professionalism – and not political preferences – as the ground for appointment.
- Long and non-renewable periods of office for the institution's decision-making body.
- Restrictions on the government's freedom to fire the members of the institution's decision-making body.
- Outright prohibitions both against the government interfering with the institution's on-going work, and against the institution taking instructions from the government.

A key factor for independence from the political system is *budgetary independence*. For central banks this is almost automatically granted since they have access to the seignorage gains. A fiscal council should have a long-term budget, removing a temptation for governments to try and influence the council's work through the size of budget appropriations. Independence is also jeopardised if the council is not provided with sufficient resources but has instead to draw on the resources of the ministry of finance.

Another crucial factor for independence is *accountability.* This may sound paradoxical, but a council which is not held accountable in the short run may risk its independence in the long run. The reason is that a council doing its job is likely from time to time to get into conflict with the government which may then want to restrict its independence or reformulate its tasks. The best protection against this would be regular evaluations of the quality of the council's work. Such evaluations could be peer evaluations done by councils in other countries (or by a more formalised international network of councils) or by international organisations such as the IMF and the OECD.

Establishing *international standards* for fiscal councils could be another way of bolstering their independence. In fact, EU finance ministers have already agreed in the van Rompuy Task Force (2010) to formulate (non-binding) recommendations on the set-up of national fiscal councils. This could be a way of raising the political cost for governments of infringing on the independence of fiscal councils. Within the EU, another way of safeguarding the position of national councils could be to give them a formal role in economic governance.This could be done, for example, through agreements with member states having fiscal councils that the latter should provide the Ecofin Council with evaluations of national stability or convergence programmes submitted to the EU.

The choice of principal for a fiscal council can also influence its independence. The council could formally be an agency under the government, but it could also be an agency under the parliament. The latter arrangement is a way of signalling independence from the government. But the arrangement could cut two ways. On one hand, it makes it harder for the government to interfere. On the other hand, the political cost of doing so might be smaller for less well-known parliamentarians than for government ministers.

The composition of a fiscal council could be important for its independence. There are at least four possible pools of people from which council members could be recruited: (i) academic researchers; (ii) public-finance experts from various parts of government administration; (iii) analysts in the financial sector; and (iv) ex-politicians.

Because academics' main arena is another one than politics and government administration, their judgements are likely to be less affected by political concerns than those of most other groups. There is a high reputational cost in the academic arena for a researcher who is seen to be acting in a political way rather than making research-based judgements.[10] Academics may not, however, have the expert knowledge necessary to make detailed assessments of budget bills. This is an argument for also including public-finance experts with a background in government administration. But there is a risk that they are to a larger extent than academics influenced by concerns over future career possibilities in government administration. An alternative are analysts from the financial sector. A final possibility is to include a minority of ex-politicians with practical experience of economic-policy making. The presence of well-known former politicians, in addition to economic experts, may be important for the legitimacy of a fiscal watchdog, and thus for its independence. This presupposes, of course, that ex-politicians are really ex.

5.3. Why does a watchdog need official status?

It is sometimes asked why academics and other experts cannot just participate in the public debate either as individuals or as groups set up by private institutions to exert an influence on fiscal policy? Why would they need the stamp of an official council? There are three possible answers.

1. It is more difficult for a government to ignore a body it has itself set up than bodies set up by others. The official status is thus likely to increase the reputational cost for a government which reneges on its own targets.
2. Only an official council can be given a *formal* role in the budget process. This can be done in several ways: through the provision of forecasts and analytical input to be used in the preparation of the budget, through explicit policy recommendations to the government at some stage, through evaluation of government proposals or through regular hearings in the parliament.
3. An official fiscal watchdog may be able to commit independent academics and other economic experts to a sustained and consistent participation in the fiscal policy discussion, in an environment where the demands of increasing research specialisation and academic publishing discourage this (Calmfors, 2010a,b).

[10] A similar argument has been advanced by Alesina and Tabellini (2007) when analysing the relative merits of political and bureaucratic decision-making. They emphasise the incentives for non-political decision-making by technocrats, because the career concerns in this group are mainly related to peer evaluations.

6. Existing fiscal councils

There exists a multitude of institutions involved in fiscal analysis in various countries. It is not obvious which should qualify as fiscal councils. We have used three requirements for qualification:

- The institutions should not just be public research or forecasting institutes, but have a clear fiscal watchdog function.
- The institutions should have macroeconomic competence, which means that pure auditing institutions are excluded.
- The institutions should have a high degree of independence from the political system.

Given these delineations, we have classified eleven fiscal institutions in as many countries as fiscal councils. They include six "old" institutions and five "new" ones set up recently. The old ones are the Central Planning Bureau (CPB) in the Netherlands (from 1947), the Economic Council in Denmark (from 1962), the Council of Economic Experts (CEE) in Germany (from 1963), the Government Debt Committee in Austria (from 1997), the Congressional Budget Office (CBO) in the US (from 1975) and the Public Sector Borrowing Requirement Section of the High Council of Finance (HCF) in Belgium (from 1989). The "new" ones in the table are the Fiscal Policy Council (FPC) in Sweden (from 2007), the Parliamentary Budget Office (PBO) in Canada (from 2008), the Fiscal Council in Hungary (in the form that existed from 2008 to 2010), the Fiscal Council in Slovenia (from 2010), and the Office for Budget Responsibility (OBR) in the UK (from 2010).

6.1. Tasks of fiscal councils

The tasks of the fiscal councils are summarised in Table 2. They are all involved in *ex-post* and *ex-ante* evaluation of fiscal policy and in fiscal sustainability analysis. The institution with the least focus on such activity is the German CEE: while it does monitoring of fiscal policy, this is only one of many activities and it is not singled out as a key area in the council's remit.

An issue in the literature is whether a council should be seen as a complement to a fiscal rule (for reasons discussed in section 3.3) or as a substitute for a rule (allowing more discretion, as suggested by Wyplosz, 2002; 2005). The table indicates that fiscal councils in practice are complements to rules. The only exception is the US where no fiscal rule is currently in place.

Only two councils, in Sweden and Slovenia, analyse explicitly how the intermediate, medium-term fiscal objectives conform to higher-level, more fundamental objectives. In the Slovenian case, this task is specified in the council's instruction; in the Swedish case it is the council's own interpretation of its remit (Calmfors, 2007). The absence of this task for most councils could perhaps be taken as an indication that most governments shy away from potential criticism of their chosen targets. In addition to the Swedish and Slovenian councils, also the ones in Canada, Hungary and the Netherlands evaluate fiscal transparency (and to some extent also the German council).

About half of the councils make their own macroeconomic forecasts. This is the case in Austria, Denmark, Germany, Hungary, the Netherlands, the UK and the US. In Canada, Slovenia and Sweden only more broad-based judgements of foreseeable developments are made. The German, Swedish and Slovenian councils also evaluate the quality of the government forecasts in the budget bill. As is clear from our two case studies in Section 7, whether or not explicit forecasting is a task for the fiscal council will depend on the existence and independence of other government agencies responsible for forecasting.

The risk that forecasting on the part of a fiscal council could expose it to government interference has received attention in both the Netherlands and the UK. Bos and Teulings (2010) report that the CPB in the Netherlands has sometimes been exposed to pressure from cabinet ministers to adjust its forecasts. Problems in the UK are discussed in Section 7.2.

The breadth of the remit varies considerably. The remit is limited to fiscal policy in Austria, Belgium, Canada, Hungary and the UK. But in most cases the remit includes other issues as well. In Slovenia these additional issues only play a minor role, but evaluation of employment, growth and other structural policies are major tasks in Denmark, the Netherlands and Sweden. So are they in Germany, but this is to be expected since fiscal policy evaluation was not mentioned as an important task in the CEE's original remit. Given the CBO's large size in the US (see Section 6.2), it can do extensive analyses of labour market developments, employment policy and climate change, although these activities account for only a small share of the total activities. Both the CBO in the US and the PBO in Canada undertake analysis of particular spending projects, which can be highly influential (such as the CBO's analysis of the US health care reforms).

The practice with respect to normative recommendations is also diverse. The explicit policy of six out of the eleven councils is only to provide positive analysis. One example is the CBO in the US, which on its website specifies its remit as providing the Congress with "objective, non-partisan and timely analysis to aid in economic and budgetary decisions".

Another example of only positive analysis is the Dutch CPB, which states on its website that "the result of an analysis will never be a straight recommendation on a particular course of action". Like the CBO, the CPB sees its task as describing policy trade-offs. The most extreme case of positive analysis is the OBR in the UK, which is explicitly forbidden to undertake any analysis of policy options. In contrast, the councils in Austria, Belgium, Denmark and Sweden make normative recommendations (on the basis of the economic objectives decided by the political system). Germany is an in-between case: the CEE is instructed not to give recommendations on specific policies, but recommendations are given nevertheless.

Our survey shows that there is no consensus in practice on what tasks should be performed by a fiscal council. Although all the councils engage in fiscal policy evaluation and sustainability analysis, there is great diversity in the other tasks. They may include forecasting, analysis of broader issues and normative recommendations in addition to strictly positive analysis. There is no clear-cut pattern in how these additional tasks are combined. Forecasting may be done by a council making normative policy recommendations (Denmark) or by those doing only positive analysis (the Netherlands, the UK and the US). Forecasting may be combined with the analysis of broader issues (Denmark and the Netherlands) or with a mandate strictly limited to fiscal policy (the UK). Analysis of broader issues may be combined with normative recommendations (Denmark and Sweden) or with positive analysis only (the Netherlands).

6.2. Resources, composition and independence of fiscal councils

Table 3 gives information on resources, composition and independence of fiscal councils. The amount of resources varies to a very large degree. At one extreme are the councils in Slovenia (no staff of its own) and Sweden (a staff of only four persons). At the other extreme are the CBO in the US (a staff of 230 persons) and the CPB in the Netherlands (a staff of 135 persons). Most of the other councils have secretariats of the order of magnitude of 15-40 persons. There is no clear relationship between the scope of the remit and the size of the staff. The CBO's remit focuses mainly on fiscal policy but it has the largest staff, the FPC in Sweden has perhaps the broadest remit but one of the smallest secretariats. This should not be surprising since assessment of broader policies can be made in both a more overall manner and a more detailed way. A possible conclusion is that when macroeconomic forecasting and costing of individual government initiatives are among the tasks, a minimum level of staff is required and that the size of this staff can expand very much depending on how detailed judgements are being made.

The number of council members differs among the various institutions. On one hand, there are institutions that are managed like ordinary government agencies with a director or board of directors at the helm (the CBO in the US, the PBO in Canada and the CPB in the Netherlands). On the other hand, there are "proper" councils with several members. These range from three or four in Hungary, Denmark and the UK, over seven or eight in Sweden and Slovenia up to twelve in Belgium and fourteen in Austria.

The composition of the councils also varies. The councils in Denmark, Germany, Hungary and Sweden are made up of only academics or a clear majority of academics. The directors of the CBO in the US and the CPB in the Netherlands have traditionally been academics. Academics also now dominate in the UK. Austria and Belgium differ from the other countries with a smaller academic element. Councils in these countries are dominated by public-finance experts from the government administration. A possible explanation is that these councils provide an input to political consensus building and that academics may be less suited for this task when the remit also includes giving normative recommendations, as is the case in Austria and Belgium. If the remit is to do only positive analysis, academics may be better placed to contribute to consensus building. This is consistent with the Dutch example, where the CPB plays an important role in providing estimates that serve as a basis for the coalition agreements preceding the formation of new governments (Bos and Teulings, 2010).

For seven of the eleven councils the government is the principal. The parliament is the principal only in Canada, Hungary and the US. In the UK, the OBR works under parliamentary oversight although it is an institution under the government.

Table 3 shows that formal arrangements to guarantee independence from the political system are rare. Periods of office are in most cases much shorter for council members than for members of the executive boards (monetary policy committees) of central banks. The period of office is five years in Belgium, Canada, Germany, Slovenia and the UK. In Denmark the period of office is three years, which it also was initially in Sweden (but where the period of office applying at the moment is one year).

Table 2 Tasks of fiscal councils

	Forecasting	Costing of policy initiatives	Evaluation of fiscal transparency	Ex-post evaluation of fiscal policy	Ex-ante evaluation of fiscal policy	Complement to fiscal rules	Evaluation of fiscal sustainability	Normative recommen-dations	Analysis of broader issues
Austria (Government Debt Committee 1997)	X			X	X	X	X	X	
Belgium (Public Sector Borrowing Requirement Section of the High Council of Finance 1989)1)				X	X	X	X	X	
Canada (Parliamentary Budget Office 2008)	(X)2)	X3)	X	X	X	X	X		
Denmark (Economic Council 1962)	X			X	X		X	X	X4)
Germany (Council of Economic Experts 1963)	X		(X)	(X)5)	(X)5)	(X)5)	(X)5)	(X)6)	X5
Hungary (Fiscal Council 2008)	X	X	X	X	X	X	X		
Netherlands (Central Planning Bureau 1947)	X	X	X	X	X	X	X		X7)
Slovenia (Fiscal Council 2010)	(X)8)		X9)	X	X	X	X		(X)10)
Sweden (Fiscal Policy Council 2007)	(X)11)		X	X	X	X	X	X12)	X13)
UK (Office for Budget Responsibility 2010)	X			X	X	(X)14)	X		
US (Congressional Budget Office 1975)	X	X		X	X		X		X15)

Notes: The year in the first column indicates when the institution was set up. 1) The Public Sector Borrowing Requirement Section (PSBRS) forms part of the High Council of Finance, established already in 1936. The council as a whole is chaired by the Minister of Finance, but the PSBRS has an independent standing. 2) Not own forecasts, but analysis of government forecasts. 3) On request from a parliamentary committee or a parliamentarian. 4) Analysis of tax, employment and other structural policy as well as environmental policy. 5) Fiscal policy is not specifically mentioned in the mandate, which is to assess overall economic developments and to help economic policy makers at all levels as well as the general public to arrive at informed judgements on economic matters. The economic-policy objectives explicitly mentioned in the Council's mandate are stability of the price level, a high rate of employment and equilibrium in foreign trade and payments together with steady and adequate economic growth. The analyses should also focus on distribution of income and wealth. 6) According to the council's mandate recommendations of specific policy measures should not be given. But in practice this is often done. 7) Analysis of a broad range of issues including tax, employment and regulatory policies as well as resource depletion and financial crises. 8) The council is not instructed to provide own forecasts but may base its analysis on an independent assessment of economic trends. The council is also to assess the quality of economic forecasts used in the preparation of the national budget. (9) This includes an explicit remit to provide an assessment of the adequacy of fiscal objectives with the medium-term fiscal framework. 10) The council shall assess the efficiency of implementation of structural policies from the aspect of ensuring long-term sustainability of public finances, economic growth and employment. 11) Not own forecasts but the council is to evaluate the quality of the government's forecasts and the models on which they are based. 12) The council's formal remit does not mention normative policy recommendations, but the council has established the practice of sometimes giving such recommendations on the basis of the policy objectives formulated by the government and the Parliament. 13) The terms of reference include evaluation of whether economic developments are in line with healthy long-run growth and sustainable high employment, and examination of the clarity of the government's budget proposals and the grounds given for various policy measures. 14) At present there exists no policy rule like the earlier golden rule and the sustainable debt rule, but the government has specified a multi-annual budget consolidation plan. 15) The CBO has recently made analyses of, for example, labour market developments, employment policy and climate policy.

Table 3 Members, independence and resources of fiscal councils

	Staff	Number of (full) members	Composition	Principal	Appointment by	Periods of office (years)	Renewability	Relationship to Ministry of Finance and central bank
Austria	N/A	14	Academics: 3 Gov adm experts: 9 1/2 Financial analysts: 1 1/2	?	Government: 6, Chamber of Commerce: 3 Federal Chamber of Labour: 3 (?)	4	Yes	Staff and funding provided by the central bank
Belgium	14	12	Academics: 3 5/6 Gov adm experts: 5 Financial analysts: 1 5/6 Ex-politicians: 1 1/3	Government	Government (Royal Decree)[1)]	5	Yes	Staff provided by the Ministry of Finance. Minister of Finance chairs the High Council of Finance, which the Public Sector Borrowing Requirement Section is a part of.
Canada	14	1[2)]	Gov adm experts: 1	Parliament	Government (Governor-in-council) after submission of three names from review committee formed and chaired by the Parliamentary Librarian through the Leader of the Government of the House of Commons	5	Yes	Independent
Denmark	35	4[3)]	Academics: 4	Government	Government after proposal from council itself	3	Yes	Independent
Germany	20	5	Academics: 5	Government	President on nomination by Government	5	Yes	Independent
Hungary	37	3	Academics: 1 2/3 Gov adm experts: 2/3 Financial analysts: 2/3	Parliament	Parliament on nomination by President, Governor of central bank and Head of National Audit Office	9	No	Independent
Netherlands	>170	1 (3) [4)]	Academics: 1 (2 1/2) Gov adm experts: 0 (1/2)	Government	Minister of Economic Affairs	7	Yes	CPB is formally a branch of the civil service within the Ministry of Economic Affairs, formal meeting with Government before publication of annual report on fiscal policy
Slovenia	0	7	Academics: 4 Gov adm experts: 1 Financial analysts: 2	Government	Government after proposal by Minister of Finance	5	No[5)]	Operating, administrative and technical tasks performed by the General Secretariat of the Government
Sweden	4	8	Academics: 6 Ex-politicians: 2	Government	Government after proposal from council itself	3 (1) [6)]	Yes	Independent[7)]
UK	?	3	Academics: 2 Gov adm experts: 1	Government but parliamentary oversight	Chancellor, veto right for Treasury Select Committee in the Parliament	5	Yes	Semi-independent[8)]
US	250	1[9)]	Academics: 1/2 Gov adm experts: 1/2	Congress	Speaker of the House of Representatives and the President pro tempore (?) of the Senate after recommendations from the two budget committees in Congress	4	Yes	Independent

Notes: 1) Proposals by Minister of Finance, the National Bank of Belgium and the regional governments. 2) The office is headed by a director. 3) Formally, the council is made up by 26 members representing unions, employers, the central bank and the government, but its four independent chairs are responsible for the work. 4) The CPB is managed by a board of directors (one director and two deputy directors). 5) A member cannot serve two consecutive periods but may be reappointed later. 6) The first members were appointed for three years. Replacements during the first period of office were for the remaining part of the three-year period. After the council's first three years, appointments were made for one year only. 7) The Swedish council operates independently from the government but there is a recurring "dialogue" with the Ministry of Finance – as is the case for all government agencies – on how well the council performs its tasks. 8) The interim OBR was staffed by personnel seconded from the Treasury and physically located in the Treasury building. The Chancellor may request the OBR to provide reports in specific areas, but the OBR may choose whether or not to produce those reports subject to its remit and resources. The OBR may consult with the Chancellor in preparing documents but is not obliged to do so. 9) The CBO is managed by a director.

A likely explanation of the short periods of office is that the issue of independence has not have been given as much attention for fiscal councils as for central banks. This interpretation receives some support from the fact that there usually are no restrictions on the renewability of periods of office. Moreover, council members can in most cases be fired at will by the principal. The exceptions are the OBR in the UK, where the consent of the Treasury Select Committee in the Parliament is required, and the CEE in Germany, where the law does not provide the possibility to fire a council member. Independence is sometimes also undermined by the fact that the ministry of finance provides staff: this is the case in Belgium and Slovenia (and was so initially in the UK). In Austria, staff is instead provided by the central bank, which instead raises the potential problem of too close a relationship with monetary policy makers.

The lack of formal safeguards for the independence of fiscal councils means that they – much more than central banks – have to rely on the *informal* independence they can acquire through building a reputation for impartial and well underpinned analysis. This will usually take time. For this reason, it is no surprise that various surveys point to a large degree of such informal independence for the CPB in the Netherlands, the Economic Council in Denmark and the CBO in the US, which are all old institutions (Debrun *et al*., 2009; Calmfors, 2010b). Both the CBO and the CPB have advisory boards. Such a board can act as a useful buffer between the government and the council, protecting its independence, and it can also help evaluate the activities of the council itself.

Examples of the political fragility of newly established fiscal councils are provided by the PBO in Canada and the Fiscal Council in Hungary. The PBO's budget was reduced in 2009-10 after the office released controversial reports on the costs of Canada's engagement in Afghanistan and the economic and fiscal outlook. After only two years of existence, the Hungarian Fiscal Council had its secretariat taken away and was transformed into a more toothless body (composed of a chair nominated by the President of the Republic, the governor of the central bank and the director of the National Audit Office). This occurred after the council had criticised the government's budget for overoptimistic assumptions and lack of transparency. The case study of the Swedish FPC in Section 7.1 provides yet another example of precariousness of newly established fiscal councils.

6.3. Impact

Ideally, one would want to run regressions including the existence and particular features of fiscal councils as explanatory variables for fiscal outcomes. But given that councils are only one aspect of the fiscal framework, their diversity and the short existence of some of them, this would not be very meaningful. We choose instead to rely on the "looser", but also more nuanced, evidence from our two case studies in Section 7.

To our knowledge there exists only one attempt at an econometric study of the impact of fiscal councils: Debrun and Kumar (2008). They use a wider definition of fiscal councils than ours, including also auditing institutions and pure forecasting institutes, based on a survey by the European Commission (2006). The authors find positive bivariate relationships between the *de jure* influence of a fiscal council and its perceived impact on fiscal performance according to survey responses, and between formal guarantees of political independence and perceived impact. But these results do not carry over to multivariate regressions explaining the cyclically adjusted primary fiscal balance with a combination of economic and political variables. Debrun and Kumar do find, however, a positive association between the stringency of fiscal rules and the role of fiscal councils, confirming our conclusion that rules and councils are complements. There also exists some evidence that fiscal transparency in general, to which fiscal councils could add, contribute to fiscal discipline (Alt and Lassen, 2006; Lassen, 2010).[11]

The most ambitious studies of an individual country so far concerns Belgium. Coene (2010) constructs an index of effectiveness, based on expert judgements, for the Public Sector Borrowing Requirement Section of the HCF. His conclusion is that the council was quite effective in promoting fiscal consolidation during the run-up to EMU in the 1990's, but that effectiveness has since declined.

7. Two case studies

We present two case studies: of the FPC in Sweden and of the OBR in the UK. Section 6 showed that the two councils differ in a number of respects. The FPC does not make forecasts, it has a broad remit, it gives normative recommendations and works at arm's length distance from the Ministry of Finance. In contrast, the OBR makes forecasts, it has a narrow remit limited to fiscal policy only, it does not analyse alternative policies and it has been co-operating closely with the Treasury.

7.1. The Swedish Fiscal Policy Council

Causality is a key issue when analysing the impact of fiscal institutions. It is difficult to assess whether a specific institution *causes* budget performance or whether both are *caused* by the same

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[11] Debrun and Kumar (2008), however, find a negative association between fiscal transparency and the role of fiscal councils.

third factor(s). These considerations are highly relevant for the Swedish FPC. Sweden faced a fiscal crisis in the first half of the 1990's of similar proportions as the ongoing crises in Ireland, Spain and the UK (see Figure 3). Sweden got out of its crisis through a consolidation programme which turned a fiscal deficit of 11.2 per cent of GDP in 1993 to a surplus of 3.7 per cent in 2000. The budget consolidation was followed up by the establishment in the late 1990's of a new fiscal framework with four pillars:[12]

- A *top-down approach* for the central government budget. The Parliament first takes a decision on expenditures in different areas. Once this is done, a particular expenditure cannot be raised without cutting down other expenditures within the same area.
- A *surplus target* for government net lending of one per cent of GDP over a business cycle.
- An *expenditure ceiling* for central government, which is set three years in advance.
- A *balanced budget requirement* for local governments.

Figure 3 General government net lending in Sweden, per cent of GDP

Source: NIER.

The rules have largely been followed. As a result, government net lending in 2000-2008 was on average 1.6 per cent of GDP. The surpluses in 2007 and 2008 were as large as 3.8 and 2.5 per cent of GDP, respectively. Hence, it is clear that the establishment of the FPC in 2007 was not triggered by any acute fiscal problems.

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[12] See Budget Bill (2009) or Swedish Fiscal Policy Council (2009) for more detailed accounts of the Swedish fiscal framework.

The idea of a fiscal council in Sweden was first raised in the discussion on whether the country should join the euro. Before the referendum in 2003 (which decided against the euro), a government commission analysed the requirements on fiscal policy in the event of euro membership. To counter the risk that fiscal policy would be too lax in upswings, the commission proposed the establishment of an independent council, which would give the government recommendations on fiscal policy (Swedish Government Commission on Stabilisation Policy, 2002).[13]

The proposal on a fiscal council was rejected by the Social Democratic government at the time. It was received more positively by the liberal-conservative opposition (see, for example, Borg, 2003). When Anders Borg became Minister for Finance after the liberal-conservative election victory in 2006, he set up the FPC, arguing that it would represent an important addition to the already existing fiscal framework that would further safeguard fiscal discipline. Hence, one can see the establishment of the council as resulting from the same determination to avoid future fiscal crises as motivated the establishment of the fiscal framework in the late 1990's.

The FPC's remit is very broad, encompassing not only analysis of fiscal policy, but also of employment and growth, as well as monitoring of the motivations given by the government for its policies. The tasks are specified in Box 7.1. Why was this broad remit chosen? A probable reason is that employment ten years after the 1990's crisis was still far below earlier levels and that the liberal-conservative parties had made employment their main issue in the 2006 election. The government may also have seen a likely political gain from an expected endorsement by the council of its employment policies, since they included several measures recommended by Swedish economists (some of them being appointed members of the FPC).

It is more difficult to explain why the FPC was given the task of examining the transparency of the government's policy proposals. This had not been suggested in the international academic discussion and was not one that any of the earlier existing institutions with fiscal watchdog tasks had. A possible explanation might have been a desire to "institutionalise" the strong Swedish tradition of heavy involvement in the economic policy debate and monitoring of policy proposals by academics.

It is not in the FPC's remit that it should do own forecasting. The probable explanation is that the government's forecasts are complemented by those of the National Institute for Economic

[13] The commission's proposal had been preceded by earlier proposals by Calmfors (1999, 2001). The commission was heavily influenced by a background paper by Wyplosz (2002). The proposal was later further developed by Calmfors (2003, 2005).

Research (*Konjunkturinstitutet*), an already existing government agency with good reputation for independent macroeconomic forecasting.[14]

Box 7.1 The remit of the Swedish FPC

According to its instruction (Förordning 2007:760), the Swedish FPC is to:

1. Assess to what extent the government's fiscal objectives are achieved. The objectives include long-run sustainability, the surplus target, the central government expenditure ceiling and that fiscal policy is consistent with the cyclical situation.
2. Evaluate whether economic developments are in line with healthy long-run growth and sustainable high employment.
3. Examine the clarity of the government's Budget Bill and Spring Fiscal Policy Bill with respect to the grounds given for economic policy and the motivations for policy proposals.
4. Monitor and evaluate the quality of the government's economic forecasts as well as the underlying models.

The council should also "work to achieve an increased public discussion in society of economic policy". The only output formally required is an annual report to the government. The parliament's Finance Committee organises a public hearing on the basis of the report.

7.1.1. The FPC's analyses. The FPC in Sweden has so far produced three annual reports. They were written in three very different situations.

The *2008 report* appeared in a boom with large budget surpluses. The report had a strong focus on the appropriateness of the fiscal rules. The council wanted the government to motivate better the choice of one per cent of GDP as an intermediate, medium-term fiscal target (see Section 5.1). In addition, the council asked for a clarification of the formulation that the budget should show a surplus *over a business cycle*. The government's fiscal sustainability calculations were criticised for lack of transparency. In the field of employment policy, the introduction of an

[14] The National Institute for Economic Research is formally less independent of the government than the FPC as it is an ordinary government agency. However, compared to most other countries all government agencies in Sweden enjoy a high degree of autonomy relative to the government.

earned income tax credit and a reduction in unemployment benefits, were judged to be effective in raising employment in the long run, whereas a general reduction of payroll taxes for young people was criticised for having too large deadweight costs. The heaviest critique concerned the government's failure to produce analytical supporting material for its decision to abolish the property tax.

The next *report* was produced at the trough of the recession in the spring of *2009*, when GDP was forecast to fall by more than four per cent in this year and unemployment to rise by around five percentage points to 2010. In this situation, the council recommended more fiscal stimulus (0.5-1 per cent of GDP in terms of the structural budget balance) than the government had proposed. (According to the government's *ex-post* calculations in the Budget Bill for 2011 there was a structural fiscal surplus in 2009 of 2.1 per cent of GDP and an actual deficit of only 1.2 per cent of GDP.) But the council also stressed that stimulus measures should be strictly temporary so as not to endanger fiscal sustainability. The government's attempts to circumvent the expenditure ceiling for 2010 by timing payments to local governments for this year so that they could instead be recorded in 2009 (when there was more room under the ceiling) were condemned. The council instead argued for the introduction of an explicit *escape clause* to the expenditure ceiling. The analysis of policies to counter the recession was complemented with a lengthy analysis of fiscal sustainability. The council again urged the government to clarify the higher-level, fundamental objectives behind the surplus target and improve the sustainability calculations. In particular, the council wanted a clearer analysis of the trade-off between *pre-funding* (fiscal surpluses once the recession was over) and a gradual increase in the *retirement age* as methods to deal with the fiscal challenges from an ageing population. An automatic adjustment of the retirement age to changes in longevity as a method of ensuring both tax smoothing and fair intergenerational distribution was advocated (see also Andersen, 2008). As to employment policies, the council endorsed the government's shift of active labour market policies towards more job search activities, but argued that this shift had gone too far, as job search activities could not be expected to be as efficient in a deep downturn as in a more normal situation (see Michaillat, 2010, and Forslund and Fredriksson, 2011).

The *2010 report* was published during an emerging recovery, much stronger than in most other EU countries (with GDP growth in Sweden of 4.8 per cent this year). The report argued strongly for fiscal caution, *i.e.* to avoid tax and expenditure changes that would involve permanent budgetary costs, in order to reserve "dry gun powder" in the event of a double-dip international recession. As to employment policy, it was again concluded that the earned income tax credit is an efficient way of raising employment in the long term. But the government was criticised for not being transparent about how rises in labour supply are likely to restrain wages and this way create the labour demand necessary for actual employment to increase. Finally, it was argued that the reforms of sickness insurance – narrowing the gateway to it – probably have had large positive employment and budget effects, but the implementation was criticised for causing unnecessary adjustment problems.

7.1.2. The FPC's impact

A well-functioning council should have an *ex-ante* impact already on government proposals, both through inducing such proposals and through discouraging others, but this is notoriously difficult to evaluate. One should not expect too much in terms of modifications of proposals already made, since the political cost for governments of *ex-post* changes may be high. Nevertheless, we point to three areas where the council may have had a significant impact:

- The degree of fiscal stimulus in 2009/10 was gradually increased relative to the government's original plans. It may seem odd that a fiscal council pushes the government to more stimulus. But it is not so surprising if one recalls that both the government fiscal stance and the establishment of the council have the same likely cause: a shift to a culture of fiscal discipline after the 1990's crisis (see Section 7.1.1). In this context, a government may feel inhibited to undertake stimulus because this could be wrongly interpreted as reneging on its medium-term fiscal target. Along the lines suggested in section 3.3, an independent council may allow the government to depart from a simple rule designed to ensure discipline without losing credibility.[15]
- The council's call to the political parties in the 2010 parliamentary election campaign to avoid committing to measures that would permanently worsen the budget balance received widespread media attention and may have helped strengthen fiscal discipline.
- Finally, the council was likely instrumental in inducing the government to clarify its position on the motives for the fiscal surplus target, its numerical value and how adherence to the target is followed up. In line with the council's recommendations, the government has announced that it is seeking broad political agreement on measures to raise the effective retirement age as a response to increasing longevity. The government has also responded to the calls for improving the fiscal sustainability calculations.

[15] The argument is similar to the one regarding monetary policy that credibility for an anti-inflationary stance gives larger scope for monetary stimulus in a downturn.

The council's recommendations on employment policy have been less influential. The government did not revise the balance between job-search activities and labour market training in the recession, and it has expanded the general pay-roll tax cuts for youth. Somewhat surprisingly, the council has so far also had only a small impact in the politically less controversial areas of improving the transparency of fiscal and employment policy. Although the council has requested that the government should provide more reporting of total government net worth (and not only financial net worth) and more information on investment and capital stock in the government sector, there have been only small improvements. There have been no responses to the council's complaints on the difficulties of getting an overview of the balance between different labour market programmes and understanding what activities actually take place in them.

7.1.3. The scope of the remit. The FPC's broad remit raises the question whether the council's analyses in other areas crowd out the public's interest in its fiscal policy analyses (see Section 5.1). To highlight this, Table 4 compares the amount of analysis devoted to various issues in the council's reports with the questions asked by MPs in the parliamentary hearings regarding the reports and the press coverage.

Fiscal policy has featured much more prominently in the council's reports than in both the parliamentary hearings and the press. On average, 55 per cent of the text in the reports have been devoted to fiscal policy, whereas only 35 per cent of the questions in the hearings and 30 per cent of the press coverage have. Employment policy has dominated the hearings and the press coverage (58 per cent and 54 per cent, respectively), whereas it has accounted for only 38 per cent of the space in the reports. In the reports, fiscal sustainability has played an important part (19 per cent of the text), whereas this issue has not at all been raised by the MPs and played only a small role in the press.

The table gives some support for the view that broader tasks for a fiscal council may crowd out public interest in fiscal issues, *viz*. long-run sustainability issues. But this conclusion is subject to the *caveat* that public finances in Sweden have been so strong that one should not expect sustainability issues to catch much public interest.

Table 4 Quantitative contents of the Swedish Fiscal Policy Council's reports, of MPs' questions in the Parliament's public hearings regarding the reports and of press coverage, per cent

	Council	Parliament	Press
Fiscal policy	55	35	30
Fiscal framework	17	20	11
Long-term objectives	14	11	7
Stabilisation policy	4	9	4
Long-term sustainability	19	0	4
Stabilisation policy	19	15	14
Forecasts	4	4	1
Employment policy	38	58	54
Employment developments	7	11	12
Unemployment insurance	6	16	17
ALMPs	9	4	7
Tax policy	11	18	14
Sickness insurance	4	5	5
Other tax policy	3	4	8
Other	1	0	7

Note: The column "Council" shows the average percentage of the council's three reports devoted to various issues. The column "Parliament" shows the average percentage of questions from MPs devoted to various issues in the parliamentary hearings. The column "Press" shows the average percentage of press articles on the Council's reports devoted to various issues.
Source: Own assessments.

7.1.4. Political fragility. The FPC's experiences also highlight the potential fragility of a fiscal council. When the council was established in 2007, the opposition – the Social Democrats, the Greens and the Left Party – voted against. The Left Party expressed its concerns in the following way:

"There is reason to assume that the Fiscal Policy Council will be another body providing false scientific clothing for the government's right-wing policy" (Motion 2006/07:Fi7).

These concerns have not been vindicated. The prevailing view in media has been that the council has worked in a politically unbiased way. Although the council has on the whole concluded that the government's fiscal and employment policies are in line with the objectives set, the critique voiced against some policies has received the most media attention. Table 5 shows there are more press articles on the council's analyses expressing a negative than a positive attitude to the government (even though the Swedish press is predominantly liberal-conservative). There are also more articles reporting negative than positive council evaluations of government policy.

Table 5 Attitudes to government in press articles on the Swedish FPC's analyses, per cent

	2008	2009	2010
Attitude to the government			
Positive	6	14	21
Neutral	73	55	49
Negative	21	32	29
Reported council attitude to the government			
Positive	9	8	27
Neutral	58	58	56
Negative	33	34	17

Note: The entries give the percentage of articles expressing a certain attitude.
Source: Own assessments.

The government has over time expressed more and more criticism of the council. In the parliamentary hearing regarding the first report in 2008, the Minister for Finance, Anders Borg, stated:

"The basic aim of having a Fiscal Policy Council is to add another component to a well-functioning fiscal framework, to improve the possibilities of evaluation and follow-up of the fiscal targets."

and

"This report has already demonstrated that the Fiscal Policy Council has an important function". (Finansutskottets betänkande 2007/08FiU20).

These statements can be compared with the Minister's remarks at a conference in 2010:

"I have established the earned income tax credit and the Fiscal Policy Council. I am convinced that at least one of the two is very useful. I am very doubtful of the other" (Örn 2010).

To understand the second citation, one should know that the earned income tax credit is the Minister's pet project. The remarks came on top of a series of pejorative comments about the council's work over several months.

How should one explain this change in attitude? A likely explanation is that several of the council's policy evaluations have been politically inconvenient for the government. Media have repeatedly used the council's evaluations as a benchmark to contrast government policy to. It seems that the government was unprepared for such a development. Early contacts between the government and the council indicated that the government expected the council to play a more advisory role "behind the scene", something the council did not find to be consistent with its evaluation task.

It is natural that a government watchdog focuses more on the scope for improvement than on praising the already good. Therefore, the reports are likely to contain substantial parts that are critical of various government policies. Since the political opposition's proposals are not subjected to similar critical evaluations, there may be an impression that the council is more critical of the incumbent government's policies than of the opposition's alternatives, even when the reverse is the case. This tendency may be reinforced by the media logic that it is more interesting news if the council is critical of government policies than if it endorses them. This problem may become less severe over time, as the public learns that the council makes critical evaluations of the policies of all governments. But to deal with the problem in the short run, the remit would probably have to be extended to evaluations of the opposition's proposals as well. In the Netherlands, a practice has developed according to which the political parties submit their election platforms to the CPB for evaluation (Bos and Teulings 2010). Acting as such a "scientific referee" in the political debate would, however, be a much larger task than the current one and might place the council even more in the political "hot air".

The FPC's experiences highlight the importance of various mechanisms to safeguard the independence of a fiscal council. The FPC has since its start argued that it is underfunded and that its functioning is based on the academic members allocating an unsustainably large share of their paid working time at universities and research institutes to council work. In November 2010, the council sent an open letter (Finanspolitiska rådet, 2010) to the government arguing for more resources. The letter also raised the issue of whether independent evaluation of government policy is consistent with being a government agency. This construction means that at the same time as the council evaluates the government, the government also evaluates how well the council performs, *i.e.* how well it evaluates the government. The government's evaluation forms the basis for budget appropriations. The council therefore proposed that it should instead have the parliament as its principal. The Minister for Finance's reaction was initially hostile (suggesting that the council had an inflated view of its importance and that the government would instead examine whether the council's budget could be cut). However, in February 2011 he changed his position and opened up for negotiations with the political opposition on whether the parliament could become the principal of the council at the same time as he started to praise the council's work (Borg, 2011). There were probably two reasons for this reversal in attitude. The FPC's reputation gave it considerable media support, and it also received support from the OECD (OECD, 2011).

Currently, the exact future role of the FPC remains unclear. At the same time as independence may be strengthened by a change of principal, the Ministry of Finance has been pushing for other, less visible, changes that are more problematic: for example, shorter periods of office for council members (maximum three consecutive years for ordinary members), fewer members (six instead of eight) as well as less emphasis on academic background for them, and closing all possibilities for the council to "buy out" members from their ordinary employment to allow them time for council work. The Ministry has also made it clear that it wants less ambitious reports, focusing more on long-term fiscal sustainability and less on the trade-off with cyclical considerations and on employment (*i.e.* areas where the council has been most critical to government policy). In sum, these proposed changes give an impression that the government wants to send a signal that the council should choose a lower profile in the future. This highlights the importance of also having strong *formal* guarantees for the council's independence.

7.2. The Office for Budget Responsibility in the UK

The UK fiscal council, the Office for Budget Responsibility, was only set up in an interim form in May 2010, and legislation establishing it on a permanent basis is currently passing through Parliament. Despite its youth, the OBR represents an interesting case study for two reasons. First, its structure and remit are very different from Sweden's Fiscal Policy Council. As its primary role is to provide the forecast on which fiscal decisions are based, it is much more integrated within government decision making. Second, it is also precluded from formally examining the consequences of alternatives to current government policy, which raises questions about how effective a 'watchdog' it can be.

An Office for Budget Responsibility was first proposed by the then opposition Conservative Party in September 2008. The Labour government had been in power since 1997, and fiscal policy over most of that period has been set in the context of two fiscal rules. These rules stated that

1. over the economic cycle, the government would only borrow to invest; and
2. over the economic cycle, the ratio of net government debt to (annual) GDP would not exceed 40%.

Both rules were thus set in relation to an economic cycle. This form of correction meant that checking that the rules were being observed required a forecast of when and how the current cycle would end, and how spending and revenues would develop over this period. Each year, the UK Treasury would publish budget projections that did just that, as well as long-term forecasts that looked at budget sustainability over a 50-year period.

Around the election year of 2005, the Labour government embarked on a substantial expansion in government spending. Tax revenues at the time were buoyant, in part due to the continuing expansion of the financial services sector, and the Treasury continued to predict that the two fiscal rules would be met. However, independent forecasters began to argue that the Treasury's forecasts were too optimistic, and that as a result the rules would be broken.[16]

The financial crisis of 2007-8 and the subsequent recession led to large budget deficits. The Labour government abandoned its fiscal rules, and argued that to combat the recession expansionary fiscal policy should be used. As an example, the VAT was reduced by 2.5 percentage points for one year at the end of 2008. Partly as a result, government net debt rose above 50% of GDP, and was expected to reach a peak of around 70% of GDP.

Although there had been occasional earlier proposals for some form of UK fiscal council,[17] calls for institutional reform of some kind increased as the fiscal crisis developed. While the Conservative Party proposal in 2008 drew on both international experience and specific proposals for the UK (such as Kirsanova *et al.* 2007), it naturally emphasised the culpability of the then government for the rapid expansion in government debt, with the suggestion that it had pressurised civil servants to make over-optimistic projections before the financial crisis. As a result, it was suggested that an independent body - the proposed OBR - should undertake budget forecasts.

Besides proposing the establishment of the OBR, the Conservative Party opposed the government's attempts to use fiscal policy to stimulate the economy, and argued that subsequent plans to bring the public finances under control were too slow. In the election of May 2010 the timing and speed of fiscal consolidation became a central issue.[18]

The election resulted in the Conservative Party forming a governing coalition with the Liberal Democrats. Although the Liberal Democrat Party had not proposed an OBR, it was accepted as part of the coalition agreement, and the establishment of an interim OBR was one of the first acts of the new government. (Sir Alan Budd, a widely respected former civil servant and later an independent member of the UK Monetary Policy Committee, had agreed before the election to

[16] As outlined in recent 'Green Budgets' published by the Institute for Fiscal Studies, or National Institute Economic Reviews published by the National Institute for Economic and Social Research.

[17] For example, Wren-Lewis (1996).

[18] In contrast, the establishment of the OBR was not. Although the Labour government had chosen not to establish such a body, neither side made this an important topic of debate during the election.

run the OBR for a temporary period.) The OBR was immediately charged with producing a more 'realistic' five-year projection of government finances, which would then be followed by an emergency budget for which the OBR would also produce the post-budget forecast.

The current remit of the OBR is:[19]

1. To undertake five-year forecasts of the economy and the public finances at least twice a year.
2. To act objectively, transparently and impartially.
3. To examine the impact of decisions made by the government on the sustainability of public finances. However, the OBR should not comment on the merits of individual policies, or examine alternative policy scenarios.

Two features of the remit stand out. First is the emphasis on forecasting. The second is that, while fiscal sustainability should be analysed, the OBR should not examine alternative policy scenarios.

7.2.1. Forecasting and independence. The task initially assigned for the interim OBR was extremely ambitious. After its establishment on 17th May 2010, it had less than a month to produce a pre-budget forecast on 14th June. It then had to produce the post-budget forecast on 22nd June. A Budget Responsibility Committee of three and a secretariat of eight produced these forecasts. This group made extensive use of Treasury resources (civil servants and models) to complete the forecasts.

Despite the lack of time, the pre-budget forecast met with little initial public criticism. Although the new government, following the narrative it had pursued before the election, might have liked the OBR's pre-budget forecast to demonstrate that previous Treasury forecasts had been much too optimistic, it did not do so. Although the OBR did suggest more pessimistic numbers for future growth, the impact of these on the public finances was offset by removing elements of caution that the Treasury had deliberately inserted into its earlier projections.

The situation changed dramatically shortly after the emergency budget. The budget itself had introduced a faster process of fiscal retrenchment. A few days after the budget, the Prime Minister suggested in parliament that OBR analysis (which happened to have been released a few hours beforehand) showed the additional budget measures would not reduce public-sector employment. Subsequent investigation by a Financial Times journalist showed that this somewhat surprising result came about because of changes in forecast assumptions between pre- and post-budget

[19] http://budgetresponsibility.independent.gov.uk/d/terms_of_reference_final.pdf.

forecasts (Giles, 2010).[20] The measures announced in the budget would themselves substantially reduce public-sector employment.

While none of the parties involved may have intended to mislead, this revelation produced a political storm. The previous Labour Chancellor (*i.e.* finance minister) is quoted as saying

> ”Right from the start the Tories used the OBR not just as part of the government but as part of the Conservative Party. They have succeeded in strangling what could have been a good idea at its birth.”

Other more neutral commentators speculated whether a body that had to rely on Treasury expertise to produce a forecast that would help determine government policy could ever be independent of government.

This row had one immediate consequence. The Chancellor gave the Treasury Select Committee in Parliament the right to veto the appointment of the head of the OBR. Subsequently Robert Chote, who had previously been director of the independent and widely respected Institute of Fiscal Studies, was appointed to succeed Alan Budd. However, it remains the case that the OBR will have to rely on Treasury expertise in producing its fiscal forecasts. The proposed eventual size of the OBR, at around 20, means that there is no suggestion that the OBR will duplicate the microeconomic fiscal forecasting expertise in the Treasury and other government bodies. As a result, there exists the potential for the government to exert some indirect influence on the OBR's forecasts.

The situation is likely to be particularly difficult during the post-budget forecast. As this forecast is published with the budget, the forecasting process is taking place as policy decisions are being made. It may therefore be inevitable that negotiations about numbers between the OBR and government take place, which given budget secrecy cannot be transparent (see, for example, Calmfors 2010c).

There is also a more general concern that has been expressed about whether the focus on forecasting may divert the OBR from potentially more important functions. In a public letter to the new director of the OBR, John Kay wrote:[21]

> “You and your colleagues should focus not on what might be inside a crystal ball, but on answering the question: what is the level of taxation that is needed to support current and future expenditure plans on a sustainable basis?”

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[20] The key change concerned public sector pensions and promotions, which although perhaps plausible consequences of new government policies, were not announced as part of the budget.

[21] Kay (2010). John Kay was a former director of the Institute of Fiscal Studies.

However, this form of policy analysis appears to be precluded from the OBR's remit, as we now discuss.

7.2.2. Policy analysis. The draft legislation for the permanent OBR is quite clear that, while the OBR should produce forecasts, it should not undertake any policy analysis. It will not, for example, examine the implications of a more gradual programme of fiscal retrenchment, or of changing the timing of cuts in public spending. The relevant clause states:[22]

"Where any Government policies are relevant to the performance of that duty, the Office may not consider what the effect of any alternative policies would be."

Given the highly political nature of current discussion about how quickly to reduce the deficit, it is perhaps not surprising that the government should be apprehensive of any OBR analysis of alternative policies. It will be aware that conventional modelling is likely to show that a more gradual reduction in the deficit will tend to raise output and reduce unemployment.[23] However, the restriction that the OBR should not consider the impact of any policy other than the government's own is quite general, and would apply to long-term sustainability analysis as well as short-term projections. For example, if current policy produced a long-term budget outlook which the OBR assessed was not sustainable, the OBR would not be able to publish any analysis of how such an outcome might be avoided.

Is it possible to conceive of a fiscal council that replaces the finance ministry's role in producing budget forecasts, but does not undertake any policy analysis? In terms of its role in producing the fiscal forecasts used by government, the OBR seems closest to the CPB in the Netherlands, but far away from the Swedish case considered earlier. However there are two important differences between the CPB and the OBR. First, the CPB does produce analysis that is seen only by the government. In contrast, the intention appears to be that all of the OBR's major pieces of analysis should be public. Second, the CPB also analyses alternative policies produced by opposition parties before an election, if those parties request such an analysis, which has become the accepted norm to do (see Section 7.1). The draft legislation for the permanent OBR excludes this possibility.

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[22] Clause 5.3, Budget Responsibility & National Audit Bill.

[23] This is confirmed by subsequent clarification of the differences between the interim OBR's pre- and post-emergency budget forecasts, and its evidence to parliament. Concerns about the possibility of markets worrying about default, and whether future policy is credible, are difficult to incorporate into a single forecast projection.

Of course any government must conduct policy analysis, and it is the intention in the UK that this continues to be undertaken by the Treasury. However, it may seem paradoxical that on the one hand the Treasury has deliberately delegated much of its expertise in producing macroeconomic fiscal projections to the OBR, but on the other hand it precludes the use of that expertise to look at the impact of alternative policies. It seems much more natural for policy analysis to be done by the same body that produces forecasts.

The inability to do policy analysis becomes particularly problematic when long-term sustainability calculations are presented. Suppose those projections indicated a lack of sustainability in the form of growing public debt. There is a danger that policy makers would put off action to address this long-term problem. This danger would be reduced if projections of unsustainable debt were accompanied by some policy analysis that indicated the costs and benefits of taking action sooner or later to avoid this outcome.

The example of the CBO in the US illustrates how policy analysis can be distinguished from policy advocacy. As Section 6.1 noted, the CBO is obliged to be impartial in its advice, which means noting both the pros and cons of particular policy actions. However, in its 2010 Long-Term Budget Report, the CBO not only looks at different interpretations of what 'unchanged policy' actually means, but also considers alternative paths for reducing deficits and making debt sustainable.

There is also a relationship between policy analysis, advocacy and independence. A fiscal council that took policy positions that tended to side with one party's views in areas subject to intense party political debate could risk its reputation for independence. As a result, a fiscal council is likely to be careful about the extent to which it advocates positions that are controversial in party-political terms. Equally, a fiscal council which is required not to examine alternatives to current government policy may appear to lack independence from that government.

More generally, the current remit of the OBR raises important issues related to the causes of deficit bias, and the reasons for delegation. If the *only* reason for deficit bias was over-optimism by politicians in producing forecasts, then simply delegating the forecast process would be logical. However, if deficit bias has other causes, including bad policy design and delaying necessary fiscal correction, then preventing a fiscal council from conducting policy analysis may severely limit its ability to counter such bias and inform the public debate.

7.3. Comparison between the FPC and the OBR

The differences in design between the OBR in the UK and the FPC in Sweden can to a large extent be explained by the different situations in which they were established. The OBR was set up in an acute fiscal crisis coming on top of earlier deficits that represented *de facto* breaches of the existing rules masked by over-optimistic forecasts. Hence the narrow remit to fiscal policy and the emphasis on forecasting. The Swedish FPC was instead a late addition to an existing fiscal framework which had already helped deliver fiscal discipline. The addition came in a situation where the economic-policy debate largely focused on unemployment persistence in a boom. Hence the broader remit including employment as well as fiscal policy.

The two case studies illustrate two different ways of trying to influence government policy and the accompanying dangers. The OBR works in close contact with the Treasury and has a guaranteed role in the budget process by working out the macroeconomic forecast in it. At the same time, these close contacts – which by definition cannot be transparent – imply risks for the independence of the OBR, and thus for the credibility of its analyses. As shown by the debate around the OBR's first post-budget forecast, the risk that the office is seen as providing support for the government is real. One way of offsetting this would be to allow the OBR to analyse different policy options.

The FPC in Sweden works at arm's length from the Ministry of Finance. The downside is no direct influence on the budget. The influence on policy comes instead via the public debate and the possibility also to give normative recommendations. This implies a larger risk for open conflicts with the government which could threaten the effectiveness of the council's work. On the other hand, the council's participation in the open economic-policy debate strengthens its credibility for independent analysis. The council's broad remit may weaken the impact of its fiscal policy analyses, but it may also allow it to more easily build a reputation for being non-partisan, as analysis of more issues almost certainly implies that there is some disagreement with all political parties.

8. Conclusions

A common feature of all fiscal councils established so far is that they only play an advisory role with none having the power to determine the size of budget deficits. This may reflect in part a lack of consensus in both the academic literature and among policy makers about the appropriate fiscal targets. Once this is acknowledged, the diversity of existing fiscal councils is striking. They range in size from the CBO in the US that employs around 250 staff to councils in Slovenia and Sweden with minimal staff. While some have a narrow remit focusing on macroeconomic fiscal assessment and sustainability, others also provide assessments of either individual fiscal projects (*e.g.* in the US and Canada) or other issues such as employment policies (*e.g* in Denmark, Sweden and the Netherlands). Some produce forecasts, while others do not.

This diversity may in part reflect the variety of explanations advanced in the literature for deficit bias. In the UK, for example, a view that government fiscal forecasts were too optimistic was important in giving the OBR a key forecasting role, while in Sweden a desire to institutionalise the strong national tradition of academic involvement in the economic policy debate may have helped give that fiscal council a wide remit. While some of this diversity may reflect national differences in political structures (with, for example, the CPB in the Netherlands providing estimates that serve as a basis for the negotiations among coalition partners), in other cases it may reflect particular circumstances of the time that may not persist. In the latter case there may be a danger that the remit of a fiscal council becomes inflexible, making it less effective in dealing with different sources of deficit bias that may subsequently arise. Of course, flexibility must not mean that remits are changed for reasons of political convenience to disarm councils critical of government policies.

In the academic research on fiscal councils, it has been debated whether they should be seen as replacement for fiscal rules, allowing policy to be more discretionary, or as complements to such rules. In practice, fiscal councils are complements in nearly all cases. They may help evaluate whether rules are likely to be met (for example in the UK, by providing fiscal forecasts), allow the rules to be more flexible (for example in Sweden where the FPC argued for more fiscal stimulus during the recession), or propose improvements to those rules. This complementarity between rules and councils makes sense once it is recognised that good fiscal rules are likely to be complex, and conditional on cyclical and other shocks to public finances.

While some councils make policy recommendations (including in Austria, Belgium, Denmark and Sweden), others are explicitly precluded from doing this (*e.g.* the CBO and the CPB). However, the councils that are mandated not to give policy advice in most cases still analyse the pros and cons of alternative policies, such as the impact of different speeds of fiscal consolidation. Here the UK is an outlier, with the OBR being prohibited from considering any policies other than the government's. This would seem to represent an unnecessary restriction preventing the OBR from making the potential contribution to policy formation that it could do.

Our most important conclusion concerns the long-run viability of fiscal councils. Although governments have strong long-run incentives to set up independent councils, there are also subsequent political temptations to constrain the activities of a council in order to avoid criticism in the short run. The danger of political conflict between councils and government is clear, as the recent experience in Canada, Sweden and particularly Hungary shows. Although such conflict can be a positive indication that councils are being effective, many remain vulnerable to political and financial pressure.

There are at least three lines of defence for a fiscal council. A first one is building up a reputation for good and independent analysis, which raises the political cost of political interference with its activities. Once this has been done, there may be no strong need for formal guarantees for independence, as shown by the CPB in the Netherlands, the Economic Council in Denmark and the CBO in the US, which all have strong positions without any formal provisions. But building a reputation takes time and newly established councils run large political risks in the beginning of their existence. This is why also other lines of defence are necessary.

A second line of defence that seems to be needed for new fiscal councils is therefore more formal provisions to guarantee independence. In our view, this aspect has been neglected when setting up some new councils. Such provisions could be modelled on the provisions applying for central banks and could include long-term periods of office, a prohibition against firing the council at will and a long-term budget. Such formal guarantees would seem most important in countries without strong traditions of open debate and countervailing powers in policy making (for example the economies in Eastern Europe).

A third line of defence could be international monitoring. The establishment of fiscal councils have recently been recommended by the IMF, the OECD, the European Commission, the ECB and the Ecofin Council. Such institutions could devise international standards for the independence of fiscal councils (without prejudice to diversity in tasks) and monitor that individual countries live up to them. The van Rompuy Task Force (2010) argues that EU-wide recommendations on the set-up of national fiscal councils should be formulated. This would be a way of raising the political cost for governments of interfering with the independence of fiscal councils. Within the EU, national councils could also be given a formal role in fiscal and macroeconomic supervision. The Ecofin Council, or the Commission, could, for example, regularly ask them for evaluations of the national stability or convergence programmes submitted to the EU.

To strengthen the accountability of fiscal councils – which is likely to be crucial for both work quality and independence in the long run – it is important that there are recurring international evaluations of their work. In addition, networking among fiscal councils (which is largely absent at present) could establish standards, disseminate good practice and research, and help monitor both the quality and independence of national fiscal councils.

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