Independent Fiscal Institutions: Developing Good Practices

GEORGE KOPITS*

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* Adjunct professor, Central European University; former chair, Fiscal Council, Republic of Hungary; and former member, Monetary Council, National Bank of Hungary.

Although relatively few and novel worldwide, independent fiscal institutions have an important oversight role over fiscal policy making in democratic societies, especially as they seek to restore public debt sustainability in the wake of the recent global financial crisis. This paper presents an overview of these institutions in OECD member countries, outlining their principal common features as well as country-specific attributes and functions, and flags the challenges they face in the surveillance of public finances. In addition, it discusses in some depth the case of the short-lived Fiscal Council in Hungary, supplemented with a comparison to the recently established Office for Budget Responsibility in the United Kingdom as perceived in financial markets. Finally, on the basis of the experience accumulated thus far, the paper derives lessons with a view to formulating internationally accepted good practices in this area.

Evolution, experience and challenges

The first national independent fiscal institution entrusted with real-time surveillance of public finances (namely, the United States Congressional Budget Office) was established in unique historical circumstances — almost accidentally — more than three decades ago. A much older post-war institution (the Central Planning Bureau in the Netherlands) began a similar fiscal watchdog function later and, eventually, a few other countries followed. More recently, in response to an unprecedented buildup in public sector indebtedness in the aftermath of the global financial crisis, an increasing number of countries have created, or are in the process of establishing, independent fiscal institutions.

These watchdogs differ markedly from other independent institutions that may have monitoring responsibilities too. In particular, they are not to be mistaken for public audit institutions that operate, with a long tradition, in more than 150 countries around the world. Although equally independent, the audit institution is responsible for conducting a detailed inspection *ex post* of the physical, financial and legal integrity of every public sector entity; in some countries, this task is complemented with performance audits. By contrast, the principal function of an independent fiscal institution (known under various names such as fiscal council, parliamentary budget office, office for budget responsibility) is analysis and assessment of the technical soundness of the budget bill or of any other legislative proposal in the fiscal area, including its consistency with fiscal rules (if any), prior to enactment. More specifically, an independent fiscal institution performs real-time costing and forecasting to ascertain the macro-fiscal consequences of the budget bill, over a short and medium term to a long-term horizon. In essence, its principal *raison d'être* is to maintain discipline and transparency in public finances during the policy-making process, which in turn helps bolster the credibility of government.

In other words, whereas the public audit institution discharges an indispensable backward-looking task, the independent fiscal institution has a forward-looking diagnostic task. In this division of complementary responsibilities, the former is comprised of a large number of lawyers, auditors and accountants, whereas the latter is for the most part staffed with a relatively small group of economists. However, both institutions serve primarily the legislature and the public at large. Although in principle neither institution has a normative role, exceptionally in a few countries the institution has an advisory function (Sweden) or recommends budgetary targets (Belgium), but at the risk of forsaking non-partisanship.

In any case, the independent fiscal institution has no decision-making authority. Unlike monetary policy, fiscal policy by its very nature cannot be outsourced by a democratically elected government to an unelected independent authority. In contrast, in most countries around the world, monetary policy is delegated to an independent monetary authority (monetary council, federal open market committee, etc.) on the grounds of a well-defined principal-agent relationship between the government and the monetary authority.

Moreover, the independent fiscal institution is to be distinguished from other advisory bodies, whether independent (Austria, Denmark, Germany) or attached to the executive arm of the government (for example, the United States Council of Economic Advisors), that do not perform a technical oversight function. Likewise, although responsible to the legislature, they are not part of it, as in the case of budget or treasury committees of Parliament. Finally, the independent fiscal institution is a permanent entity, unlike periodically established review entities (finance commissions in India). Typically, such an institution has a broad mandate mainly over the central government, as distinguished from a narrow monitoring task (United States Trustees of the Social Security and Medicare trust funds).[1]

In all, there are more than half a dozen countries with independent fiscal institutions that meet the above characteristics. In each case, however, there are features that are specific to each country's needs, legal traditions and initial historical context at the time of establishment. These features, of course, evolve over time, as the institution acquires experience.

As regards its organisational structure, the institution is headed either by an individual or by a council (or committee), appointed or elected by a legislative committee or the legislature as a whole. Typically, the head is a remunerated professional who serves for a predetermined period spanning beyond the term of the government. In most cases, the institution has its own technical staff, with full access to all necessary data and information from the government. However, the Belgian High Council of Finance and the Swedish Fiscal Policy Council are supported by the staffs of other public institutions[2] with proven impartiality and analytical competence.

The terms of reference of independent fiscal institutions include preparation of estimates and forecasts of the fiscal and macroeconomic consequences of proposed measures in time for consideration by Parliament during the legislative debate and before enactment. Prior to submission of the budget bill, the institution produces short- and medium-term no-policy-change forecasts to serve as baselines for subsequent forecasts that incorporate the proposed fiscal measures. In addition, periodically, it prepares quantitative long-term scenarios and sensitivity analyses for specific policy

[1] In Belgium, the remit of the High Council of Finance extends explicitly to the regions and communities.

[2] In Sweden, the National Institute of Economic Research and the National Financial Management Authority are responsible for preparing short- and medium-term macro-fiscal forecasts. In Belgium, this task is performed by the National Accounts Institute, while the Secretariat of the Council (consisting of finance ministry personnel) drafts analytical reports for the High Council of Finance.

options, with clearly spelled out macroeconomic and demographic policy assumptions. The forecasts of the independent watchdog are not necessarily more accurate than other official or private forecasts, but they report publicly the underlying data and methodology. The goal is to assess the reliability of the government's estimates and forecasts, including the associated assumptions, with a view to determining the sustainability of sovereign debt and gauging the risks associated with the prospects. An additional function of the Netherlands Central Planning Bureau consists of assessing the economic platform of major political parties, at their request, during electoral campaigns.

Table 1 summarises the structure and remit of the institution in selected countries. It excludes fiscal councils established in Romania and Slovenia and the recently downgraded council in Hungary, as none of them meet the characteristics identified above. In all three cases, the council is comprised of a non-remunerated part-time chair and non-remunerated members who periodically release opinions on fiscal trends and on the budgetary outlook, without any support from a technical staff.

Table 1. Selected countries: structure and functions of independent fiscal institutions

	Structure			Remit / Functions			
	Head	**Staff**	**Compliance**	**Macro-fiscal**	**Sustainability**	**Costing**	**Advisory**
United States (CBO)	individual	X		X	X	X	
Netherlands (CPB)	individual	X	rules	X	X	X	
Belgium (HCF)	collective	other	targets	X	X		X
Korea (NABO)	individual	X		X		X	
Sweden (FPC)	collective	other	rules	X	X		X
Canada (PBO)	individual	X	targets	X		X	
Hungary (former FC)	collective	X	rules	X	X	X	
United Kingdom (OBR)	collective	X	target	X	X	X	

A major issue that emerges in any discussion of independent fiscal institutions is their effectiveness in promoting fiscal discipline and transparency. Although in most countries the track record is rather short, on balance they appear to have had a positive impact on both counts. Any evaluation of their effectiveness is clouded by several considerations; namely, the institution (along with fiscal rules) may be simply a formal manifestation of the government's political commitment, underpinned by the electorate's preference for discipline. By the same token, it is difficult to ascertain a more subtle influence of the institution, as fiscal behaviour over time may be conditioned by the mere presence of the institution — whereby the government anticipates, and therefore averts, a potential confrontation by forgoing a more relaxed or opaque fiscal stance. In sum, the main difficulty lies in our inability to observe the counterfactual.[3]

Technical preparatory work and consensus building are under way in setting up independent fiscal institutions in Australia, Ireland, Serbia and the Slovak Republic. Also, in Chile a formal fiscal council, on top of two existing panels of experts, is currently in the design stage.

The International Monetary Fund and the European Commission encourage the establishment of independent fiscal institutions. A more ambitious initiative, to create an EU-wide supranational watchdog to assess the budget bills of all member countries, has not met with success. Instead, for EU members, it would be useful to provide minimum criteria to ensure the independence of these institutions at the national level, enforced by the Commission, much like the European Central Bank watches over central bank independence in member countries (see Kopits, 2010).

The evolution of independent fiscal institutions has not occurred without stumbling blocks. Indeed, these institutions have had to face considerable challenges along the way. First, in the initial phase-in period which may last through as many as one or two changes in government, the institution has to prove its non-partisanship and technical competence. This was the case in the United States, where the CBO earned a reputation for impartiality well into the Carter administration, following the Nixon administration, only after it was able to display the same critical demeanour toward both governments. Second, the government may react to a critical assessment by reducing or threatening to reduce the appropriated budgetary funding to the institution, as has occurred in Canada and Sweden. Third, the government may be less than forthcoming in making data available to the institution, which happened in Canada. In these cases, the institution is likely to be protected primarily by public opinion and financial markets, galvanised by alert and informative media.

However, in some instances the very existence of such a watchdog is under threat by a government that cannot tolerate critical assessment by independent institutions. The first institution to succumb was Venezuela's Congressional Budget Office — designed largely after the United States model — following three years of operation, terminated by President Hugo Chávez in 2000. More recently, Hungary's Fiscal Council was denied access to some official information and was threatened with a major cut in funding, but finally its remit was significantly narrowed and its technical staff abolished under Prime Minister Viktor Orbán at the end of 2010 (discussed below).

[3] An attempt by Debrun and Kumar (2007) at measuring the effectiveness of fiscal institutions through econometric estimates on cross-country EU data, although methodologically rigorous, is highly questionable. Notably, the underlying "fiscal council index" based on a survey by the European Commission (2006) covers a large number of entities that are not comparable across countries, are not amenable to quantification, and do not conform to the characteristics discussed above.

The experience of Hungary

In many respects, the short-lived experience of Hungary's Fiscal Council (FC) illustrates in fast motion the range of challenges faced by an independent fiscal institution in an environment characterised by fiscal indulgence and low policy credibility. Following a rapid gestation period, the FC was in operation for nearly two years before its demise and actual termination.

Background

Hungary's public finances deteriorated markedly over the period 2000-06.[4] Beset by both time inconsistency and common-pool problems, fiscal performance was dominated primarily by the electoral cycle rather than by macroeconomic fluctuations. From the bursting of the IT bubble at the beginning of the last decade until the global financial crisis, Hungary benefited from sizeable capital inflows to cover its wide external imbalances, driven by low private propensity to save and by large public sector dissaving. During the so-called Great Moderation abundant global liquidity, easy access to financing — especially in the lead up to EU membership — facilitated these imbalances. Under the assumption of an implicit guarantee conferred by EU membership, carry-trader investors were engaged in a moral hazard game, attracted by high yields on government paper. By 2006, the general government deficit peaked at nearly 10% of GDP, the highest among EU member countries.

Despite a fiscal correction as the global financial crisis unraveled, Hungary became exposed to a rapid loss of investor confidence. With a sudden stop in access to the secondary sovereign market, in October 2008, the authorities launched an adjustment programme supported by a stand-by arrangement with the International Monetary Fund and the European Union. Thus, in contrast with the rest of the Europe, Hungary's expansionary fiscal stance was followed by the most contractionary stance during the financial crisis. In the meantime, public debt surged to over 80% by the end of 2010 from about 50% of GDP in 2001.

Apart from the destabilising effect on the economy reflected in output volatility and a contraction well below capacity, the greatest damage inflicted by reckless fiscal policy was the sharp erosion in credibility. Low credibility was rooted not only in an actual buildup of public indebtedness, but also in the opaque demeanour of the authorities. Less-than-transparent and incomplete reporting of public accounts (including abuses with PPP projects and delayed recognition of state-owned enterprise losses) and optimistic macro-fiscal projections became endemic practices.

Birth of the Fiscal Council

Faced with the deterioration in public finances in the spring of 2006, in the run-up to general elections, there was renewed interest in restraining fiscal indulgence through the introduction of permanent fiscal rules and an independent fiscal institution (see Romhanyi, 2007, and Kopits, 2007) —

[4] See Berger, Kopits and Székely (2007) for an analysis of fiscal indulgence in Central Europe prior to EU accession, and Ohnsorge-Szabó and Romhányi (2007) for the Hungarian case.

in part drawing a parallel with the relatively well-functioning inflation-targeting regime, run by the Monetary Council of the National Bank of Hungary, that had been in operation since 2001. These initiatives, mostly from non-government quarters, were supported by some leading spokesmen of the main opposition party. In fact, it was only a year later that the government expressed interest in establishing a rules-based framework.

Proposed options for fiscal rules encompassed ceilings on public debt, budget deficits and expenditures. There were two main competing proposals for an independent fiscal watchdog. One was a fiscal council resembling the Swedish model, with technical support from the State Audit Office, presumably with a beefed-up staff to undertake fiscal analysis. The other option was an office with a relatively large staff, broadly following the example of the United States Congressional Budget Office.

An additional contentious issue was whether to endow the institution with authority to enforce compliance with the rules. Some argued that it should have coercive power to reject a budget bill submitted to Parliament — entirely unusual in other countries — if it deemed it unrealistic and in violation of the fiscal rule; in the event, the bill would have to be modified accordingly or passed by a two-thirds majority of Parliament. Others countered that such legal authority might run counter to democratic principles or was not necessary, as the Council would have sufficient dissuasive power *vis-à-vis* the government through other means — as such institutions do elsewhere.

In the summer of 2007, the Hungarian Ministry of Finance unveiled draft legislation that called for the adoption of fiscal rules and of an independent parliamentary office. The initiative was taken up by the President of the Republic who summoned legislative party leaders to reconcile their differences and enact the legislation. This was followed by 18 multi-party reconciliation meetings chaired by the then finance minister over a period of nearly a year, but with meagre tangible results. In November 2008, however — as part of the adjustment programme — Parliament passed the Fiscal Responsibility Law broadly based on the initial draft. Although the new law contained a number of compromises, it failed to gain the support of the main opposition party. Key features of the law, which amended the organic law on public finances as well, included the adoption of a set of policy rules, procedural rules and transparency standards. In addition, the law called for the establishment of the Fiscal Council, a collective body with its own technical staff (Office of the Fiscal Council) but without legal authority to enforce its assessments.

The Council was comprised of three members nominated by the President of the Republic, the Governor of the National Bank of Hungary, and the President of the State Audit Office. Following hearings in the Budget and Finance Committee, they had to be elected by a simple majority in Parliament. Actually, the Council members were supported by the Committee and elected unanimously on the floor — a rare occurrence in Hungary's highly polarised political spectrum. In fact, the overwhelming vote was interpreted as a vote of confidence in the Council, and implicitly as widespread support for the enabling legislation.

The FC was scheduled to begin operating in the course of 2009, mostly on a pilot basis, in many respects shadowing its actual mandate that was to become effective in 2010. Instead, the Council decided to embark on an early start. As rapidly as legal and physical conditions permitted (hiring, procurement, etc.), preparations began to establish the Office of the Fiscal Council by the summer of 2009. Though still short of manpower, the Office issued the first baseline projection in anticipation of the 2010 budget bill.

Goals

Given the economy's continued vulnerability, the overarching goal of the Council from the outset was to restore the credibility of fiscal policy making in the eyes of the electorate at home and of the financial markets abroad. For this purpose, the Council sought to enforce the new standards of transparency as enshrined in the law. The objective was to ensure public access to timely, comprehensive and understandable information on the state of public finances. This effort involved compelling the government to publish, with sufficient frequency and detail, updates of actual and estimated outcomes of public sector operations — above and beyond the requirements of Eurostat or the commitments under the stand-by arrangement.

Ultimately, the Council aimed at restoring public debt sustainability, in line with the mandate of the fiscal responsibility legislation. Apart from increased transparency, this required continuous surveillance of the reliability of macro-fiscal projections and compliance with the real debt rule and the pay-go rule (discussed below), both designed for this purpose. Success would be reflected in a decline in sovereign risk premium. The resulting savings in the government's annual interest bill would total well in excess of EUR 1 billion (more than one percentage point of GDP) if the risk premium declined to the average of Visegrad countries, accompanied by a sizeable decline in interest costs in the private sector as well. More important, the benefits would further induce additional growth over time.

Basic modus operandi

The fundamental feature of any effective fiscal monitoring agency is maximum independence from government interference and from influence by any particular political party or interest group. The law provides the Fiscal Council with a high degree of independence. To be eligible to become members of the Council, the nominees must not have had any active party affiliation or held a political position in the previous four years. The members' non-renewable tenure was set at nine years — that is, spanning more than two four-year electoral cycles.

The Council was a creation of Parliament and, by the same token, could be abolished by a legislative act. Accordingly, its members were elected, and could be removed with cause, through simple majority vote, as spelled out in the Fiscal Responsibility Law. Parliament, its committees or members could invite the Council to express its opinions and for consultations; in this sense, Parliament was the Council's primary client. However, the Council was not an integral part of the legislature. Once in office, the

Council was entirely independent from Parliament. The only exception was, of course, its annual budgetary appropriation which was in the hands of the legislature. Likewise, it was independent from the government and its agencies. The operations, procurement practices and financial activities of the Office of the Council, as any other public institution, were subject to review by the State Audit Office.

During its brief history, the independence of the Council was respected by Parliament and the government. There was no attempt to curtail or influence its activities directly or indirectly, including through its budgetary appropriation, except in the last few weeks of its existence (discussed below). The Council did not co-ordinate, or let alone negotiate, its analysis, forecasts or views with any other public or private entity, domestic or foreign. In this respect, the Council could be regarded as a truly independent authority in public finances in Hungary.

The Office of the Council held technical consultations with the Ministry of Finance, line ministries, the National Bank of Hungary, the Treasury, the Tax and Financial Control Administration, the Government Debt Management Agency, the Central Statistical Office, and other public and private institutions when warranted by its analytical needs. In addition, public institutions were obliged by law to submit (within two weeks upon request) any data to the Council to perform its functions, including confidential data as confidentiality requirements are binding on the Council as well. The modality of these consultations and data provision was formalised in bilateral agreements signed by the heads of the corresponding institutions. Consultations with the government and data submission by the government were fairly successful, and previously unavailable information was increasingly being released to the Council.

Whether dealing with domestic or foreign entities, the Council maintained an arm's-length distance, as all information released by the Council was being made available to all interested citizens. An exception to this guideline was that, before their official release to the public, all pertinent analyses and communiqués were transmitted by the Chair to key official counterparts.[5] In addition, the Chair met periodically to inform them of the position of the Council on relevant fiscal policy issues. This practice helped remove unnecessary surprises in the flow of information and promote efficient policy making in economic and financial areas. This practice was particularly important in times of fiscal stress.

The law vested the Chair with decision-making authority in, and responsibility for, the Council, and as chief executive officer of the Office of the Council. However, in practice, Council members had opted to take all decisions in consensus (other than day-to-day operational and administrative decisions). This approach enhanced both the efficiency of the Council and the effectiveness of its statements.

[5] These official counterparts are the President of the Republic, the Prime Minister, the Minister of Finance, the Governor of the National Bank of Hungary, and the Chair of Parliament's Budget and Finance Committee.

Functions: evaluation

The law required the Council to evaluate the consequences of the budget bill as well as all other legislative proposals with potential repercussions on central government revenue or expenditure. At an aggregate level, the law instructed the Council to prepare macro-fiscal projections, excluding as well as incorporating the proposed measures. At a disaggregate level, the Council was obliged to present quantitative assessments of the effect of each bill upon submission and before the final vote on mandatory central revenues and expenditures.[6] Although the law envisaged a phase-in of these and other functions in the first year of operation, the Council endeavoured to fulfill these responsibilities starting in 2009 to conform to the spirit of the law.

As a first step, at the aggregate level, the Council issued a set of medium-term baseline macro-fiscal projections in mid-August, in anticipation of the budget bill, scheduled for submission to Parliament in the following month. This was in essence a projection conditional on current legislation (including measures mandated by law but not yet effective) prevailing through a medium-term horizon. The baseline projection was to be updated by the end of March, assuming implementation of the approved budget. This was in line with the schedule that calls for baseline projections to take place at the beginning of each semi-annual parliamentary season (usually late summer and early spring). The baseline projection provided a convenient benchmark for evaluating the effects of measures contained not only in the budget bill, but also in any other legislative proposal. In addition, the Council presented projections incorporating the effects of the budget bill immediately after submission of the bill to Parliament, in order to assist an informed legislative debate.

Macro-fiscal projections were accompanied by special analyses focused on timely policy issues. For instance, the August 2009 report contained a simulation of medium- to long-term macroeconomic effects of the structural reform package, consisting of changes in the tax system and social transfers, enacted in early summer. The March 2010 report included a sensitivity analysis estimating the effects of deviations from the projected path due to marginal changes in selected tax and expenditure categories.

The projections and the simulations were based on an estimated dynamic stochastic general equilibrium (DSGE) model of the Hungarian economy, enhanced with a fiscal block.[7] The model-based projections were built around trend estimates and, whenever warranted, modified with expert opinion. Although their use as a forecasting tool has been questioned[8] especially because of failure to anticipate the impact of the recent financial crisis on the real sector — absent a satisfactorily specified financial

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6 Actually, assessment of the effects of any legislative proposal—including motions for amendment—on discretionary items is an option rather than an obligation. However, as a means of protecting local governments from unfunded mandates imposed by the central government, constrained by the new set of fiscal rules, the Council was required to assess the impact of legislative proposals on the fiscal position of local governments.

7 The DSGE model developed by Jakab and Világi (2008) provides the basis for this approach.

8 See, for example, Gordon (2009).

sector — DSGE models proved to be a robust and versatile basis for baseline projections, as well as for fiscal policy simulations, notably because they explicitly treat expectations.[9]

At a disaggregate level, the staff prepared real-time estimates of the budgetary effects of all mandatory expenditure programmes and tax categories. These estimates were consistent with the macroeconomic projections and, wherever possible, were supplemented by incorporating behavioural and technical parameters based on econometric estimates and expert opinion. All projections, estimates and underlying methodology were made promptly available to the public on the webpage of the Fiscal Council.

The Council found that the official budgetary forecasts contained in the budget bills were broadly more realistic than those in previous years — though subject to a considerable risk margin — even when taking into account the world financial crisis and its impact on activity. The government's overall budgetary forecasts, as well as the underlying macro assumptions, were found to be broadly compatible with those of the Council.[10] However, the medium-term projections released with the 2011 budget bill, submitted to Parliament in November 2010, were deemed by the FC to be grossly optimistic, as they were based on an excessive supply-side macroeconomic impact attributed partly to the introduction of the flat personal income tax rate. The FC pointed to the lack of transparency in the allocation of the assets transferred from the government-mandated defined-contribution pension funds to the traditional defined-benefit public pension scheme.

Functions: compliance with standards and procedures

The Fiscal Responsibility Law constituted a significant step toward transparency in the public accounts and strengthening control over government expenditure, effective with the 2010 budget. These innovations included: consolidation of central government operations; reporting accrued losses and profits of majority state-owned enterprises; separation of mandatory budgetary components from discretionary categories; and significant reduction in the scope for expenditure overruns without supplementary appropriation. For the most part, these changes meant a stricter practice than ESA95 or Eurostat standards, with a view to restoring credibility in public finances.

The former socialist government of Hungary made several attempts to dilute or remove the existing standards in the law. For one thing, the government ignored some of them in the 2010 budget bill. The Council called attention repeatedly to these departures from the law, urging the government to comply.

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9 The importance of expectations cannot be overstated in an analysis of the effects of fiscal policy. It is well known that the same fiscal measure can even have opposite effects if agents expect them to prevail permanently or only transitorily. In the presence of fiscal rules, the effects depend crucially on the public expectations about the actual nature and time path of the authorities' fiscal and monetary reaction functions.

10 The absence of the typical surplus bias in 2010, manifest in previous years' planning practice, can be attributed on both counts in part to the fact that forecasts and assumptions were subject to supervision by the European Commission and the International Monetary Fund under the terms of the stand-by arrangement.

Notwithstanding promises to withdraw some of these proposals, the budget bill was enacted untouched. Only during execution has the government shown some willingness to apply the law.

A much more serious breach was a proposed amendment to repeal the obligation to report periodically the losses and gains of state-owned enterprises, at a time when financial scandals were raging in public transport enterprises. The Council's protestations over this matter, which it regarded as totally unacceptable, prompted the socialist government to rescind support for the proposal. The successor Fidesz government restored the proposed amendment and enacted it, ignoring the protestations of the FC. In the same amendment, the government relaxed the threshold deficit that requires submission of a supplementary budget.

Functions: compliance with fiscal rules

The centrepiece of the fiscal responsibility legislation was to contain the rapid buildup of public indebtedness experienced over the past decade. This objective was to be pursued while preventing the continuation of a pro-cyclical stance that accentuated the volatility of the economic fluctuations. The three major rules are geared to: prevent a deficit-generating net impact for any single legislative proposal (pay-go rule) in the current and the subsequent year; limit the growth of primary expenditures (expenditure rule); and set a permanent limit on the real stock of central government debt (debt rule). The debt rule limits the stock of central government liabilities, corrected for inflation. To this effect, starting three years in advance, the rule prescribes a two-step algorithm to derive a ceiling on the discretionary primary deficit which serves as the binding operational target, consistent with the *ex ante* debt limit.[11]

The law envisaged that compliance with the rules and surveillance would be phased in over time. However, the Council decided to apply the pay-go rule for the purposes of the 2010 budget bill debate. Of some 1 400 proposed amendments submitted by Members of Parliament, the Office of the Council selected some 300 proposals to examine whether they complied with the rule. Based on the disaggregate methodology being developed, the staff performed estimates (over a three-day interval) of the net budgetary impact and found that the overwhelming majority of the selected proposals violated the rule. A similar exercise was reiterated in connection with amendments to the 2011 budget bill. The estimates and the underlying calculations for each proposal were made available to each MP and to the public. The estimates received considerable media coverage.

[11] Whereas the ultimate targets under policy rules are to be understood easily by interested citizens, the actual linkage to operational targets is not always obvious. In this regard, some fiscal rules, particularly the debt rule, are comparable to prevailing monetary rules. For instance, in an inflation-targeting regime, the target inflation rate is widely understood, and the difference between the target and actual rate is tracked by the non-specialised media, but the transmission mechanism between the base interest rate and the inflation target can be followed only by a specialist in monetary economics.

Likewise, the FC ascertained that both the 2010 and 2011 budget bills were consistent with the expenditure rule. Assessment of compliance with the debt rule was characterised by less than full co-operation from the government in supplying the appropriate information on the separation of mandatory and discretionary components of the budget forecasts. In any event, by flagging the need to comply with the rules, the Council played an early warning role, helping the government to focus on medium-term policy planning and on formulating the necessary fiscal reforms, consistent with the goal of debt sustainability.

Enforcement

As indicated above, during the preliminary debate over the fiscal responsibility bill, there was a clash of views on whether the Council should be endowed with a legally binding instrument of enforcement. In the final version, the law did not grant any legally binding enforcement tool to the Council. In fact, the Council had to rely entirely on pressure generated by public opinion and financial markets, as in the case of practically all other existing independent fiscal institutions. Therefore, the primary tool is communication and dissemination of Council views through various channels. It boils down to influencing government behaviour through dissuasion (through pressure from the public and the financial markets) rather than coercion.

The main channels of communication consisted of public and private contacts with Parliament and the government. In the course of the fall debate over the budget bill, the Chair of the Council was invited several times to Parliament. He presented his views at hearings of the Budget and Finance Committee, addressed the plenary session on the budget and, lastly, read a closing statement to the Committee prior to the final legislative action. In addition, the Chair met on a number of occasions with the President of the Republic, the Prime Minister, the finance minister and several Members of Parliament. Also, he was asked to address a meeting of the parliamentary caucus of the opposition parties.

However, probably the most powerful communication channel was the media. The Chair and members of the Council made themselves available to the media through periodic press conferences, interviews and statements posted on the FC webpage. Also, they gave lectures at professional conferences and held meetings with representatives of civic groups and financial investors. While not actively seeking the "limelight", the Council felt that public presence was necessary in order to reach out to Parliament as well as the electorate, for both informational and pedagogical reasons.

Hypothetically, a formal binding enforcement could be triggered by the President of the Republic and, eventually, by the courts. In the first instance, the President could return a piece of proposed legislation enacted by Parliament on the grounds that it was inconsistent with existing legislation. The

President had discretion in deciding the gravity of the inconsistency and in exercising this prerogative.[12] In any case, such an action would have required a new vote in Parliament on a modified version of the bill (at least slightly modified) for automatic passage thereafter.

Demise

Following general elections in May 2010, the FC held a one-day seminar for newly elected members to familiarise them with the budgetary process and the role of the FC. However, apart from sporadic informal contacts with some members of government or of Parliament, and invitation of the FC Chair to committee hearings and to address Parliament at the beginning of the budget debate, the Fidesz government avoided any mention of, or formal contacts with, the Council. By the same token, the government did not exert any pressure on the Council.

The new government, elected by a two-thirds majority, viewed with disdain the preceding government and with suspicion all policies and institutions inherited from the past. But, more important, the government sought to mould existing institutional arrangements to suit its political preferences and did not tolerate any criticism inherent in checks and balances. Vacancies in both the presidency of the Republic and the presidency of the State Audit Office were filled with sitting Members of Parliament loyal to the majority party. When the Constitutional Court struck down a confiscatory tax on severance pay, Parliament immediately limited its sphere of influence over cases involving fiscal issues. However, attempts to oust the governor of the central bank failed because of opposition by the European Central Bank, as they contravened the Maastricht Treaty.

In this context, it was not surprising that, following the Council's critical views of the lack of a coherent medium-term budgetary plan in the 2011 budget bill, a Fidesz Member of Parliament proposed to cut funding for the FC to an insignificant fraction of the original budget request. Ignoring widespread protests in the international and domestic press and in professional and academic circles, as well as adverse reaction in the financial markets,[13] the government submitted a proposal to disband the Office of the Council, change the composition of the Council, and radically narrow its remit. The official argument for these changes was budgetary saving — without regard to the value-for-money principle, evidenced by the interest cost associated with the risk premium paid for the government's low policy credibility. The dismissal of the Council was without cause and contradicted the unanimous vote of support by Parliament the preceding year.

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[12] Absent a precedent and because of mitigating circumstances, such as the fragile economic environment, the President of the Republic decided not to exercise this option in the case of the 2010 budget bill, even though it contravened the fiscal responsibility law as discussed.

[13] See the letter signed by the heads of the independent fiscal institutions in Sweden, the United Kingdom and the Netherlands, respectively (Calmfors, Chote and Teulings, 2010). In addition, more than 700 university faculty, researchers and public figures signed a petition to withdraw the government proposal.

Parliament amended the fiscal responsibility legislation accordingly, against the will of the much-weakened opposition parties. The composition of the modified Council is as follows: the Chair, appointed by the President of the Republic, who serves for six years on a non-remunerated part-time basis,[14] and two members who are *ex officio* the governor of the central bank and the president of the State Audit Office. Without a staff, the remit of the Council is limited by law to stating a broad opinion on the budget bill (excluding all other legislative proposals, regardless of their potential budgetary impact) and giving a recommendation to Parliament on whether to pass or reject the bill.[15] Thus Hungary's Council has been reduced to a part-time body much like the part-time fiscal councils in Romania and Slovenia. More important, the Council no longer has any specific responsibility (such as macro-fiscal forecasting or costing of legislative proposals) in applying criteria of fiscal transparency and sustainability.

Comparison with the United Kingdom

The *de facto* termination of Hungary's Fiscal Council was striking in light of the recent creation of the Office for Budget Responsibility (OBR) in the United Kingdom, particularly given its close resemblance in both structure and terms of reference.[16] The demise of the former and the establishment of the latter provide an interesting illustration of the influence of policy signaling on market expectations. These contemporaneous episodes provide some stylised facts for this purpose, ignoring a myriad of attributes that differentiate the two countries. A feature in common to both countries was the concurrent election in 2010of a centre-right government, succeeding a centre-left government notorious for fiscal indulgence over an extended period.

In the United Kingdom, shortly after assuming power in May 2010, the new coalition government set an ambitious structural balanced-budget target (called the fiscal mandate) for the end of its term. In addition, it immediately established an interim OBR, to be succeeded three months later by the permanent OBR headed by a three-member Committee for Budget Responsibility (elected by, but independent from, Parliament) and staffed by about two dozen economists and budget specialists, with a remit that includes real-time assessment of all legislative proposals in the fiscal area. The OBR is responsible for monitoring fulfillment of the mandate, preparation of macro-fiscal forecasts (a task taken over from the Treasury) and analysis of debt sustainability. In addition, as an initial step toward the mandate, the government of the United Kingdom introduced a number of tangible policy measures such as pruning welfare entitlements and raising the value-added tax rate.

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14 Given his close affiliation to the Fidesz party and as head of an insurance company, the non-partisanship of the current chair is questionable on conflict-of-interest grounds.

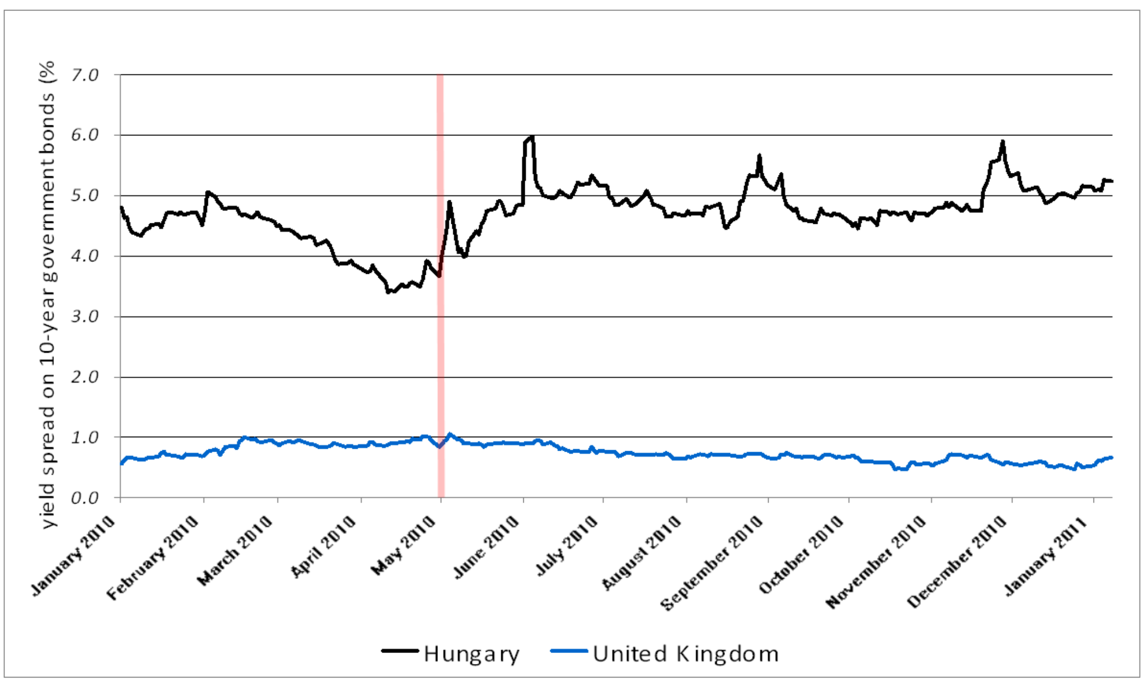
15 Oddly enough, the new constitution instructs the Council to ascertain whether the budget bill is in compliance with a new rule limiting public debt to one-half of GDP. Further, it authorises the Constitutional Court to reject the budget law if it fails to approximate this ceiling, at a time when public debt exceeds 80% of GDP.

16 There were several contacts regarding the establishment of the OBR between the Fiscal Council and the United Kingdom authorities, both in Budapest (including a visit by 14 members of the Treasury Committee of the House of Commons) and in London, culminating in a request for submission of evidence by the Chair of the FC (see House of Commons, 2010).

The new government in Hungary, in command of a two-thirds parliamentary majority, inherited a rules-based fiscal framework which it chose to ignore. It dismantled several modest structural measures under the IMF - EU supported adjustment programme, and imposed distortionary asset taxes on selected activities, which were followed by amalgamation of defined-contribution government-mandated private pension funds into the traditional defined-benefit pay-as-you-go system. None of these measures contributed to reducing the structural budget deficit. Further, as noted, the government weakened significantly the oversight of fiscal policy by independent institutions (Constitutional Court, State Audit Office and Fiscal Council).

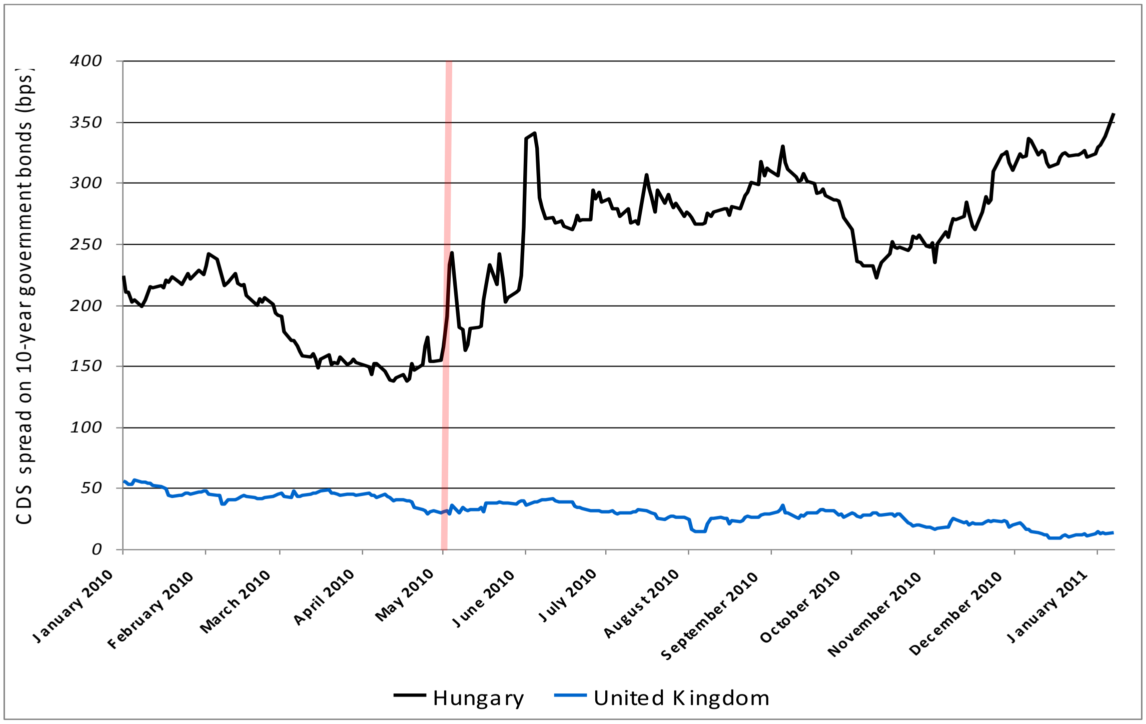
Although the above policy shift had no immediate consequence on macro-fiscal trends, the adopted measures influenced market expectations regarding the medium- to long-term fiscal outlook. Markets reacted promptly to the contrasting policy signals in the two countries, as reflected in long-term interest rate spreads on sovereign paper (Figure 1) which combine currency risk and default risk. In the United Kingdom, sovereign interest rate spreads declined steadily on all maturities. In contrast, in Hungary, following a pre-electoral decline in anticipation of the change in government, which was anticipated to break with past behaviour, markets were disappointed, and spreads bounced back sharply to their level at the beginning of the year. The disparity in market perceptions of the credibility of the two governments was reflected even more sharply in the credit default swap (CDS) spread on long-term government bonds (Figure 2), an indicator of sovereign default risk.

Figure 1. Hungary and United Kingdom: sovereign risk premium



Source: Reuters.

Figure 2. Hungary and United Kingdom: sovereign default risk premium



Source: Reuters

Lessons for good practices

Independent fiscal institutions are relatively few and of recent vintage. Yet, at least on a tentative basis, the experience accumulated so far can be useful toward formulating an internationally accepted set of good practices. Admittedly, these institutions must be judged within their country-specific context. For this and other reasons, it would be far-fetched to promulgate best practices or absolute standards in this area. Subject to this caveat, the following good practices can be identified as being critical for the effectiveness of an independent fiscal institution.

First, the institution must be home-grown and home-owned in every respect. It must address local needs (in particular, lack of transparency and discipline in public finances); also, it must conform to the country's legal framework and political culture. It should not be adapted from abroad or established under pressure from an international or regional authority pursuant to an external commitment. Indeed, credibility cannot be imported from abroad; it must be based on broad political consensus at home.

Second, the institution must be independent, non-partisan, technically competent, and accountable to the legislature. These characteristics are primarily determined by the professional standing and manner of appointment (preferably elected by the legislature) of the leadership of the institution. The governing body must be appropriately remunerated and free from any conflict of interest (both in substance and appearance), and its tenure should preferably cover more than an electoral cycle and not be renewable, to strengthen its independence. The institution should exercise its independence to the fullest extent possible, as provided by law, and with an adequate level of resources. It should not be inhibited in openly expressing its differences with the government, though unnecessary conflict must be avoided at all times. Whether organisationally embedded in the legislature or not, the institution should stand ready to serve all legislators, but especially the members of the budget or treasury committee, in a non-partisan manner.

Third, the institution can only conduct meaningful surveillance of fiscal policy making and fulfill its remit with the support of a skilled technical staff and with unlimited access to timely information from the government. The need for competent support staff and a strong mandate to secure access to information is higher if there is a greater degree of opacity in public accounts and official budgetary projections. The staff should be hired through open competition and should not have any links to other public or private institutions. There should not be any impediment in access to government information, though with appropriate safeguards (that is, security clearance for staff) for protection of state secrets in the areas of national defense and security.

Fourth, the remit of the institution should consist of assessment of fiscal stance and debt sustainability — including monitoring compliance with fiscal rules or targets, if any — through real-time evaluation of the budgetary effects of all legislative proposals. This involves preparation of pre-budget baseline (no policy change) macro-fiscal forecasts, to be followed by forecasts upon submission of the budget bill, as well as costing of the effects of major legislative proposals. Periodically, this should be supplemented with computation of numerical long-term scenarios, based on prudent macroeconomic and demographic assumptions. All quantitative estimates and forecasts should be made publicly available (in time for the legislative debate and well ahead of enactment), along with a full account of the underlying data and methodology. Surveillance by the institution should in no way overlap or duplicate the monitoring task of the national audit office; in fact, the tasks of the two institutions are complementary. Furthermore, the remit of the independent fiscal institution should preclude any policy-making or normative responsibility, and any advisory role should be conducted in a strictly non-partisan manner.

Fifth, a newly created independent fiscal institution must identify itself and start operating according to its terms of reference as soon as possible. This is the first and most important step toward establishing a reputation and public support because “cement dries quickly”. It cannot be taken for granted that the role and attributes of the new institution will be readily understood, its non-partisanship trusted, or its beneficial effects recognised without proof. Speed in implementation is all the more important since, in order to gain respectability and protection from threats to its existence, the institution’s non-partisanship must be tested over at least two electoral cycles, possibly covering governments of different political orientation.

Lastly, the institution must develop effective communication channels very early, especially with the media. Given that the institution can only have influence over fiscal policy making through dissuasion (rather than coercion by means of legal sanctions or other punitive measures), it must avail itself of media outlets which in turn can help foster an informed constituency (and financial markets) that will exercise timely pressure on the government to behave transparently and responsibly and thus build credibility. Ultimately, in a free society, the media are the closest allies and promoters of the institution.

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