# Fiscal Councils

## SUMMARY

*Fiscal watchdogs, so-called fiscal councils, have been proposed as a method to counter deficit bias of fiscal policy. The paper analyses theoretically what role fiscal councils could play and surveys empirically the activities of existing councils. Case studies of the Swedish Fiscal Policy Council and the UK Office for Budget Responsibility are done. It is concluded that fiscal councils should be advisory, rather than decision-making, and work as complements, rather than substitutes, to fiscal rules. Although no panacea, fiscal councils could play a useful role by at the same time strengthening fiscal discipline and allowing rules-based fiscal policy to be more flexible. A key issue is their political fragility and how their long-run viability should be secured. Three ways of guaranteeing their independence are suggested: (1) reputation-building; (2) formal national rules; and (3) international monitoring.*

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Economic Policy October 2011 Printed in Great Britain

# 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 many 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-1990s was characterized by rapidly increasing government debt in most OECD (Organization for Economic Cooperation and Development) economies. It then became customary to see fiscal policy as being subject to *deficit bias*. Discretionary policy fell into disrepute. Instead *fiscal rules* designed to discipline policy makers were emphasized. At the EU level, the stability pact imposed ceilings on 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 is that, when deficit ceilings were respected, fiscal outcomes lay so close to them that there

We are grateful for helpful comments from Fritz Bos, Robert Chote, Jens Clausen, Nicola Gennaioli, Lars Jonung, Augustin Landier, Philip Lane, Robert Östling, Kevin Page, Stephen Tapp and two anonymous referees, for research assistance from Georg Marthin, and for secretarial assistance from Astrid Wåke. Calmfors was the first chair of the Swedish Fiscal Policy Council, and Wren-Lewis is a member of the expert panel of the Office for Budget Responsibility, but both write in a personal capacity.
The Managing Editor in charge of this paper was Philip Lane.

Economic Policy October 2011 pp. 649–695 Printed in Great Britain

was no margin for contingencies (Portugal, France and the UK). In some countries there was over-optimism 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, International Monetary Fund (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-1990s.[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, while others propose delegation of forecasting, analysis, and evaluation.

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 set up in a number of countries, including Australia, Ireland, Portugal and Slovakia.[2]

We analyse what role fiscal watchdogs can play. Why might delegation help reduce deficit bias, particularly if fiscal councils only have an advisory role? Should fiscal councils undertake forecasting, should they give normative recommendations, and are they a complement to or substitute for fiscal rules? How should independence from the political system be guaranteed?

We discuss these issues theoretically and analyse the experiences of existing councils. Section 2 briefly reviews the development of government debts. To have a benchmark, Section 3 discusses optimal debt policy. Section 4 surveys various explanations of deficit bias, while Section 5 examines how fiscal councils might mitigate this bias. Section 6 surveys how existing councils function. Section 7 offers two complementary case studies: of the Fiscal Policy Council in Sweden and of the Office for Budget Responsibility in the UK. Section 8 concludes.

[1] See, for example, von Hagen and Harden (1995), 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.

[2] The establishment of fiscal councils in Ireland and Portugal formed part of the 2011 agreements with EU/IMF on support programmes.

## 2. TRENDS IN GOVERNMENT DEBT

The current increase in government debt is unprecedented in most countries. Figure 1 shows that consolidated gross debt in the OECD area increased from 73% to 97% of GDP between 2007 and 2010.

The recent sharp rise in government debt has resulted from a combination of automatic stabilizers 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.

Looking further back, the secular rise in the ratio of government debt to GDP between the mid-1970s and the mid-1990s stands out. During this period, the gross debt ratio nearly doubled in the OECD, rising from around 40% of GDP to about 75%.

## 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 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.

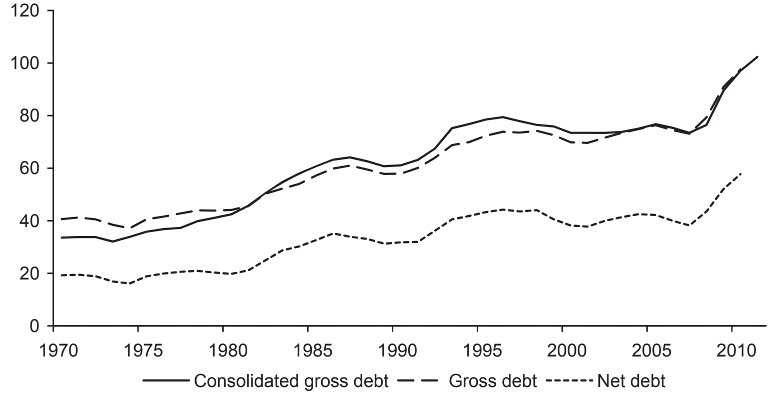


**Figure 1. Government debt in the OECD area, percentage of GDP**

*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.

*Sources*: OECD Economic Outlook November 2009 and European Parliament.

### 3.1. Fiscal rules

Although studies of the effects of fiscal rules 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 it is also clear that rules have often been violated. This is probably most evident with the EU's stability pact. According to it:

- government budget deficits shall not exceed 3% of GDP; and
- consolidated gross government debt shall not exceed 60% of GDP, or if the debt ratio is larger, it shall be approaching the debt limit 'at a satisfactory pace'.

Table 1 summarizes the cases where at least one of the two rules was violated. (The debt rule is interpreted 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 (45 out of 177 possible cases). The rules obviously did not bind.

**Table 1. Breaches of the Stability Pact**

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 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 |
| Poland | | | | | | 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 3% of GDP, or a gross government debt exceeding 60% of GDP that is not falling (or both). A grey field indicates that the country, at the time, was not an EU Member State.

*Sources*: ECB.

### 3.2. Optimal debt policy

An analysis of optimal debt policy often starts with the implications of tax smoothing (Barro, 1979). If we could choose our initial debt level, then in a world without public-sector capital we would choose a negative level (positive wealth) that could generate interest income sufficient to 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. 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 call this the random-walk debt result.[3]

The rise in OECD debt prior to 2008 would only be consistent with random-walk debt if government finances had been hit by a run of bad shocks. There is no reason to believe this to be so. Furthermore, qualifications to the random-walk debt result suggest declining, rather than rising, optimal debt (Wren-Lewis, 2010b). In particular, if the interest rate exceeds the discount rate, either because of a default premium or because the current generation fails to internalize the welfare of future generations, 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, 2010a), 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% of GDP compared to 2009 on a permanent basis across the EU as a whole (European Commission, 2009).

[3] 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).

### 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.[4] Government debt should be a short-term buffer rather than a 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 this approach is that the incentives to achieve targets *ex ante* become weak. Here, a fiscal council could play a role in assessing whether *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 rules. The appropriate design of such councils, however, is likely to depend on the causes of deficit bias, which we now turn to.

## 4. UNDERSTANDING DEFICIT BIAS

The research literature has identified several reasons for deficit bias, which could also provide a case for independent fiscal institutions. Below we try to isolate the key ingredients that may be involved, although in reality these may be interrelated.[5] The section ends with a short discussion of pro-cyclicality in fiscal policy.

### 4.1. Informational problems

Maskin and Tirole (2004) discuss the danger of elected representatives 'pandering to popular opinion'. This phrase may appear paradoxical, as we would normally

[4] 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.

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

want governments to reflect public opinion. But a key point about 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 the true fiscal position. 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 jeopardize 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 (2006), Broesens and Wierts (2009) and Lassen (2010) show that budget outcomes are more favourable in countries where fiscal policies were more transparent.

A related cause of deficit bias could be 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 pressurize civil servants to produce over-optimistic forecasts.

### 4.2. Impatience

Impatience at the level of individuals or governments may result in deficit bias. 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 (2009), and Rogoff and Bertelsmann (2010) apply this idea to explain deficit bias.

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.

### 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 formalized 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, 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.

### 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) are involved in formulating budgets, and these decision makers fail to internalize the overall costs of higher debt (see von Hagen and Harden, 1995, for example).

This theory suggests a direct link between different institutional set-ups 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. 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.

### 4.5. Time inconsistency and inflation bias

It is legitimate to ask whether deficit bias is related to inflation bias. If fiscal policy is used as a stabilization 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]

### 4.6. Exploiting future generations

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

### 4.7. Procyclicality

In principle, fiscal policy could be pro-cyclical without exhibiting deficit bias, and it is the latter which is relevant for long-term debt sustainability. In practice, deficit bias results in large part from a failure to exercise budget discipline 'in good times' (see Manasse, 2006, and Tornell and Lane, 1999, for example). While some of the potential causes of deficit bias, such as exploiting future generations, have no implications for the cyclicality of policy, others may encourage pro-cyclicality. The public focus on actual, rather than cyclically adjusted, budget positions can be seen as an information problem which encourages pro-cyclicality. If voters believe that politicians may spend buoyant tax revenues on prestigious projects or on particular interest groups, in ways that are hard to monitor, they may put more pressure on governments to cut taxes to avoid money being wasted in this way in cyclical upswings (Alesina *et al.*, 2008; Andersen and Westh Nielsen, 2010).

## 5. THE POTENTIAL CONTRIBUTION OF FISCAL COUNCILS

The previous section shows there is no shortage of explanations for deficit bias. This section considers what form of delegation these different explanations imply, and how this analysis might translate into a remit for a fiscal council.

[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).

### 5.1. 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. Section 6 shows that all existing fiscal councils are advisory. But it has been suggested that such bodies could go a stage further, and take actual policy decisions (see, for example, Debrun *et al.*, 2009). 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.[8] With other explanations of deficit bias, an advisory role may be sufficient to affect policy, as discussed below, although one would always expect delegation of decision-making power to be more effective. For this reason alone, it is unlikely that advisory councils on their own would be sufficient to eliminate deficit bias.

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. First, while there is a consensus on the goals for monetary policy, there is much less consensus with fiscal policy. As we noted in Section 3, theory at present has very little to say about what constitutes an appropriate debt target. Alesina and Tabellini (2007) suggest that consensus about policy objectives is a prerequisite for the successful delegation of decisions. If such a consensus is lacking for debt policy, then this argues against taking decisions over debt and deficits away from an elected government.[9] 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, since they involve issues of income distribution requiring value judgements.[10] Both arguments may explain why existing fiscal councils are advisory.[11]

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[8] 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, and so they care about what future generations will think of them. A fiscal council could therefore represent the interests of future generations. However, it is not clear why a government would cede power in these circumstances.

[9] A similar argument can be used to make a positive case for delegation of evaluation and advice. A fiscal council may be useful for both encouraging research on optimal debt policy and evaluating this research. (One striking feature 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.

[10] The relative importance of value judgements and professional competence as a guide for the desirability of delegation of decision making to expert bodies was analysed by Majone (1996). Some proposals on delegation of fiscal-policy decisions have envisaged only delegation of variations of a single tax instrument around a politically determined base level (Ball, 1997; Blinder, 1997; EEAG, 2003). Wyplosz (2002, 2005) instead argues that only decisions on deficits (debt) should be delegated to a fiscal council, and that such decisions involve no intra-generational distribution issues.

[11] Similar arguments also explain why fiscal councils are more suitable as complements to rules than as substitutes for them, since a rule determined by the political system gives an advisory council a clear, democratically decided, benchmark against which to judge policy.

Even if it is believed that delegation of fiscal decision-making is desirable, such delegation is clearly not politically *feasible* at present. This motivates our focus on advisory councils.

### 5.2. Different roles for advisory councils

If a fiscal council is only advisory, what useful role can it play that cannot be provided by government or private sector bodies? Once again we can look at different causes of deficit bias.

**5.2.1. Information and forecasting problems.** If governments are thought to be over-optimistic in making fiscal projections, then these forecasts could be delegated to a fiscal council, or alternatively a council could audit government forecasts. If the main information problem instead is insufficient understanding of the government's intertemporal budget constraint, that is, of the future consequences of current deficits, providing fiscal sustainability calculations highlighting these consequences might alleviate the bias. In both cases, the essential characteristics a council would need to have are *expertise* and *independence*. Of course, forecasts and information on budgetary impacts can be provided by non-governmental bodies, but in many cases the expertise and independence (from government or other interests) of these bodies may be unclear to the media and electorate. There may be no principals ready to supply non-partisan institutions with enough funding. And even if a non-governmental body has established a reputation for authoritative and independent advice, it would be difficult to give it a formal role in the budget process. In addition, an official fiscal watchdog may be able to commit independent academics and other economic experts to sustained and consistent participation in the fiscal policy discussion, in an environment where the demands of increasing research specialization and academic publishing discourage this (Calmfors, 2010a,b).

**5.2.2. Impatience, electoral competition or time inconsistency.** If the government is committed to fiscal rules, then a council can make explicit judgements on the consistency of policy with these rules. This would serve to increase the *reputation cost* for governments of violating the rules. It is clearly important in this case that the fiscal council has been established and funded by the government, because it is more difficult for a government to ignore a body it has itself set up. The political costs of ignoring a fiscal council are likely to be significantly higher than the costs of ignoring only a fiscal rule, because the fiscal council has an 'active voice'.

**5.2.3. Common-pool problems.** Here, a fiscal council could promote the *co-ordination* necessary to make individual agents internalize the effects of policies that benefit them on others (see Section 6.2 in the context of the councils in Austria, Belgium and the Netherlands). 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. The recommendations of a council could also strengthen the authority of a finance minister within government. Once again, some official status is required to facilitate this role.

As we noted earlier, the fact that rules may not be sufficient to prevent deficit bias could reflect the difficulty in designing rules that are both simple and optimal. This suggests a potential division of labour between a government and a fiscal council. A government can retain the power to formulate the fiscal rule. A council can then either advise the government and electorate on whether the rule is being adhered to (if it is complex), or suggest when it is legitimate to depart from that rule (when it is simple), thereby helping to avoid distortions that simple targets might otherwise create.[12]

**5.2.4 What can fiscal councils achieve?** How likely is it that experts in an independent fiscal council would not be subject to the same short-termism as politicians? It is, of course, naive to believe that independent experts cannot be influenced by political considerations. The point is that they are likely to be less politically motivated than elected politicians. Provided that the council members are recruited on the basis of professional competence, the desire to maintain their reputation among their peers would act as a disciplining force.[13] In the literature on monetary policy, it has also been observed that central bankers with a political background tend to encompass the traditional objectives of central banks once they represent them (the so-called *Thomas-Becket effect*).[14] Such an effect might operate with a fiscal council. Still there is, of course, always the risk that a council is guided by members' idiosyncratic motives or just does a poor professional job (for example, because of group think). For this reason, regular peer evaluations should be used to hold council members accountable (see Section 5.4).

### 5.3. Fiscal council tasks

Whatever the cause of deficit bias, the following tasks are almost certainly required to be undertaken by a council:

[12] 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 pre-commitment at the national level to desirable productive government spending, in the context of externally imposed deficit limits.

[13] This is a general argument advanced by Alesina and Tabellini (2007) when analysing the relative merits of political and bureaucratic decision-making.

[14] Goodman (1989) and Berger and de Haan (1997). Thomas Becket was Chancellor and a good friend of the English 12th-century king Henry II. Becket's appointment as Archbishop of Canterbury was heavily criticized by the clergy, who feared that the independence of the church would be jeopardized. Once Archbishop, Becket became a staunch defender of the independence of the church, and was eventually murdered by four of the king's knights.

1. *Ex-post* evaluation of whether fiscal policy has met its targets in the past.
2. *Ex-ante* evaluation of whether fiscal policy is likely to meet its targets in the future.
3. Analysis of the long-run sustainability and optimality of fiscal policy.
4. Analysis of fiscal transparency.

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 behaviour. The risk of later being criticized by an official watchdog should strengthen the incentives for governments to exercise fiscal discipline. These incentives are even stronger if a council also engages in *ex-ante* evaluation of fiscal policy.

Long-run fiscal analysis should also be a main 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, 2011). There is an obvious temptation for governments to make benign assumptions. A council can therefore exert influence either by making its own calculations or by careful monitoring of government calculations.

There are other potential tasks that are more specific to particular types of deficit bias, or where there is a choice in exactly how to counteract that bias.

**5.3.1. Commenting on fiscal rules.** 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 fiscal council could evaluate the consistency of intermediate targets with higher-level objectives. There is, however, a potential conflict with the core task of assessing whether policy is consistent with medium-term targets. Should a council act both as a policeman for the intermediate targets set by the government and as a judge of the appropriateness of these targets? The credibility of the council when policing the adherence to intermediate targets may be compromised if it is also critical of the targets. 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. If a task is to evaluate the long-run sustainability of fiscal policy, it is difficult to see how this task would be fulfilled without also evaluating the medium-term targets.

**5.3.2. Forecasting.** Another contentious issue is whether a fiscal council should do macroeconomic forecasting. An argument in favour is that over-optimistic 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 and may also crowd out other 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, 2010b; Calmfors 2010b). If the council produces the official forecast on which budgetary decisions are made, its independence may be compromised (see Section 7.2.1). An alternative is that the council only audits the government's forecasts.

**5.3.3. Normative analysis.** While a council has to analyse the consequences of government policy, a more ambitious approach is to also spell out the consequences of alternative policies. The council could go further still and give outright policy recommendations. These issues involve difficult trade-offs. On the 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 council's impact on actual policy (Debrun *et al.*, 2009).

**5.3.4. Countercyclical policy.** A council could 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. It is clear, for example, that a number of eurozone countries should have followed more contractionary fiscal policies than the zone's rules implied before the recession. However, advising on the size of any countercyclical fiscal action would represent an extension of the fiscal council's role beyond issues of long-run debt sustainability.

**5.3.5. Broader scope.** Should the remit of a fiscal council be broadened to other areas as well, like employment and growth? A broader remit has the drawback that resources 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 and so on, could receive more public attention than less tangible fiscal sustainability issues. One argument in favour of broader tasks has to do with the strong interaction between fiscal sustainability and employment. Assumptions on future employment developments can be key to the results of sustainability calculations (Swedish Fiscal Policy Council, 2009, 2011). 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).

### 5.4. Independence

Fiscal council independence is required for all the potential roles outlined above. 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 ongoing work, and against taking instructions from the government.

A key factor for independence 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 jeopardized 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*. A council 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 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 formalized network of councils) or by international organizations such as the IMF and the OECD.

Establishing international standards for fiscal councils could be another way of bolstering their independence. EU finance ministers agreed in the van Rompuy Task Force (2010) to formulate recommendations on the set-up of national fiscal councils. This is 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, if a member state's fiscal council provided 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 be an agency under the government, but it could also be an agency under the parliament. The latter arrangement would signal independence from the government. But the arrangement could cut two ways. On the 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 council could be important for its independence. There are at least four pools of people from which members could be recruited: (i) academic researchers; (ii) public-finance experts from government administration; (iii) financial-sector analysts; and (iv) ex-politicians. Because academics' main arena is not 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. Academics may not, however, have the expert knowledge necessary to make detailed assessments of budget bills. Public-finance experts from government administration would have this expertise, but there is a risk that they will be concerned with 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. Their presence 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.

### 5.5. Viability

For the same reason that a government has an incentive to renege on a 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 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 council is not inevitable: the council may help validate optimal departures from simple rules. 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 dangers here.

In principle, there are several ways to handle the political fragility of a fiscal council. The council itself can build up a reputation for impartial and competent analysis, so that the political cost of interfering with its activities outweighs the political gains. But this may take time and therefore not be enough for protecting newly established councils. Other ways are formal provisions for protecting the independence of the council and establishing international standards as discussed above. These issues are discussed further in Sections 6.2 and 8.

## 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:

1. The institutions should not just be public research or forecasting institutes, but have a clear watchdog function.
2. The institutions should have macroeconomic competence, which means that pure auditing institutions are excluded.
3. 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.[15] Well-established institutions are the Central Planning Bureau (CPB) in the Netherlands (from 1945), the Economic Council in Denmark (from 1962), the Council of Economic Experts (CEE) in Germany (from 1963), the Congressional Budget Office (CBO) in the US (from 1975), the Public Sector Borrowing Requirement Section of the High Council of Finance (HCF) in Belgium (from 1989), and the Government Debt Committee in Austria (from 1997). More recently established 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

The tasks of the fiscal councils are summarized in Table 2. They all do *ex-post* and *ex-ante* evaluation of fiscal policy and fiscal sustainability analysis. The institution with

[15] Any classification implies a large element of subjectivity. European Commission (2006) includes a greater number of institutions in its list of independent fiscal institutions (see also Hagemann, 2010). For example, three institutions in France are included: Cour des Comptes, Commission Economique de la Nation (CEN) and the Annual Economic Conference (CEA). Although all of them analyse fiscal policy, we have not labelled any of them a fiscal council. The Cour des Comptes is mainly an auditing institution. The CEN is a consulting body for the Finance Minister, composed of 28 members (academics and other policy experts, members of the central bank and representatives of trade unions and private business) with no staff of its own, holding only four meetings a year and not producing any reports. The CEA is an annual meeting for consultation with the social partners. In Italy, we did not include the Institute for Studies and Economic Analyses (ISAE), which existed in 1999–2010 and analysed fiscal developments, as it had more the character of a public research institute than of a watchdog. Our list of councils conforms broadly to the delineation made by the Fiscal Council in Hungary at its 2010 conference on fiscal councils (Mihály, 2010).

**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 recommendations | 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)[a] | | | | X | X | X | X | X | |
| Canada (Parliamentary Budget Office 2008) | (X)[b] | X[c] | X | X | X | | X | | |
| Denmark (Economic Council 1962) | X | | | X | X | | X | X | X[d] |
| Germany (Council of Economic Experts 1963) | X | | (X) | (X)[e] | (X)[e] | (X)[e] | (X)[e] | (X)[f] | X[e] |
| Hungary (Fiscal Council 2008)[g] | X | X | X | X | X | X | X | | |
| Netherlands (Central Planning Bureau 1945) | X | X | X | X | X | X | X | | X[h] |
| Slovenia (Fiscal Council 2010) | (X)[i] | | X[j] | X | X | X | X | | (X)[k] |
| Sweden (Fiscal Policy Council 2007) | (X)[l] | | X | X | X | X | X | X[m] | X[n] |

**Table 2. (Continued)**

| | 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 recommendations | Analysis of broader issues |
|---|---|---|---|---|---|---|---|---|---|
| UK (Office for Budget Responsibility 2010) | X | | | X | X | (X)[o] | X | | |
| US (Congressional Budget Office 1975) | X | X | | X | X | | X | | X[p] |

*Notes*: The year in the first column indicates when the institution was set up.

[a] 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.

[b] Fiscal projections based on private-sector forecasts.

[c] On request from a parliamentary committee or a parliamentarian.

[d] Analysis of tax, employment and other structural policy as well as environmental policy.

[e] Fiscal policy is not specifically mentioned in the mandate, which is to assess overall economic developments and to help economic policymakers 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.

[f] According to the council's mandate recommendations of specific policy measures should not be given. But in practice this is often done.

[g] The council was effectively abolished 2010.

[h] Analysis of a broad range of issues including tax, employment and income distribution issues as well as regulatory policies, resource depletion and financial crises.

[i] 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.

[j] This includes an explicit remit to assess the adequacy of fiscal objectives with the medium-term fiscal framework.

[k] 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.

[l] Not own forecasts but the council is to evaluate the quality of the government's forecasts and the models on which they are based.

[m] 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 government's policy objectives.

[n] The remit includes 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.

[o] At present there exists no policy rule, but the government has specified a multi-annual budget consolidation plan.

[p] The CBO has recently made analyses of, for example, labour market developments, employment policy and climate policy.

the least such activity is the German CEE: it monitors fiscal policy, but this is only one of many activities and it is not singled out as a key activity in the council's remit.

An issue is whether a council should work as a complement to a fiscal rule or as a substitute for it (see Sections 3.3 and 5.2). The table indicates that fiscal councils in practice are complements to rules. The only exceptions are Canada and the US where no fiscal rules are 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 Slovenia, this task is specified in the council's instruction; in Sweden it is the council's own interpretation of its remit (Calmfors, 2007).[16] The absence of this task for most councils may indicate 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, Germany, Hungary and the Netherlands evaluate fiscal transparency.

Most of the councils conduct 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 Swedish and Slovenian councils also evaluate the 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 could expose a council 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. The UK case is 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 elsewhere the remit includes other issues as well. In Slovenia these additional issues play a minor role, but evaluation of employment, growth and other structural policies are major tasks in Denmark, Germany, the Netherlands and Sweden. 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 healthcare 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.

[16] The Swedish government has, however, in a memorandum to the Parliament expressed the view that the FPC should not evaluate the medium-term fiscal targets (Regeringens skrivelse 2010/11:79). In contrast, the draft proposal for a Budget Advisory Council in Ireland envisages assessment of medium-term fiscal targets as a key task (Reforming Ireland's Budgetary Framework, 2011).

On its website, the CBO 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'.[17] Like the CBO, the CPB sees its task as describing policy trade-offs. The most extreme case of only positive analysis is the OBR in the UK, which is explicitly forbidden to analyse various policy options. In contrast, the councils in Austria, Belgium, Denmark and Sweden make normative recommendations (on the basis of the objectives decided by the political system). Germany is an in-between case: the CEE is instructed not to give policy recommendations, 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 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, and these vary 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 170 persons). Most of the other councils have secretariats 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.

[17] The CPB's focus on positive analysis does not, however, preclude its participation in various bodies that advise the government on economic policy like the Social Economic Council (SER) and the Council of Economic Affairs (CEC): see Bos and Teulings (2010).

**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<br>Gov. admin. experts: 9 1/2<br>Financial analysts: 1 1/2 | | Government, Chamber of Commerce and Federal Chamber of Labour | 4 | Yes | Staff and funding provided by the central bank |
| Belgium | 14 | 12 | Academics: 3 5/6<br>Gov. admin. experts: 5<br>Financial analysts: 1 5/6<br>Ex-politicians: 1 1/3 | Government | Government (Royal Decree)[a] | 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[b] | Gov. admin. 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[c] | 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<br>Gov. admin. experts: 2/3<br>Financial analysts: 2/3 | Parliament | Parliament on nomination by President, Governor of central bank and Head of National Audit Office | 9 | No | Independent |

**Table 3. (Continued)**

| | Staff | Number of (full) members | Composition | Principal | Appointment by | Periods of office (years) | Renewability | Relationship to Ministry of Finance and central bank |
|---|---|---|---|---|---|---|---|---|
| Netherlands | 135 | 1 (3)[d] | Academics: 1 (2 1/2) Gov. admin. 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. admin. experts: 1 Financial analysts: 2 | Government | Government after proposal by Minister of Finance | 5 | No[e] | Operating, administrative and technical tasks performed by the General Secretariat of the Government |
| Sweden | 4 | 8 (6)[f] | Academics: 6 (4 1/2) Ex-politicians/ former civil servents 2 (1 1/2) | Government | Government after proposal from council itself | 3 | (Yes)[g] | Independent[h] |
| UK | 20 | 3 | Academics: 2 Gov. admin. experts: 1 | Government but parliamentary oversight | Chancellor, veto right for Treasury Select Committee in the Parliament | 5 | Yes | Semi-independent[i] |

**Table 3. (Continued)**

| | Staff | Number of (full) members | Composition | Principal | Appointment by | Periods of office (years) | Renewability | Relationship to Ministry of Finance and central bank |
|---|---|---|---|---|---|---|---|---|
| US | 250 | 1[j] | Academics: 1/2 Gov. admin. 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*: [a] Proposals by Minister of Finance, the National Bank of Belgium and the regional governments.

[b] The office is headed by a director.

[c] 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.

[d] The CPB is managed by a board of directors (one director and two deputy directors).

[e] A member cannot serve two consecutive periods but may be reappointed later.

[f] In 2011 the number of members was reduced from eight to six.

[g] The chair can be reappointed for a new three-year period, the other members can be reappointed in the future, but not immediately after having finished their terms.

[h] 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.

[i] Although the OBR is dependent on economists in various government departments to provide detailed fiscal forecasts, it can require them to change the assumptions behind those forecasts. 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.

[j] The CBO is managed by a director.

The number of council members differs among the various institutions. On the 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 six or seven in Slovenia and Sweden, 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. Their councils 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. 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 of central banks. The period of office is five years in Belgium, Canada, Germany, Slovenia and the UK. In Denmark and Sweden the period of office is three years.

A likely explanation of the short periods of office is that the issue of independence has not 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 be fired at will by the principal. (The only exception is the OBR in the UK where the consent of the Parliament's Treasury Select Committee is required). Independence is sometimes also undermined by the fact that the Ministry of Finance provides staff: this is the case in Belgium and Slovenia. In Austria, staff are instead provided by the central bank, which raises the potential problem of too close a relationship with monetary policymakers.

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 reputation building, which as discussed in Section 5.5 usually takes 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 can also help evaluate the activities of the council itself.

Examples of the fragility of newly established 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 (Page, 2010). 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 criticized the government's budget for over-optimistic assumptions and lack of transparency. The case study of the Swedish FPC in Section 7.1 provides yet another example of the problems newly established fiscal councils can meet.

### 6.3. Impact

Ideally, one would want to run regressions including the existence and 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 meaningful. We instead rely on the 'looser', but also more nuanced, evidence from our two case studies in Section 7.

To our knowledge there exists only one 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 and pure forecasting institutions, based on a survey by the European Commission (2006). The authors find positive bivariate relationships between, on the one hand, the *de jure* influence of a fiscal council and formal guarantees of political independence and, on the other hand, the perceived impact on the fiscal balance according to survey responses. But these results do not carry over to multivariate regressions with a combination of economic and political explanatory variables.[18] The study does find, however, a positive association between the stringency of fiscal rules and the role of councils, confirming our conclusion that rules and councils are complements. There also exists some evidence that fiscal transparency in general, to which

[18] The economic variables include the standard ones of the output gap, lagged government debt and lagged fiscal balance. The political variables include government stability, government fragmentation, a dummy for election year and fiscal-rules variables.

fiscal councils could add, contribute to fiscal discipline (Alt and Lassen, 2006; Lassen, 2010).[19]

The most ambitious study 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 effective in promoting fiscal consolidation during the run-up to EMU in the 1990s, 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, has a broad remit, gives normative recommendations and works at arm's length from the Ministry of Finance. In contrast, the OBR makes forecasts, has a narrow remit limited to fiscal policy, does not analyse alternative policies and has been cooperating 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 third factor(s). These considerations are highly relevant for the Swedish FPC.

Sweden faced a severe fiscal crisis in the first half of the 1990s (see Figure 2). Sweden got out of its crisis through a consolidation programme which turned a deficit of 11.2% of GDP in 1993 to a surplus of 3.7% in 2000. The consolidation was followed up by the establishment in the late 1990s of a new fiscal framework with four pillars:[20]

1. A *top-down approach* for the central government budget. The Parliament first decides expenditures in different areas. Once this is done, a particular expenditure cannot be raised without cutting down other expenditures within the same area.
2. A *surplus target* for government net lending of 1% of GDP over a business cycle.
3. An *expenditure ceiling* for central government set three years in advance.
4. A *balanced budget requirement* for local governments.

The rules have largely been followed. As a result, government net lending in 2000–2010 was on average 1.3% of GDP. The surpluses in 2007 and 2008 were as

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

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


**Figure 2. General government net lending in Sweden, percentage of GDP**

*Source*: National Institute for Economic Research.

large as 3.8% and 2.5% of GDP, respectively. Hence, it is clear that the establishment of the FPC in 2007 was not triggered by any acute fiscal problems.

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 fiscal policy in the event of euro membership. To avoid too lax policy in upswings, the commission proposed the establishment of an independent council, which would give recommendations to the government (Swedish Government Commission, 2002).[21]

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 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 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 1990s.

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 government's explanations of its policies. Why was this broad remit chosen? A probable reason is that employment was still far below the level before the 1990s' crisis and that the liberal-conservative parties had made employment their main issue in the 2006 election. The government may also have seen a political gain from an expected endorsement by the council of its employment policies, since they included several

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

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 motive might have been a desire to 'institutionalize' the strong Swedish tradition of heavy involvement in the economic policy debate and monitoring of policy proposals by academics.

The FPC's remit does not include forecasting. The probable explanation is that the government's forecasts are complemented by those of the National Institute for Economic Research (*Konjunkturinstitutet*), an existing government agency with a good reputation for independent forecasting.[22]

**7.1.1. The FPC's analyses.** The FPC has so far produced four annual reports. The *2008 report* appeared in a boom with large budget surpluses. There was a strong focus on the appropriateness of the fiscal rules. The council wanted the government to motivate better the choice of 1% of GDP as the medium-term fiscal target (see Section 5.3.1). The council also asked for a clarification of the formulation that the budget should show a surplus *over a business cycle*. The government's sustainability calculations were criticized for lack of transparency. In the field of employment policy, the introduction of an 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 criticized for having 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 *2009 report* was produced at the trough of the recession (GDP fell by 5.3% that year). In this situation, the council recommended more fiscal stimulus (0.5—1% of GDP in terms of the structural budget balance) than the government had proposed. (According to the Spring Fiscal Policy Bill 2011 there was a structural fiscal surplus in 2009 of 3.0% of GDP!) At the same time, the government's attempts to circumvent the expenditure ceiling for 2010 by timing payments to local governments for this year so that they were instead 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. In particular, the council wanted a clearer government stand on 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

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

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).

The *2010 report* was published during a strong recovery (with GDP growth in Sweden of 5.5% that year). The report argued strongly for fiscal caution, that is, 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. 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 criticized for not being transparent about how rises in labour supply are likely to restrain wages. Finally, it was argued that the reforms of sickness insurance – narrowing the gateway to it – probably had large positive employment and budget effects, but the implementation was criticized for causing unnecessary adjustment problems.

The *2011 report* concluded that, in the absence of new discretionary decisions, fiscal policy was on track towards increasing surpluses. But the FPC also warned that an arising inconsistency between planned tax cuts and a loose expenditure ceiling, permitting large expenditure increases, implied risks for the future attainment of the surplus target. The council recommended the government to lower the expenditure ceiling if it were to go ahead with large tax cuts or to shelve the tax cuts if it were not prepared to lower the ceiling. The report also analysed how the tax system had developed since the comprehensive tax reform in 1990/91 and concluded that, although some of the changes could be motivated by optimal taxation considerations, the system had become increasingly patchy. The political parties were recommended to try to reach a new cross-party agreement on a comprehensive tax reform built on transparent principles.

**7.1.2. The FPC's impact.** A well-functioning council should have an *ex-ante* impact on government proposals, both through inducing proposals and through discouraging others, but this is notoriously difficult to evaluate. One should not expect too much 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 planned government fiscal stance and the establishment of the council have the same likely cause: a shift to a culture of fiscal discipline after the 1990s' 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. As 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.[23] The call for more stimulus in the recession can also be seen as an attempt to avoid pro-cyclical policies just as the warnings about too expansionary policies in the strong upswing in 2011.

- 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.
- The FPC was instrumental in inducing the government to clarify its position on the motives for the fiscal surplus target and how adherence to the target is followed up. In line with the council's recommendations, the government is now 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.

Somewhat surprisingly, the FPC has so far had only a small impact in the politically less controversial areas of improving the transparency of policy. Although the council has repeatedly requested the government to provide more reporting of total government net worth (and not only financial net worth) and more information on investment and the capital stock in the government sector, there have been only small improvements.

**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 interest in its fiscal policy analyses (see Section 5.1). Table 4 shows that fiscal policy has featured much less prominently in both the questions asked by MPs in the parliamentary hearings regarding the reports and in the press coverage of them than in the reports themselves. On average, 55% of the text in the reports have been devoted to fiscal policy, whereas only 35% of the questions in the hearings and 30% of the press coverage have. Employment policy has dominated the hearings and the press coverage (58% and 54%, respectively), whereas it has accounted for only 38% of the space in the reports. In the reports, fiscal sustainability has played an important part (19% 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. 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.

[23] 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.

**Table 4. Quantitative contents of the Swedish FPC's reports, of MPs' questions in the Parliament's public hearings regarding the reports and of press coverage (%), 2008–2010**

| | Council | Parliament | Press |
|---|---|---|---|
| Fiscal policy | 55 | 35 | 30 |
| Fiscal framework | 17 | 20 | 11 |
| Long-term objectives | 14 | 11 | 7 |
| Stabilization policy | 4 | 9 | 4 |
| Long-term sustainability | 19 | 0 | 4 |
| Stabilization 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 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 media view 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.

The government has over time become increasingly critical of the council. In the parliamentary hearing regarding the first report in 2008, the Minister for Finance, Anders Borg, stated:

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

**Table 5. Attitudes to government in press articles on the Swedish FPC's analyses (%)**

| | 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.

This statement 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.

A likely explanation of this change in attitude 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 this. Early contacts between the government and the council indicated that the government expected the council to play also an advisory role 'behind the scene', something the council did not find 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).

The FPC's experiences highlight the importance of mechanisms to safeguard independence. 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 proposed that the council's independence should be strengthened by moving it under the Parliament instead of the government. The current arrangement means that at the same time as the council evaluates the government, the government evaluates how well the council performs, that is, how well it evaluates the government. The government's evaluation forms the basis for budget appropriations. The Minister for Finance's reaction was initially very hostile (suggesting that the council had an inflated view of its importance and that its budget should instead be cut). However, in February 2011 he changed his position and invited the opposition to talks on how the role of the FPC could be strengthened 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 (2011) and the IMF (2011).

In April 2011, an agreement on the FPC was concluded between the liberal-conservative government and the three opposition parties to the left. It is not clear how the agreement will influence the council's role. On the one hand, the position of the council was strengthened because the parties that initially voted against its establishment now endorsed it and enhanced resourcing for the secretariat was promised. On the other hand, shorter periods of office for members (maximum three consecutive years for ordinary members) were introduced, and there was less emphasis on academic background. All possibilities to 'buy out' members from their ordinary employment to allow them time for council work were closed, which likely puts a limit on how ambitious the reports can be. There was not a change of principal from the government to the Parliament. In earlier discussions, the Ministry had said it wanted the council to focus 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). This was reflected in the FPC's new instruction, which emphasized sustainability more than before, but at the same time the council's remit was broadened also to include analysis of distribution effects of fiscal measures.

### 7.2. The Office for Budget Responsibility in the UK

The UK fiscal council, the Office for Budget Responsibility, was set up in an interim form in May 2010. Legislation establishing it on a permanent basis was enacted in 2011. The OBR represents an interesting case study for two reasons. First, its remit is 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 precluded from examining the consequences of alternatives to current government policy, which raises questions about how effective 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 was set in the context of two fiscal rules. These rules stated that, over the economic cycle, the government would only borrow to invest and that 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 (50-year) fiscal forecasts.

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 predicted that the two fiscal rules would be met. However, independent forecasters began to argue that the Treasury's forecasts were too optimistic.[24]

The financial crisis of 2007–2008 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,[25] calls for institutional reform 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 emphasized the culpability of the then government for the expansion in government debt, with the suggestion that it had pressurized civil servants to make over-optimistic projections. As a result, it was proposed that an independent body 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

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

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

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.[26]

The election resulted in the Conservative Party forming a governing coalition with the Liberal Democrats. The establishment of an interim OBR was one of the first acts of the new government. (Sir Alan Budd, a former civil servant and past independent member of the UK Monetary Policy Committee, had agreed before the election to 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 remit of the OBR is:[27]

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 17 May 2010, it had less than a month to produce a pre-budget forecast on 14 June, and then a post-budget forecast on 22 June. The office 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 criticism. Although the new government 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 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 later, the Prime Minister suggested in parliament that OBR analysis (released a few hours beforehand) showed the additional budget measures would not reduce pub-

[26] 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 a topic of debate during the election.

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

lic-sector employment. Subsequent investigation by a *Financial Times* journalist found that this somewhat surprising result came about because of changes in forecast assumptions between pre- and post-budget forecasts (Giles, 2010).[28] 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. (Giles and Parker, 2010)

Other 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 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 size of the OBR, at around 20, means that the OBR will not 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), although the OBR has published a log of all its meetings with Treasury ministers and their immediate advisors in the months before the budget. There is also a more general concern that the focus on forecasting may divert the OBR from potentially more important functions.[29]

**7.2.2. Policy analysis.** The legislation for the permanent OBR makes it clear that it should not undertake any policy analysis. It will not, for example, examine the implications of a more gradual programme of fiscal retrenchment. Given the highly

[28] 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.

[29] See, for example, Kay (2010).

political nature of current discussion about how quickly to reduce the deficit, it is not surprising that the government should be apprehensive of any OBR analysis of alternative policies. Conventional modelling is likely to show that a more gradual reduction in the deficit will tend to raise output and reduce unemployment.[30] 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 appear to apply to long-term sustainability analysis as well.

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 proposed 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 legislation establishing the OBR excludes this possibility.

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 policymakers 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.

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,

[30] This is confirmed by subsequent clarification of the differences between the interim OBR's pre- and post-emergency budget forecasts in 2010, 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.

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 only delegating the forecast process would be logical. However, if deficit bias has other causes, then preventing a fiscal council from conducting policy analysis may severely limit its ability to counter such bias.

### 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 imply risks for the independence of the OBR, and thus for the credibility of its analyses. 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 existing fiscal councils 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 academic research and among policymakers about the appropriate fiscal targets.

The diversity of existing 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 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 institutionalize 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 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. But flexibility must not mean that remits are changed for reasons of political convenience to disarm councils critical of government policies.

It has been debated whether fiscal councils should be seen as replacements 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. Complementarity between rules and councils makes sense once it is recognized 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. 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.

One important conclusion concerns the long-run viability of fiscal councils. Although governments have strong incentives to set up independent councils, there are also subsequent political temptations to constrain the activities of a council in order to avoid criticism. 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 other lines of defence are necessary.

A second line of defence required for new fiscal councils are more formal provisions to guarantee independence. This aspect has been neglected when setting up some new councils. Such provisions could be modelled on the provisions applying to 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 policymaking (for example, the countries in Eastern Europe).

A third line of defence could be international monitoring. Institutions like the IMF, the OECD and the European Commission 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. 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.

Our conclusion is that advisory fiscal councils can play a useful role in counteracting deficit bias. But at the same time it is important to warn against over-optimism. Deficit bias is a deep-rooted problem and fiscal councils are no panacea. Their success depends on both building up a solid reputation and an electorate valuing independent evaluations of government policy.

## Panel discussion

Refet Gürkaynak thought the paper should focus more on what fiscal councils should do rather that what they do. He noted that some of the fiscal councils studied in the paper do not undertake a forecasting role and asked the authors to explain how this affects their ability to give policy advice and policy projections. He did not see it as a complete abandonment of democratic principles that some aspects of the fiscal policy decision-making process are independent. In analogous to the function of central banks in how it determines the best approach to achieving a particular goal or target objective, fiscal councils could provide technical expertise in how best to achieve particular fiscal objectives. He argued that fiscal councils should perform an independent monitoring and auditing function which would provide observers with confirmation that government fiscal action is appropriate and in line with stated objectives.

Nicola Fuchs-Schündeln suggested that authors should link the discussion of how fiscal councils function to the various theories on the deficit bias. This would provide better insight and guidance into what the optimal design of a fiscal council should be. Michael Haliassos focused on the composition of fiscal councils and suggested it was important that fiscal councils should consist of members with international experience. He also felt that some level of international coordination between fiscal councils would be beneficial. He suggested that fiscal councils appointed by a minister may find it very difficult to outrightly oppose the Finance minister and also be forced to share responsibility for mistakes made by government. On that basis, he thought independent think-tanks with similar expertise could perform a similar role and be as effective in influencing government while maintaining their independence. Peter Dolton added that the degree to which fiscal councils are linked to the political process and how they are funded would appear to have a significant influence on the action and advice given by fiscal councils. Richard Portes suggested that an important function of fiscal councils should be to educate the public on the underlying principles of fiscal policy and to publicly correct inaccurate statements made by politicians on fiscal policy. He believed that greater attention will be given *ex post* to forecasts made by fiscal councils compared to private forecasts. As the council is likely to be wrong on occasion, this unbalanced attention may undermine their authority and the value of their advice. Michael Devereux reminded the panel that monetary policy was very poorly used up until the 1980s before acceptance of the role of inflation targeting. He thought that if people were successfully convinced that fiscal surpluses are good on average, thus lessening the problem of the deficit bias, fiscal councils would be useful in the political process.

In response to Michael Haliassos, Simon Wren-Lewis remarked that the advice of a fiscal institution set up by the government is more politically costly to ignore compared to advice given by independent think-tanks. He believed in order to tackle the various sources of deficit bias the remit of a fiscal council should be wide enough to include all the functions of those discussed in the paper.

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