

Credibility of fiscal policies and independent fiscal bodies

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***Abstract:** In this paper we address the problem of credibility in fiscal policy. In many instances fiscal policy as conducted by governments is not perceived as credible. The targets set forward by government are often not met and usually the divergence is on the negative side. Taxes are overestimated and spending is underestimated, leading to a deficit bias and growing indebtedness of governments. To enhance the credibility of fiscal policy several schemes are put forward. Most frequently used are fiscal rules that replace discretionary decision making. Fiscal rules however are difficult to sanction and although they can improve the quality of fiscal policy, they do not guarantee sound fiscal policy. Therefore it is sometimes suggested to install fiscal councils on top of the fiscal rules. Fiscal councils with tasks in forecasting and assessing fiscal policy have been and are being introduced in more and more countries. Some economists want to go further however and propose to establish fiscal councils with independent powers to conduct fiscal policy within the borderlines that parliament lays down. In this paper these tendencies are analyzed.*

JEL-codes: H3, H6

Keywords: budget institutions, fiscal rules, fiscal agencies, credibility

1. Introduction

One of the ways in which governments have handled the financial and economic crisis is by injecting large budgetary funds into the economy. This has led to huge imbalances in the public finances and growing public indebtedness of countries all over the world.

Previous experiences in the wake of the oil crisis in the seventies have shown that governments find it much easier to expand in times of distress than to contract after a crisis or a recession.

The reason for this has been searched in the intricacies of the political system and the personal preferences of political actors.

To avoid the self-sustaining build up of government debt new methods to control government finance will have to be developed.

In recent years a lot of thinking has been done on the role of formal fiscal rules and fiscal councils in containing public finances. The discussion has evolved into the direction of considering the idea of installing independent fiscal agencies that would take over part of the responsibilities of politics in managing public finances.

The central position in these ideas is taken up by the credibility question. As is shown by the recent cases of Greece and Ireland the lack of credibility of budgetary policy

can cause market reactions that make the financing of deficits even more expensive and add to the budget problems causing a cumulative negative effect on the public financial position.

In this paper we will discuss fiscal rules, fiscal councils and independent fiscal agencies as possible solutions to the credibility problem. We start with a general discussion on regulators and credibility. We then go on focusing on fiscal policy and the different methods to enhance its credibility on matters such as the deficit bias.

The most obvious solution to deal with the deficit bias is the installation of fiscal rules. We analyze how fiscal rules can contribute to the elimination of the deficit bias. Fiscal rules are not free from problems however, since governments that do not like the consequences of the rules at a given time can choose to evade the rules. The experience with the rules imbedded in the Stability and Growth Pact of the European Union is an obvious example.

Therefore the logical next step is the introduction of fiscal agencies, which take over part of the budgetary process from politicians. Depending on whether autonomy is given over, there is a distinction to be made between fiscal councils with no real autonomy in policymaking and independent fiscal agencies with a certain degree of autonomy.

The analysis tries to answer several research questions. One research question is whether it is thinkable in an analytical way that politics would contract out the setting and the guarding of the budgetary track to an independent fiscal body in order to buy credibility. In other words, could an independent fiscal body constitute a successful model for more sustainable public finances?

A next research question is about how this could be organized in a practical way.

The last research question is how independent fiscal bodies should be viewed in relationship with fiscal rules? What can these bodies achieve that cannot be expected from the introduction of fiscal rules?

2. Independent agencies and credibility

We start with a general description of the link between credibility of policymaking and the position of the policymakers. It is a general belief that credibility can be enhanced by creating institutional agencies operating independently from politics and from the target groups of the specific policy.

Two approaches to the credibility question can be found in the literature. The first approach (e.g. followed by Gilardi (2002)) is narrow and only looks at independence of agencies from government. The second and broader approach also considers independence from stakeholders and consumers.

In the first approach the starting point is the decision made by governments to delegate authority. This decision has to do with the time-inconsistency problem that is connected to credible policy making.

Credibility is the capacity for inspiring belief. A credible policy is a policy worthy of being accepted as true or reasonable. A politician/government/regulator is credible when agents believe he will fulfil his promises. Credibility is needed when coercion is not an option for policy makers.

A typical situation is posed by investment decisions in a liberalized setting. These decisions are made by private investors and not longer by government itself or by public companies. Another typical situation is when economic actors make decisions

about wages and prices in the context of the goals for monetary policy set by government.

This latter kind of situation was the starting point for the literature on central bank independence. In a seminal paper, Kydland and Prescott (1977) stress the importance of an independent central bank because there is a potential conflict between policymakers' discretion and policy optimality, called the 'time inconsistency of policy'. Often policymakers need to credibly bind themselves to a fixed and pre-announced course of action. Otherwise the danger exists that policy is altered because of changes in preferences of policymakers (Gilardi 2006).

In a more general sense a time consistent policy is a policy that will be sustained as circumstances change over time. Adhering to a policy rule may require pursuing a policy at a particular point in time that is not optimal at that time. In contrast, policy that is time inconsistent will be reversed in the future due to predictable developments over time.

In a typical democratic setting time inconsistency will be the rule rather than the exception as democracies are characterized by the short term time horizons of politicians in view of elections and by the accompanying changes of the ruling party or coalition.

In regulatory policy credibility is important, especially in the aftermath of utilities privatization and liberalization (Gilardi 2002 and 2006). There are clear links between the literature on central bank independence and this literature. Policy makers have incentives to promise a favourable regulatory environment to attract investors, necessary for fostering competition. Once relatively irreversible investments are made, policymakers may be tempted to go back on their commitment. Rational investors will not invest in the first place, creating a suboptimal situation. In the literature this is called the 'hold up' problem (Kirkpatrick, Parker & Zheng 2006).

A device to guarantee a time consistent policy is to create a commitment mechanism for removing the risk of opportunistic policy in particular contingencies. Independence for regulators can act as such a commitment mechanism (Gilardi, 2002). In this way, governments prohibit themselves and future policymakers from taking these short-sighted decisions.¹ They 'tie their hands', so it will be politically more costly to overrule a decision made by an agency. Thus policymakers cannot use discretionary policy as a mechanism to favour a particular interest group.²

The more independent an agency is, the more credible the policy is for stakeholders, potential investors, consumers, etc. Policymakers delegate to increase the credibility of their policy commitments.

The 'credibility hypothesis' is stated extensively in the literature (Gilardi, 2002; Gilardi 2006, Genoud, 2003, Larsen et al. 2006). Credibility is a valuable asset for governments, because rational individuals base their expectations on all economically available information at the moment of decision. Rational actors' beliefs are influenced by beliefs about future actions of policy makers.

¹ Independence of regulatory authorities should not be understood as autonomy for developing actions and programming policies ignoring the government, but rather as the probability of implementing policies without the interference of political or private agents (Oliveira et al. 2005).

² Another explanation for delegation has to do with political uncertainty (Gilardi, 2003). Several authors state that, because of political uncertainty, a government may delegate authority to an agency because it wants to increase its own political influence for longer periods in time (Johannsen, 2001; Gilardi, 2006). A government has a political property right today, but is uncertain about still having such a property right tomorrow. Future policy makers will be less able to change the policy of current decision makers when authority is delegated.

Credibility and independence however are by no means synonyms. Optimally, one would measure credibility directly, and link it to regulatory independence to test whether a more independent regulator is effectively more credible. In the literature independence is used as a proxy for credibility because it is assumed that a more independent regulator is also more credible.

The approach taken above is a rather narrow one. A regulatory agency may be very independent from political influence, but at the same time very influenced by company interests. This problem has been highlighted extensively by the capture theory of regulation (Stigler 1971). Capture can again be avoided by installing independent agencies.

We should therefore take into account a broader view on independence. The definition we use in this paper is taken from Johannsen (2003). She follows Smith (1997) who states that independence consists of three elements:

- an arm's length relationship with regulated firms, consumers and other interests;
- an arm's length relationship with political authorities;
- attributes of organizational autonomy.

This definition contains the definition used by Gilardi (2002).

3. Fiscal policy and credibility

3.1. The problem of credibility in fiscal policy

The next step in the discussion is to apply the insights about credibility to fiscal policy.

The objective of fiscal policy is to run the budget in the interest of society. Along musgravian lines the budget is used for three functions: improving the allocation of scarce resources (mainly providing for public and merit goods and discouraging demerit goods), improving the distribution of income and wealth, and stabilizing the economy (meaning fighting business cycles and safeguarding economic growth).

The budget is the instrument of fiscal policy. It has itself the characteristic of a common pool resource, in the sense that exclusion of various special interest groups calling on the budget is difficult while this appeal is rival. This feature leads to so called deficit bias, meaning that the frequency of negative budget balances tend to be higher than the frequency of positive balances.

The public choice school taught that a keynesian budgetary policy will be asymmetrically implemented and thus offers an explanation of the deficit bias (Buchanan, Rowley and Tollison, 1987). According to the recipes of a keynesian budget policy, an expansionary policy should be carried out in times of recession, causing a deficit balance. In good times a restrictive policy is called for, leading to a budgetary surplus. The public choice school states, with the electoral myopia of governing politicians, that politicians will asymmetrically implement such a budget policy. The first, good times part coincides with the electoral interest of politicians, while the second, bad times part goes against that interest.

The perspective of spending more and taxing less in a recession is attractive to politicians. In that case they can meet the multiple budgetary wishes of interest groups and voters without having to let pay the price in the form of higher taxes, all this in hope of an electoral return.

The inverse does not happen in an overheated economy: against the prescription of functional finance no surplus is created. Higher taxes and lower spending are not very attractive from an electoral point of view. Politicians steer clear of them and infect public finance with a deficit bias.

According to Hallerberg & Von Hagen (1999, p. 209) there are two strands in literature that deal with this deficit bias. The first one concentrates on differences in electoral systems. The second one deals with governmental institutions.

In the first approach the focus is on proportional representation systems versus pluralist electoral systems. The first type of political system seems to be more unstable than the second type. The effect is that politicians in the first system are more unlikely to hold their position in the longer run and thus are more prone to increase debt levels. Also the first type usually goes hand in hand with coalition types of government. In coalition governments partners can more easily block budget cuts in their own ministries, but are also unable to let the other partners limit spending in their departments. On the contrary pluralist governments tend to limit the creation of public debt (Hallerberg & Von Hagen 1999, p. 210).

The second approach considers how budgetary institutions affect the size of deficits: the strength of the finance minister, the presence of negotiated spending targets, the role of the parliament in the budget process, the way the budget is implemented and the ex post control.

One aspect of the deficit bias is the forecast bias.

Regarding this bias Beetsma (2009, p. 756) puts it this way: "...fiscal plans may be distorted by the need to comply with ex-ante fiscal rules that require fiscal discipline only in terms of plans but not in terms of outcomes. This is, in particular, the case for the so-called Stability and Convergence Programs (SCPs) of Europe's Stability and Growth Pact (SGP)."

It should not come as a surprise then that official forecasts of economic growth used in projecting budgetary spending and taxing often are too optimistic. This leads to projected income that is higher than is realistic and projected spending that is lower than in reality. A structural forecast bias leads to persistent deficits and growing public debt.

"When forming their plans governments are under political pressure to be ambitious in terms of fiscal discipline as well as generous to the various groups in the voting population. Hence, there are several reasons why plans may differ from realized fiscal outcomes." (Beetsma 2009)

The deficit bias reflects a time inconsistency problem in the sense described in the preceding paragraph whereby the long-term discipline objective is systematically overlooked when short-term discretion is being used. A solution to the problem is presented by the 'rule school', which aims at preventing discretion by binding fiscal policy in the short run (see next section).

In general the challenge in designing fiscal institutions arises from the need to discourage the undesirable manifestations of fiscal discretion while retaining the policymaker's flexibility to respond to unexpected developments, and to fulfil the democratic mandate, the latter posing the problem of accountability. One practical difficulty in doing so is to find the thin line between ways to discourage the misuse of discretion, and outright limitations on it. "Fiscal frameworks may be able to help improve policy outcomes and stabilize expectations regarding fiscal behaviour, reduce uncertainty and volatility, and have a positive impact on investment and growth." (Debrun e.a. 2009)

3.2. Fiscal rules

3.2.1. Fiscal rules as a solution for the debt bias.

The adoption of fiscal rules has been considered as the instrument of choice to deal with deficit bias (Debrun & Kumar 2008).

The history of fiscal rules is impressive. All over the world over the last decennia countries have experimented with fiscal rules. A fiscal rule is defined as "a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance" (Kopits & Symansky 1998).

There are rules available on deficit limits, spending limits, taxing limits, debt limits, etc. (see IMF (2009), and table 1).

One of the most ancient deficit rules is the golden rule, stating that current spending and income should be balanced and that only public investment can be debt financed. Other well known deficit rules are the cyclical budget balance, the structural budget balance, the full employment budget balance. The 3 % limit, one of the Maastricht criteria and the criteria in the Stabilisation and Growth Pact, has acquired an iconic stature in Europe.

Examples of spending limits are the rule limiting the increase to the inflation rate or the rule holding spending constant in relation to gross domestic product.

The 60 % debt rule from Maastricht and SGP is a famous example of a debt rule.

Numerous studies describe the coverage, nature, degree of state contingency and the specific targets of desirable fiscal rules (e.g. Calmfors, 2005; Kopits, 2004; and Morris, Ongena and Schuknecht, 2006), and conclude to the often beneficial role of such rules.

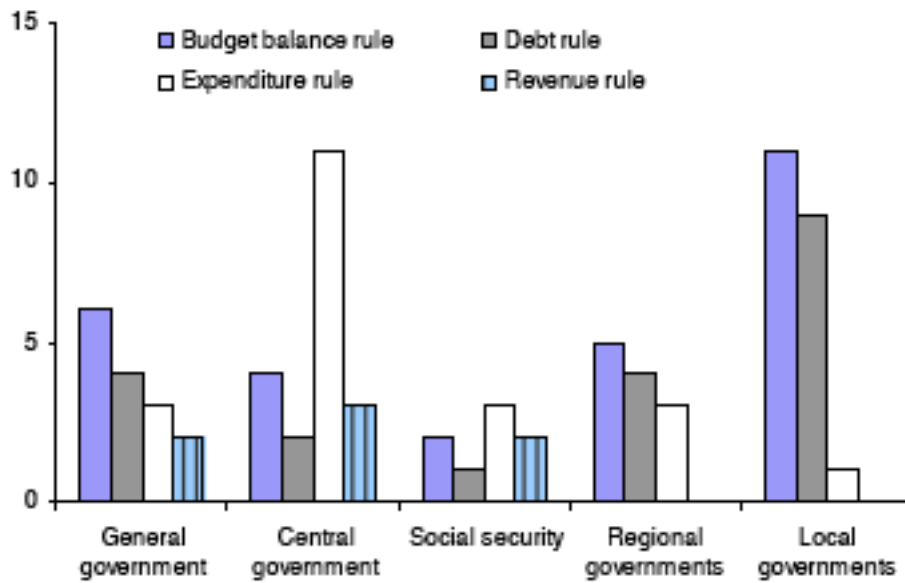
Graph 1 gives an idea of the existence of fiscal rules within the EU divided into type and level of government where they are applied. Graph 2 documents the increasing use of rules in the EU, as measured by the fiscal rule index. The fiscal rule index was developed by the European Commission (2006) and measures the strength as well as the coverage of budgetary rules in the member states.

Table 1: Target definitions by type of rule

Budget Balance Rules	Golden rules	Balanced budget rules	Nominal ceiling	Ceiling as a % GDP	Rules in structural terms	Total
	5	10	7	1	3	26
Debt Rules	Debt ceiling in nominal terms	Debt ceiling as a % of GDP	Debt ceiling related to repayment capacity	Other		Total
	5	3	8	2		18
Expenditure Rules	Nominal expenditure ceiling	Real expenditure Ceiling	Expenditure growth rate (nominal)	Expenditure growth rate (real)	Other	Total
	5	2	4	3	3	17
Revenue rules	Tax burden as a % GDP	Rule related to tax rates	Allocation of extra revenues	Other		Total
	0	1	4	1		6

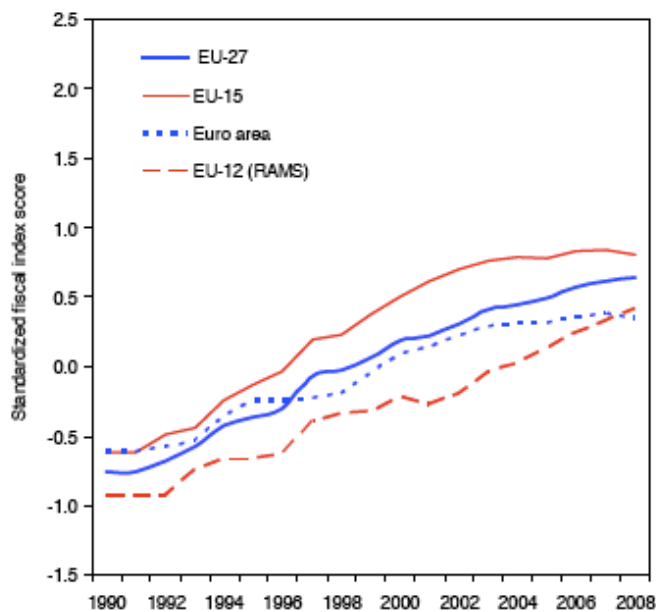
Source: EC (2009)

Graph 1: Fiscal rules in the EU Member States by type of rule



Source: EC (2009)

Graph 2: Development of fiscal rule index in the EU



Source: EC (2009)

The European Commission (2009) has performed an econometric analysis linking the fiscal rule index and budgetary outcomes measured by the cyclically adjusted primary balance (CAPB) in the EU27 Member States. The coefficient reflecting the influence of the fiscal rule index on the CAPB is positive and significant, which indicates that an increase in the value of the index (i.e. a larger coverage and/or stronger features of fiscal rules) leads, ceteris paribus, to lower deficits or higher surpluses (see table 2).

Table 2: Influence of fiscal rules on the primary cyclically adjusted balance (EU-27, 1990-2008)

Explanatory variables:	Dependent variable:
	Cyclically-adjusted primary balance (CAPB)
Lagged output gap	-0.058 (-1.1)
Lagged CAPB	0.54 (9.6)***
Lagged debt ratio	0.04 (3.6)***
Fiscal rules index	0.48 (-2.7)**

(1) Estimation method: OLS with time and country-fixed effects. Heteroscedasticity robust and adjusted for 27 clusters standard errors. The "t" values are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 percent level. Coefficients for fixed-effects are not reported.

Source: EC (2009)

Nevertheless these outcomes cannot hide that there is no consensus in the literature on whether fiscal rules are a robust remedy against the deficit bias.

This is painfully shown by the recent Greek and Irish case, but it was already predicted in *tempore non suspecto*: “In the particular case of monetary unions, the centralization of monetary policy can reduce individual countries’ incentives for fiscal discipline. Normally, the unpleasant prospect that excessive public debt may ultimately increase future inflation and interest rates is likely to impose some self-restraint on governments. In a monetary union, however, this effect is likely to be diluted, particularly for the smaller members of the union, and could lead to excessive debt accumulation (Beetsma and Bovenberg, 1999). In addition, monetary unions can entail a moral hazard related to the greater likelihood of a bailout by other member states or by the common central bank.” (Debrun e.a. 2009).

3.2.2. Criticism on rules based fiscal policy

According to Wyplosz (2005) fiscal rules can work as far as the long-run pursuit of discipline is concerned, but at the cost of ignoring the short-run objective. This means that there is a risk of fiscal policy becoming pro-cyclical, especially during downswings when tax revenues are endogenously declining.

There can also be an impact of rules based policy in other domains, such as monetary policy, on fiscal policy. In the case of monetary policy time inconsistency was a key argument behind the reform of institutions (Rogoff, 1985). But those very reforms may have aggravated the time-inconsistency problem of fiscal policy. “Governments may use fiscal activism to make up for the loss of monetary policy as an instrument to boost demand. Loss of control in monetary policy (through rules or delegation) may thus encourage unwarranted, demand-side fiscal expansions, essentially transforming the inflationary bias into a deficit bias (Agell *et al.*, 1996; Castellani and Debrun, 2005).” (Debrun e.a. 2009).

Lessons learned from monetary policy reforms can also in another way be helpful for the case of fiscal policy. According to Debrun e.a. (2009) experience over the past two decades with the monetary policy reforms shows that the underlying problem

does not lie with discretion as such, but with the incentives shaping the behaviour of those who exercise it. “This suggests that rather than remove discretion and put policy on an automatic pilot, institutional reforms aimed at improving or correcting incentives would be preferable. Indeed, in this respect, the analogy with monetary policy is instructive: central bank reforms have in general not eliminated discretion. Instead, they have sought to create a framework, and to provide clear institutional guarantees that significantly reduce the likelihood that discretion could be misused” (Debrun e.a. 2009).

Wyplosz (2005) argues that the literature is far from unanimous on the benefits of rules over discretion in fiscal policy. Rules-based fiscal frameworks *per se* need not deliver. “Rather under quite plausible and realistic assumptions, they are likely to end up meeting the same fate as monetary rules because their effectiveness is based on the same faulty premise, namely the assumed capacity of rules to permanently suppress or constrain discretion” (Wyplosz, 2005). Debrun & Kumar (2008) state that there will always be circumstances in which scrapping or ignoring rules will be preferable for policymakers. This suggests a credibility problem. “Thus a credible solution to biased policies cannot be to suppress discretion but to find mechanisms through which it could be exerted more wisely”.

An important category of criticism focuses on the EU Stability and Growth Pact, a case of fiscal rules laid down not by a national government for its own fiscal policy but by a supranational organism, the European institutions, for the fiscal policy of the EU member states. It is clear that the fiscal rules of the SGP have not worked properly in the Greek and Irish crises, neither the preventive arm, nor the corrective arm. The preventive part concerns the stabilization programmes that governments gave to present to the European Commission each year and in which governments point out how they will match spending and taxing over the next 6 years. These programmes suffer from the forecast bias, as long as forecasts are not made up by sufficiently independent agencies.

Table 3: Proposals for rules and institutions for EU fiscal policy-making

	Domestic	International
Changes in procedures and rules	(I) Expenditure Rules: Mills and Quinet (2001) Improving National Budgetary Process: von Hagen (2002)	(II) Debt Stability Pact: Pisani-Ferry (2002) Golden Rule: Blanchard and Giavazzi (2003) Permanent Balance: Buiter and Grafe (2003) Tradeable Deficit Permits: Casella (2001) Index of Institutional Reforms: Eichengreen (2003) Quality of Fiscal Policy: Beetsma and Debrun (2003)
Changes in institutions	(III) Fiscal Policy Committee: Wyplosz (2002) Calmfors (2003) Fiscal Regulator: Wren-Lewis (2002)	(IV) Sustainability Council: von Hagen (2003)

Note: The table covers a small yet, in our view, representative set of proposals for reforming the Stability and Growth Pact.

Source: Jonung & Larch 2004

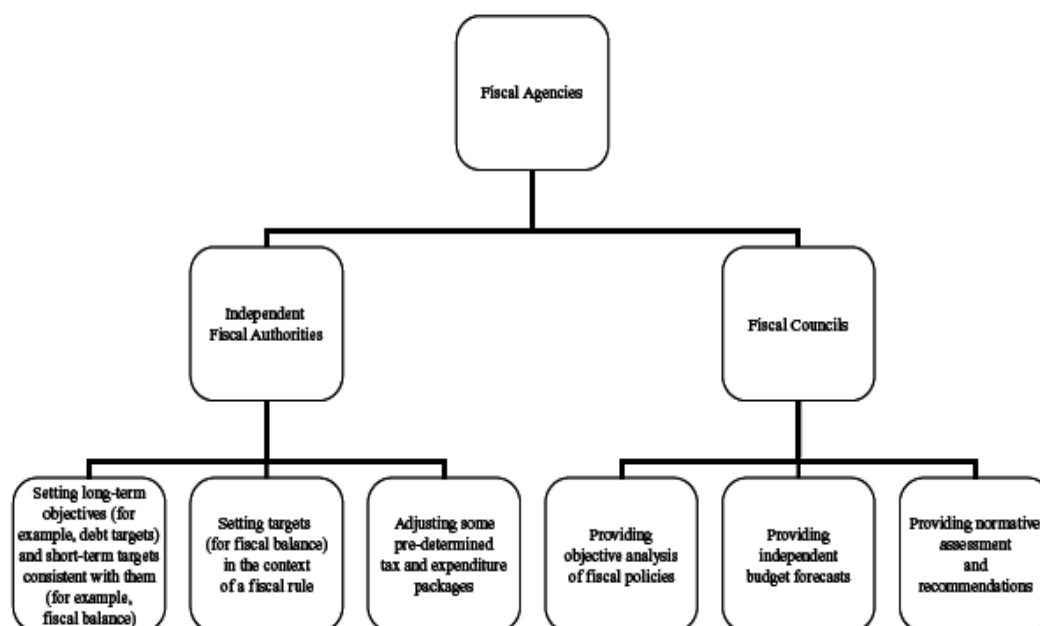
The corrective arm involves sanctioning member states that occur excessive deficits by imposing obligatory deposits and finally fines. It has failed completely in the recent crises and it has shown flaws before when big EU member states such as Germany and France escaped sanctions when their public deficit did not meet the 3 % criterion in the years 2003-2004. In short sanctioning has never been applied. The reason for the failure is that sanctioning has to be imposed by the European Council of Ministers (Ecofin in this case), where the member states that should undergo sanctions have a seat. The representing ministers are not very eager to sanction other countries or their own countries.

A solution for this problem could lay in delegating the sanctioning power to a more autonomous institution, whereby the Commission is sometimes put forward. Table 3 gives an overview of proposals that at one point in time or another have been put forward.

3.3. Fiscal institutions

This brings us to fiscal institutions as an alternative or a complement to fiscal rules. Debrun e.a. (2009) make a distinction between two types of fiscal institutions (see graph 3).

Graph 3: Types of fiscal institutions



Source: Debrun e.a. (2009)

The first type are called fiscal councils. These councils take up tasks of independent analysis, forecasts or normative judgments and in this way help to improve fiscal policy. Van Meensel (2008) attributes either positive or normative functions to fiscal councils. To the first category belong institutions, which make up macroeconomics forecasts, public finance forecasts, impact analyses of shocks and policies. The second institutional category make policy recommendations and/or assessments of

fiscal performance in comparison with targets. Neither type of fiscal councils receives any specific authority over fiscal policy (Bogaert e.a. 2006).

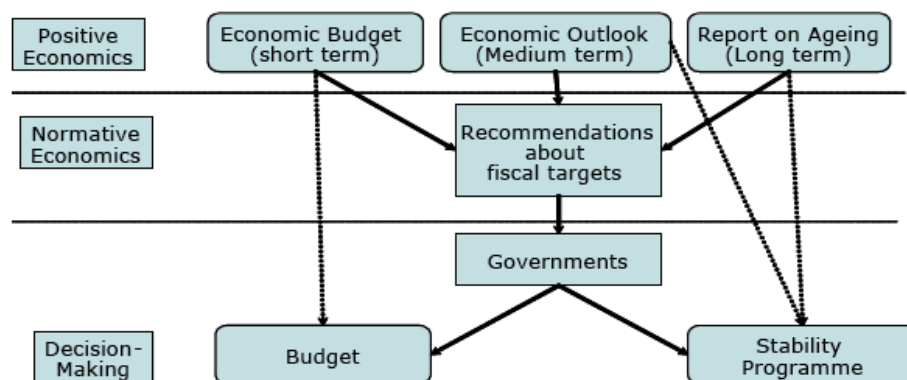
Fiscal councils add value to the policy process by affecting policymakers' incentives and motivations. There can be an impact through public debate of the findings of fiscal councils. There is evidence suggesting that fiscal councils of the second category generally contribute more to fiscal discipline than those of the first category (Debrun e.a. 2009).

Besides fiscal councils Debrun e.a. (2009) mention also independent fiscal agencies (IFAs). IFAs would receive a mandate comparable to that of independent central banks or independent sectoral regulators. This mandate would include setting and enforcing long term fiscal objectives and annual budgetary targets, f.i. for the budget balance (Bogaert e.a. 2006). They could also be mandated to veto proposals at odds with a given fiscal rule. To date no IFAs exist, suggesting that politicians are reluctant to delegate parts of their competences. There could also be a problem of democratic accountability.

3.3.1. Fiscal councils

The diagram in graph 4 shows how fiscal councils and their responsibilities can be designed in practice. The diagram gives an overview of the main activities, normative as well as positive, of the existing Belgian fiscal councils, which are regularly cited as good examples (see Calmfors 2003, Beetsma e.a. 2009, Wyplosz 2005).

Graph 4: Responsibilities of fiscal bodies



Source: Bogaert e.a. (2006)

A number of countries have installed fiscal councils (cf. the Office of Budget Responsibility in the UK as recently as May 2010) and there are a variety of proposals for new ones. Table 4 gives an overview of the field of fiscal councils in some EU countries as of 2008 and of their nature (independence, perceived impact on fiscal discipline) (Debrun 2008). In order to quantify these aspects Debrun and Kumar (2008) constructed a number of indices that characterize the setup, independence and the potential influence of the agencies on the budgetary process. The maximum score is 10. The average scores on the various aspects remain rather low. The maximum is 4.2 for the aspect of formal guarantees on political independence. The most important aspect in our view, the perceived impact on fiscal discipline, scores an average of 3.2. This average hides high scores for countries such as Belgium, Estonia, the Netherlands and Spain.

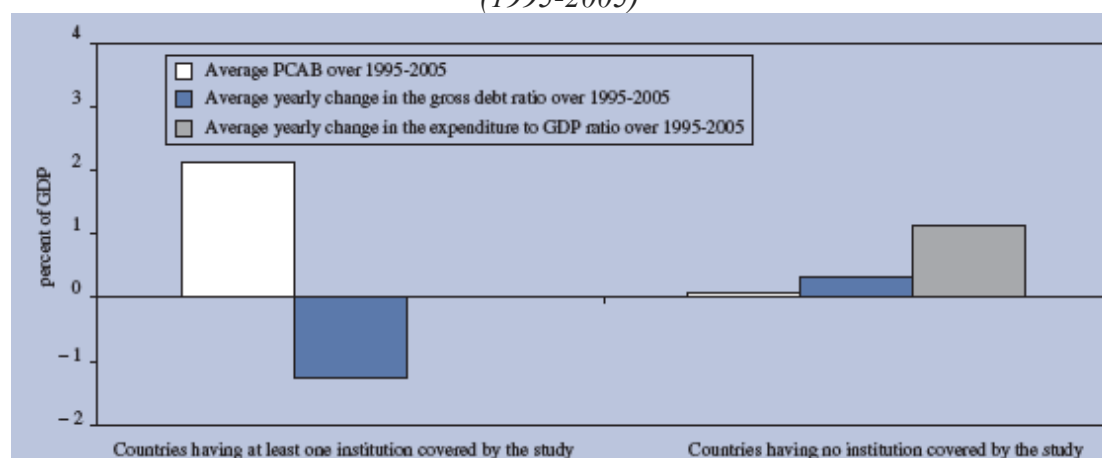
EU (2006) analyses the link between the presence of fiscal councils and budgetary performance over the period 1995-2005 (see graph 5). “On average, countries having at least one independent institution had a larger primary surplus and the general government debt ratio has on average gone down in the last ten years, which is not the case in the group of countries with no independent institutions” (EC 2006).

Table 4: Features and perceived impact of fiscal councils in the EU

	Number of councils	Overall (de jure) influence and independence	De jure influence on the budget process (legal)	Impact of independent forecast	Formal guarantees on political independence	Perceived impact on fiscal discipline
Austria	1	1.3	0.8	0.2	1.7	1.5
Belgium	2	5.7	6.5	2.3	4.9	6.3
Denmark	1	3.5	2.4	0.0	4.6	0.8
Estonia	1	4.0	2.9	0.0	5.2	7.1
France	2	1.7	1.5	0.0	1.9	1.3
Germany	4	3.7	1.4	0.2	6.1	2.5
Greece	1	1.5	0.2	0.0	2.7	0.2
Hungary	1	4.2	4.6	0.0	3.8	3.3
Italy	1	1.9	1.1	0.0	2.7	2.5
Luxembourg	1	4.8	3.6	0.0	6.0	2.7
Netherlands	1	3.5	2.6	1.1	4.4	6.3
Portugal	1	4.1	2.5	0.0	5.6	1.5
Spain	2	5.5	5.0	0.0	6.1	7.1
UK	1	1.9	2.0	0.0	1.9	1.5
Average		3.4	2.7	0.3	4.1	3.2
Average euro Standard deviation		3.4	2.5	0.4	4.2	3.2
		1.5	1.8	0.7	1.6	2.4

Source: Debrun and Kumar (2008). Maximum score is 10.

Graph 5: Budgetary developments in countries with and without fiscal councils (1995-2005)



Source: EC (2006)

3.3.2. Independent fiscal agencies

Although there seems to be some evidence on the positive effects of the presence of fiscal councils, academic thinking has taken the debate one step further by discussing the desirability of installing independent fiscal agencies. As stated IFAs are supposed to be given some kind of autonomous function in the budgetary process, meaning that politicians would lose a part of their autonomy in that process. The situation would be similar to monetary policy or competition policy, where a body independent from politics such as the central bank or the competition authority, can make policy decisions without interference from the government.

Alesina & Tabellini (2007) address the question in which circumstances such a delegation would be a good idea. In their opinion it is preferable that politicians keep autonomy if ability to perceive and execute a policy is less important than the effort involved or if there is little uncertainty about whether the policymaker has the required abilities. They prefer bureaucrats in the opposite case. In that vein of thinking it comes as no surprise that highly technical tasks such as monetary policy and regulatory policies, but also public debt management, are typically delegated to high-level bureaucrats.

The situation is different in the case of redistributive policies. Here voters and politicians gave a different view on who has to deal with these policies. Voters would prefer a bureaucrat, if they can see that the redistributive goals can be clearly and fairly specified *ex ante* and if they can trust the bureaucrat to implement them. "If, instead, redistribution implemented by a bureaucrat is arbitrary or unpredictable, then risk-averse voters prefer a politician" (Alesina & Tabellini, 2007). The situation is different from the point of view of politicians. They do not want to delegate redistributive tasks, because they can use this policy to build coalitions and so increase their incumbency advantage and their re-election chances. Alesina & Tabellini (2007) offer this insight as an explanation for the fact that "delegation to independent bureaucrats is very seldom observed in fiscal policy, even if many fiscal policy decisions are technically very demanding".

So the question is whether it is possible to make a clear distinction between the technical part of fiscal policy consisting of the stabilisation objective and the redistributive part of it. According to Calmfors (2003) "macroeconomic stabilisation involves relatively little of value judgements and is to a large extent a question of technically finding the best ways of achieving what can be regarded as a commonly shared objective of minimising macroeconomic fluctuations."

Debrun et al. (2009) point at four basic criteria that should dictate whether it is desirable to delegate some or all aspects of policy.

Firstly, there must be socially harmful distortions in policy implemented by the political representatives. This is clear in the case of monetary policy, where inflation that runs too high can cause unacceptable effects. It is equally clear that this is also the case with competition and regulatory policies. Fiscal policy is also an obvious candidate, since the effect of the persistence of government deficits and the accumulation of public debt can clearly be socially harmful. In the absence of distortions however there is no reason to delegate and the other three criteria noted below would not apply.

Secondly, there should be a broad consensus on what constitutes 'sound policy' in any particular domain. For example, consensus on price stability for monetary policy, the protection of consumer welfare for competition policy, a target for the budget balance or a target for the debt/gdp ratio for fiscal policy can be or could be basis for

a delegation of policy to an independent agency. In the absence of such a consensus, difficult policy trade-offs would have to be made. These trade-offs can only be resolved by politicians who are democratically accountable.

Thirdly, as pointed out above delegated mandates should steer clear from decisions that are primarily distributive or have major distributive consequences. Again, distributional decisions involve difficult trade-offs for which elected representatives are needed.

Fourthly, delegation should not give lead to major policy coordination problems. If a policy in a particular area or some aspect of it is delegated, it should not create conflicts with policymakers in another area that is not delegated or is delegated to another agency (the coordination problems between a competition authority and sectoral regulators are a well known example (Naert 2009)). Otherwise, the coordination difficulties should be lower than the benefits from delegation.

So far for the preliminaries. The next item is about how an independent fiscal agency could look like and what could be its mandate? As mentioned already we enter a field of speculation here, because no IFAs are active to date. Some proposals have been made in literature however. For example Wyplosz (2005) and Calmfors (2003) have come up with rather detailed descriptions of the features of an IFA.

According to Calmfors (2003) one of these features should be that the members of the IFA are unelected experts appointed for a fixed duration. The duration should be long enough to make the experts fully independent from politics and it should exceed the horizon of the policy target. This is a general feature, which we also recognize in the institutional design of central banks, competition authorities and sector regulators.

Next feature is that the IFA is given a debt target by the relevant political authorities, to be achieved over a given horizon that corresponds with the length of business cycles. Wyplosz (2005) makes the suggestion that this target could be based on a target for the budget balance over the cycle, which should be decided upon by parliament. The parliament also decides the stabilization policy objectives for the IFA and by specifying to what extent one should rely on the automatic stabilizers and to what extent one should resort to discretionary action.

The mandate of the IFA would then comprise the power to decide on the budget balance on the basis of an explicit and independent gdp growth forecast. The final budget law approved by parliament must specify a budget balance that matches the IFAs decision for the most likely growth forecast. Thus the parliament delegates the right to decide the budget balance target in a given year (depending on the cyclical situation) to the IFA and commits to following its recommendations.

The parliament would keep the autonomy to decide which taxing and spending policies are required to reach the target for a given year set by the IFA.

The IFA monitors budget and cyclical developments over the fiscal year and can request amendments to the budget to meet the target it has set.

Finally the IFA should be accountable to parliament.

Where does this scenario differ from the actual scenario in many countries? Usually government prepares and parliament decides on the long-term budgetary trajectory considering sound public finances and debt control. The actual way of doing things is that government and parliament then translate this trajectory into a yearly target for the actual budget balance. It is here that an IFA can make a difference by being delegated this last decision. After the government and parliament would have decided upon the role it wants discretionary fiscal policy to play on top of the mitigating effect of automatic stabilizers, the IFA would come in to decide on the actual budget balance in the next fiscal year.

Then government and parliament enter again to decide democratically on the spending and taxing with a distributive effect within the boundaries of the actual budget balance laid down by the IFA.

Calmfors (2003), referring to Ball (1997), Business Council of Australia (1999), and Seidman (2001), proposes also an alternative structure involving the following five steps:

- (i) The parliament decides a target for the budget balance over the cycle.
- (ii) The parliament decides base values for all tax rates and government expenditures. These base values should be consistent with the budget target over the cycle.
- (iii) The parliament delegates the right to vary certain tax rates or government expenditure levels within predetermined margins to the IFA.
- (iv) The parliament decides the stabilisation policy objectives for the IFA and guidelines for how the instruments delegated should be used. The guidelines should require that the committee varies the fiscal policy instruments under its control in such a way that the budget objective over the cycle is met.
- (v) Following its instructions, the IFA varies the tax rates and/or government expenditure levels under its control around the base levels set by the parliament.

The advantage of this scheme is that the IFA is better equipped to pursue the macro-economic stabilization objective, since it now controls the tax rates and spending levels and can so better take into consideration the different multipliers of different tax and spending categories.

Drawback is that “one could fear that overoptimistic judgements of potential output on the part of the government might cause it to systematically overestimate the cyclically adjusted balance, which might contribute to a deficit bias” (Calmfors 2003).

4. Conclusions

In this paper we analyzed the subject of credibility in fiscal policy. As the recent problems of Greece in containing the deficit and the growth of public debt show, a lack of credibility in the eyes of the financial markets can lead to a domino effect which can also infect other countries and which even can put a major currency under speculative pressure. The credibility question is directly linked to the question whether it is better to leave policy making in the discretionary hands of government and its politicians or whether it is better to bind the hands of politicians by putting them under the constraints of rules or even by handing over the autonomy of policy making to a non-political institution.

There seems to be a consensus in the academic world that curtailing politicians is a good method to establish credibility in the field of monetary policy, as well as in the field of regulatory policy. In these domains the handing over of large chunks of policymaking power to independent bodies such as central banks and regulators even has become an established practice. Concerning fiscal policy academics have been less outspoken. Although it is taken for granted that introducing fiscal rules and trusting the tasks of economic forecasting and assessment of the execution of fiscal policy to independent fiscal councils is an effective remedy against deficit bias, only a few voices are heard that advice to go further and to create really independent fiscal

agencies that themselves are entrusted with powers in executing fiscal policy. The main reason here is that fiscal policy contrary to monetary or regulatory policy is besides being technical also highly distributive. Income and wealth redistribution creates winners and losers, necessitating democratic handling by elected parliaments and governments. Nevertheless a case can be made for devolving some part of fiscal policy making powers to independent fiscal agencies, although it never has been tried in practice. A further shift away from discretion towards rules seems to be warranted by the difficulties that many governments seem to have in dealing with their budget deficits. That is why the proposals of Calmfors (2003) and Wyplosz (2005) should receive renewed attention by the academic world and by policy makers. These authors search for ways to take discretion, leading to deficit bias, out of the hands of politicians without endangering the accountability of fiscal policy. Their proposals are a careful mixture of decisions that can be taken by government and decisions that better can be delegated to independent fiscal agencies. These set-ups take advantage of the improved academic insights into the cyclical and structural behaviour of the budget.

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