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WHAT SHOULD FISCAL COUNCILS DO?

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What should fiscal councils do?

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1. Introduction

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

The recent explosion in government debt suggests that the rules approach was not sufficient for stable public finances. One reason is that rules were not observed (Greece), another that, when deficit ceilings were respected, fiscal outcomes lay so close to them that there was no margin for contingencies (Portugal, France and the UK). In some countries there was an overoptimism about the sustainability of booms, such that when they came to an end, huge budget deteriorations could result (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, the IMF, the OECD, 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". In line with this, the EU/IMF agreement with Ireland on financial aid in December 2010 contained a commitment to set up an advisory fiscal council.

The recent interest in independent fiscal institutions has also been stimulated by a series of academic proposals starting in the mid 1990s (see Calmfors 2005 and Debrun et al. (2009) for surveys). The common idea is that it should be possible 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 to an independent fiscal institution, others propose delegation of only forecasting, analysis, evaluation and advising.

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 Public Borrowing Requirement Section of the High Council of Finance in Belgium. In recent years, similar institutions have been created in Sweden, Hungary, Canada, Slovenia and the UK. All existing independent fiscal institutions are of the watchdog type. They are often labelled *fiscal councils*, which is the term we shall use.

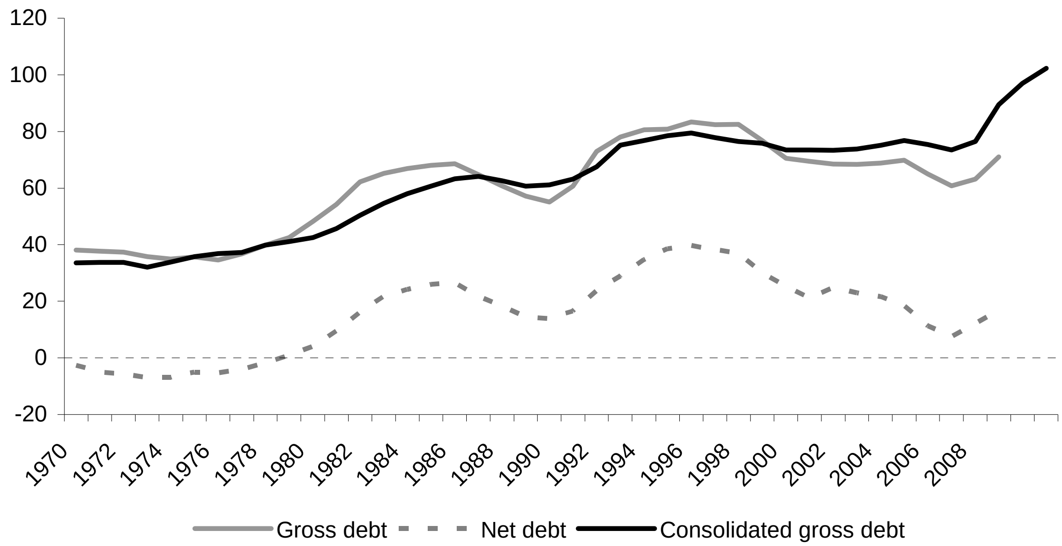
This paper analyses what role fiscal watchdogs can play. What tasks should they have? Should they do their own forecasting or only evaluate the government's forecasts? Should they only undertake positive analysis or in addition give normative policy recommendations? Should they be complements to fiscal rules, helping to monitor them, or substitutes, allowing a more discretionary policy approach? Should fiscal watchdogs just evaluate the extent to which intermediate, medium-term fiscal objectives are attained or should they also analyse the appropriateness of these objectives? Should the remit be confined to fiscal policy only or can it be broadened to other policy areas as well? How should the independence from the political system be guaranteed? How should members be recruited?

We discuss these issues from a theoretical perspective and analyse the experiences of existing councils. The paper is structured as follows. As a background, Section 2 briefly reviews the actual development of government deficits and debts. To have a benchmark for the subsequent analysis, Section 3 discusses optimal debt policy. Section 4 surveys various explanations of deficit bias and what they imply for the impact of fiscal councils. Section 5 discusses how they can be constructed in practice. Section 6 provides a broad survey of how existing councils function. This survey is complemented by two case studies in Section 7: of the Swedish Fiscal Policy Council and of the Office for Budget Responsibility in the UK. Section 8 concludes.

2. Government debt developments and fiscal rules

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

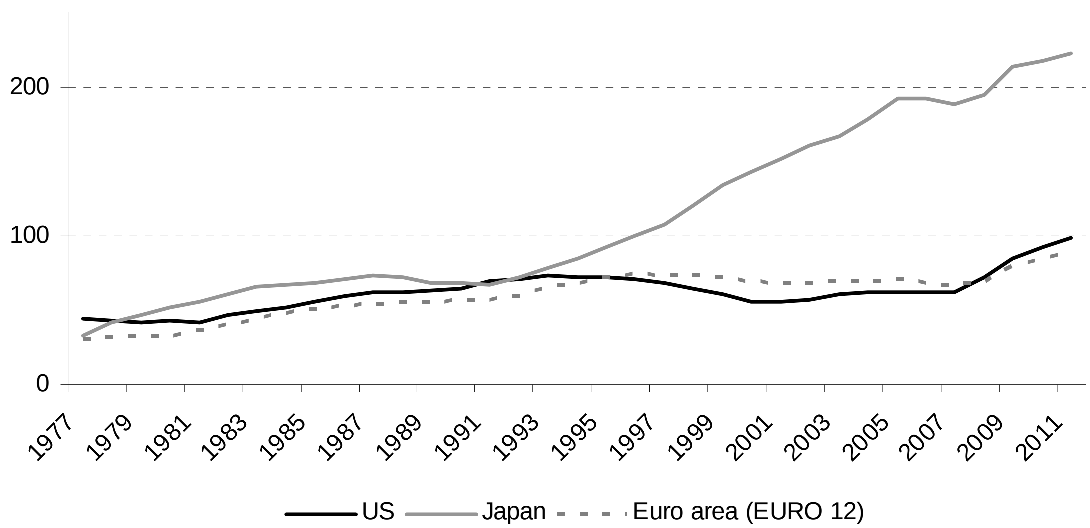
Figure 1 Government debt in the OECD area, per cent of GDP



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

The recent explosion in government debt results from a combination of automatic stabilisers being allowed to work in the recession, discretionary action to counter the recession and support to the financial sector in some countries. For the OECD area as a whole, the last years' increases in government debt stand in contrast to a stable or falling debt-to-GDP ratio in the preceding decade. The earlier development for the whole of OECD, masks, however, differential developments in various areas in previous years: debt ratios have increased in Japan and the US and fallen in the euro area.

Figure 2 Consolidated government gross debt in the euro area, Japan and the US, per cent of GDP



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

Looking further back, the most noteworthy development is the secular rise in the ratio of government debt to GDP between the mid 1970s and the mid 1990s. During this period, the gross debt ratio nearly doubled in the OECD, rising from around 40 per cent of GDP to about 75 per cent. Developments were surprisingly similar in Europe, the US and Japan. These developments gave rise to a large literature on *deficit bias*, which we summarise in Section 4. As noted in the introduction, the debt accumulation triggered the establishment of fiscal rules to rein in developments (the canonical work on how such rules should be formulated is Kopits and Symansky 1998).

The break in the trend towards higher government debt around 1995 is usually associated with the imposition of deficit, debt or expenditure rules. It is less clear whether both the fiscal rules and the budget improvements can be explained by the same political determination to impose more fiscal discipline or whether the establishment of rules have actually caused budget improvements, although some studies find evidence of the latter (for example, European Commission 2006 and OECD 2007).

The most well-known rules are probably the ones in the EU's stability pact, which was agreed upon in 1997. According to them:

- government budget deficits shall not exceed three per cent of GDP; and

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

It is obvious that these rules have not been binding. Table 1 summarises the number of cases where at least one of the two rules has been violated (the debt rule has then been given the liberal interpretation that it is followed as soon as the debt ratio falls, however small that fall is). The number of breaches from 2008 and on are not, of course, surprising given the recession, and they are also permitted according to the stability pact's escape clause which accepts temporary violations when there is negative output growth and/or "an accumulated loss of output during a protracted period of very low growth relative to potential output". What is more remarkable is the large number of breaches before 2008. In fact, there were 44 breaches out of 177 possible cases, i.e. in nearly 25 per cent of the cases. 34 of the breaches involved "old" EU members, i.e. those that were members already when the monetary union started in 1999.

Another indication of the limited impact of the rules on fiscal 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 compared to 2009 which is required to meet the government's intertemporal budget constraint (i.e. to be able to pay the interest on the outstanding debt) given current tax and expenditure rules as well as the projected demographic developments. This gives a forward-looking measure of the state of public finances where budget strains associated with an ageing population play a large role. The arithmetic average is as high as 7.4, implying that the fiscal balance must improve by 7.4 per cent of GDP on a permanent basis. Several countries lie in the 10-15 range (Czech Republic, Greece, Spain, Cyprus, Lithuania, Luxembourg, Slovenia and the UK) and Spain as high as 20.

Table 1 Breaches of the stability pact

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

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

3. Optimal debt policy and the inadequacy of fiscal rules

Until recently, most of the analysis of how to avoid deficit bias focused on fiscal rules. The academic literature on fiscal rules is much too large to survey here. Instead our focus is on why such rules have proved so difficult to sustain and enforce.

The argument for fiscal rules might run as follows. The rule embodies something close to best practice (it comes close to an optimal policy that would maximise social welfare). But governments will not always follow best practice (for reasons discussed in Section 4), so a rule has to be imposed. If they fail to stick to the rule, they will be punished in some way – perhaps by the electorate, or in a monetary union by the union as a whole. This provides an incentive to stick to the rule. The rule is useful because it easy to verify, while computing optimal behaviour and seeing how close actual policy has been to this may be much more difficult to establish.

For this argument to work, the fiscal rule must be reasonably simple, must approximate the optimal rule, and there must be an effective punishment mechanism. Our discussion here focuses on simplicity and optimality. Effectiveness is likely to be predicated on optimality. If a rule is generally seen as being seriously suboptimal, then punishment for not obeying the rule is less likely to be enforced.

It is helpful to distinguish between optimality and sustainability. Fiscal policy can be said to be sustainable if debt will not explode (or implode) in the long run. This means that the debt-to-GDP ratio tends to move to some constant long- run equilibrium level. There are likely to be infinitely many sustainable policies, some involving high long-run debt levels and others low debt levels, some involving a very gradual approach to this long run and others more rapid adjustment. Some of these sustainable policies may be viewed as quite undesirable. A rule that just ensured sustainability might be a poor rule, and as a result difficult to enforce.

3.1. Random-walk long-run debt

What is the optimal level of government debt, and how quickly should we try and get there? Suppose we start with a very basic set-up, where agents care about their children so that they in effect live forever, and we do not have to worry about different generations. To the extent that debt is financed by distortionary taxation, then if we could choose our initial debt level, we might choose a negative level, so that government spending could be financed from the interest on net assets.[1] But, if we instead inherit a positive debt level, then it would be undesirable to eliminate it, even if it was not the initial level of debt we would have chosen. This is sometimes called the random-walk steady-state debt result, but it is really just an extension of tax smoothing (Barro 1979). The result was first shown in the context of models with sticky prices by Schmitt-Grohe and Uribe (2004) and Benigno and Woodford (2003).

The result is derived in Box 1, but the intuition is straightforward. While a future with zero taxes might on its own be desirable, to achieve it we would need to raise taxes substantially now to pay back existing government debt. This policy would involve a combination of high taxes today and zero taxes tomorrow. In contrast, keeping debt constant

[1] Financial debt would be appropriate if it was used to finance public-sector capital projects, where those projects yielded a financial return. We might also use debt to finance capital projects for reasons of intergenerational equity, which we discuss below.

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. The implication is that if a shock to public finances changes the debt stock we inherit, this shock should be accommodated. As a result, the path of debt will follow a random walk, simply reflecting the past pattern of shocks.

This framework implies that debt targets applied ex post do not make sense. Instead government debt is a buffer which we should allow to be blown this way and that according to the economic wind.[2] We immediately have a problem for any fiscal rule that involves trying to achieve ex post some debt-to-GDP target, or which involves an upper bound for public-sector deficits. Neither fits easily with the random-walk steady-state result.

3.2. Departures from the random-walk result

There are several reasons for questioning the random-walk steady-state debt result. One unfortunately topical reason is if debt is sufficiently high that it attracts a default premium. Then the interest that the government has to pay is likely to significantly exceed the discount rate, and so the benefits of reducing debt will exceed the costs in terms of higher short-run taxes.

The possibility of default plays an influential role if we believe that occasionally the economy is hit by large negative shocks of the type just experienced, particularly if we require an expansionary fiscal policy to compensate for hitting a zero bound for interest rates in such situations (Wren-Lewis 2010). In such circumstances we would want to ensure that in normal times debt was well away from any level at which it might attract a default premium, to avoid getting pushed into that area if a large negative shock hit. This is a precautionary-savings motive for low debt. Asymmetric shocks, or countercyclical action when a zero bound for interest rates are hit, will also imply a departure from the random-walk result. As Mash (2010) shows, standard tax-smoothing arguments will imply the need for debt to fall in normal times in such situations.

[2] This benchmark result also explains why governments might not worry about what the optimal debt level is, even when debt targets are imposed, because the least damage is done by having a target equal to the inherited debt stock.

Box 1: The random-walk steady-state debt result

Suppose we ignore government spending, and assume debt is entirely financed by distortionary taxes. Assume also that the per-period cost of taxes is quadratic. (For example, positive income taxes distort because they discourage the supply of labour. Equally a negative income tax would be bad because it would encourage too much labour supply.) The optimal level of debt in the absence of history is clearly zero, because with no debt taxes can be zero. However suppose we actually inherit a positive level of debt $D_{-1}>0$. The optimal policy involves choosing taxes in each period to minimise discounted costs:

$$\sum_{t=0}^{\infty} \beta^t T_t^2$$

subject to

$$D_t = (1 + r_{t-1})D_{t-1} - T_t,$$

where T is the tax level, β is the discount factor and r is the real interest rate. The optimality condition for this problem is

$$\beta(1 + r_t)T_{t+1} = T_t$$

for all t. If the real rate of interest is equal to the rate of time preference, i.e. $\beta(1+r_t)=1$, taxes will be constant in every period. If debt is not to explode, this implies a constant debt level. So taxes in each period are enough simply to finance the interest payments on the inherited level of debt, and the optimal policy involves keeping debt at this level, whatever it might be.

The assumption that $\beta(1+r_t)=1$ is crucial. If instead $\beta(1+r_t)>1$, then the optimality condition could only hold in the long run if the steady-state level of taxes was zero. (This is obviously true if we do not discount at all, because in that case we just aim for the optimal long-run level of taxes.) So in this case the optimal long-run level of debt would be zero, although the optimality condition would still imply that taxes would only gradually tend towards zero. If we added a positive, but exogenous, level of government spending into the budget constraint, then the optimal long-run level of debt would be negative, so that the interest receipts on government assets rather than taxes would pay for government spending.

In overlapping-generations (OLG) models, the random-walk steady-state debt result no longer holds for two reasons. First, the real rate of interest may be above the social discount rate, which implies tax smoothing no longer holds and the benefits of reducing distortionary taxes in the furure can outweigh the short-run costs of raising those taxes (Erosa and Gervais 2001). Second, in OLG models government debt crowds out private capital, and in addition the equilibrium level of the capital stock is unlikely to be socially optimal. As a result, government debt could be used as an instrument to achieve the socially optimal level of the capital stock (although not all generations might benefit from such changes).[3]

These considerations suggest that random-walk long-run debt is a knife-edge result. First, it depends critically on the equality of interest rates with the rate of discount. If we discount at less than the interest rate, the gains from zero taxes in the future will outweigh the cost of the high taxes today, so it will be optimal to have a long-run debt target. Second, if there are *any* costs to debt being away from some particular level *beyond* the implications for taxes of paying interest on debt, then a long-run debt target re-emerges (Wren-Lewis 2010). What is much more robust is tax smoothing, or more generally the implication that sharp movements in fiscal instruments should be avoided, which in turn implies a slow adjustment towards any long-run target (see Leith and Wren-Lewis 2000 and Marcet and Scott 2008). This implies that year-by-year targets for debt and deficits will generate significant costs when the economy is hit by shocks which impact on public finances. Box 2 below gives an example of this.

3.3. The implications for fiscal rules

The above analysis has two important implications. First, the approach to any optimal debt target is likely to be very slow. Second, it will be optimal to largely accommodate shocks to debt in the short run.[4] Simple rules involving ex-post targets for debt or deficits will find it difficult to satisfy these criteria. This means that following simple rules of this kind 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

[3] The optimal long-run debt target is likely to be negative in these models. Positive government assets are probably required to eliminate distortionary taxation and still fund government spending, and with zero debt the economy is probably not dynamically inefficient, implying that capital is likely to be below its socially optimal level. See Leith et al. (2011).

[4] For similar reasons, this analysis is also likely to be compatible with using countercyclical fiscal policy when monetary policy is constrained, because the benefits of doing this will probably outweigh the costs of any delay to reaching the optimal debt target.

objective in the future, but it would not require any policy reaction. The problem with such an approach is that the incentives to achieve targets ex ante become weak. Another possibility is to design more complex rules, which are explicitly contingent on shocks that might hit the economy. Unfortunately the contingent nature of such a rule is likely to make it difficult to monitor, and it therefore may *on its own* be ineffective (see Wyplosz 2005, Kirsanova et al. 2007 and Debrun et al. 2009).

3.4. Fiscal councils and policy rules

If our argument for the inadequacy of simple fiscal rules is accepted, two questions arise. First, may the establishment of a fiscal council negate the need for rules, or can such councils be complementary to rules? Second, does the uncertainty over the optimal target for government debt have implications for the nature of any fiscal council that is created?

We noted above that a good fiscal rule is likely to be complex, because debt paths will be contingent on shocks. This immediately suggests a potential role for a fiscal council working in conjunction with a fiscal rule. If the rule is not easy to monitor, then a fiscal council can provide this monitoring service in an independent manner. Alternatively, if the fiscal rule is simple, a council could adjudicate on when departures from this rule are justified. It may also be able to provide objective advice on improving the rule, as opposed to changes suggested by a government which might be opportunistic.

A fiscal council may also help to avoid distortions that simple targets might otherwise create. Krogstrup and Wyplosz (2010) examine how aggregate budget targets may allow productive government spending to be squeezed out in favour of transfers to specific interest groups. They suggest a fiscal council could have a role in allowing precommitment at the national level to desirable productive government spending, in the context of externally imposed deficit limits.

Whether a fiscal rule exists or not, the discussion above indicated that there was no consensus about what constitutes an optimum debt target, although there is probably more agreement that adjustment towards it should be slow and contingent. The lack of consensus on optimal fiscal policy may also have important implications for the nature of any fiscal delegation. Alesina and Tabellini (2007) suggest that widespread consensus about the goals of policy is a prerequisite for the successful *delegation of decisions*. If such a consensus is lacking for optimal debt policy, then this argues against taking decisions over debt and deficits away from an elected government.

A similar argument can be used to make a positive case for *delegation of evaluation and advice*. It will be very difficult for the public alone to judge how successful a government's fiscal policy has been. A fiscal council could play a useful role in assessing whether policy has been appropriate given the shocks to the economy. It can also provide a focus for the debate about how quickly any excess debt should be reduced.

While helping the electorate evaluate government's fiscal decisions (and thereby improve the quality of those decisions) may be an important role for any fiscal council, it could also play a useful role in stimulating and summarising research. One of the striking features of delegated monetary policy is how well central banks network in processing academic research. A delegated body may be preferable to government in this role because an independent body would be better able to take an objective view of research.

4. Reasons for deficit bias

Although our discussion has suggested that there is little consensus on what is an optimal debt path, the deficit bias illustrated in Section 2 is unlikely to represent an optimal policy. There is no reason to believe that public finances in the OECD area as a whole over the last 30 years have been subject to predominantly negative shocks that could justify the strong trend rise in debt-to-GDP levels. Instead, the deficit bias appears to represent a serious departure from optimality, and may also be unsustainable.

There are a several reasons for deficit bias discussed in the literature, and that therefore could provide a case for independent fiscal institutions.[5] Below we try to isolate the key ingredients that may be involved, although in reality these may be interrelated.[6] We distinguish the following classes of explanation: (i) informational problems; (ii) impatience; (iii) exploiting future generations; (iv) electoral competition; (v) common-pool theory; and (vi) time inconsistency.

A useful question in all cases is whether these explanations apply to individuals, or involve the relationship between individuals and governments. If that deficit bias involves governments not pursuing policies that individuals would like, we need also some theory of why the electorate cannot impose their will on politicians.

We also explore whether different causes of deficit bias have different implications for the form of any fiscal agency that might be contemplated. If deficit bias results from

[5] Deficit bias is in practice closely related to pro-cyclicality. In principle fiscal policy could be pro-cyclical without exhibiting deficit bias, but in general deficit bias results in large part from a failure to control spending and tax decreases 'in good times'.
[6] This extends earlier attempts by, for example, Calmfors (2010b) and Bertelsmann and Rogoff (2010).

asymmetric information between governments and the electorate, for example, then the only form of delegation required might be to establish a watchdog that seeks to redress that imbalance. In contrast, if deficit bias reflects the deliberate exploitation of future generations by the current generation, there could be a case for delegation of actual fiscal decision.

4.1. Informational problems

One class of theories focuses on informational problems. An example is over-optimism about future growth, either by the electorate (who elect a government that reflects this optimism), or by the government relative to the electorate. Over-optimism about future growth can lead to deficit bias because future tax revenues will not be as high as is hoped. Politicians may overestimate their ability to influence the growth rate, and may pressurise civil servants to produce over-optimistic forecasts. If this is the source of deficit bias, then delegating just the forecasting process to an independent agency would be appropriate.

More generally, Maskin and Tirole (2004) talk about the danger of elected representatives ‘pandering to popular opinion’. Although this phrase is often used, it appears paradoxical, as we would normally want governments to reflect public opinion. However, a key point about representative democracy is that the electorate normally delegates decision-making to representatives, whose job it is to take ‘good decisions’ that the individual has neither the time nor the competence to make. In this sense, representative democracy presumes a lack of information on the part of the electorate, and this lack can be exploited by a government.

Voters may be unaware of what the true overall fiscal position of the government is. A government may argue, for example, that particular spending increases are affordable within existing fiscal plans, and it may be very difficult to verify whether this is the case of not. This ignorance may allow the government to increase its chances of re-election, creating a political business cycle (Calmfors 2003a). As these incentives for politicians are asymmetric (there is no similar incentive to raise taxes or cut spending), this will lead to deficit bias.

The idea here, therefore, is that voters would be able to discipline governments that allow deficit bias if they had full information, but lack of information prevents this happening. Ignorance here could take many forms. The borrowing implications of spending plans could be deliberately concealed, or moved ‘off-budget’ using accounting devices. Ignorance could reflect a belief that tax cuts ‘pay for themselves’. Or it may just be that the majority of the electorate (or politicians themselves) are not thinking in terms of an intertemporal budget constraint. Even if they are, it is often difficult to see through what requirements it places on current and future fiscal adjustments. Such lack of information might help explain the results in Alesina et al. (1998) that successful fiscal adjustments do not appear to jeopardise government popularity: if voters are made fully aware of the fiscal arithmetic, they may support short-term costs for longer-term gains. Broesens and Wierts (2009) and Dreyer Lassen (2010) show that budget outcomes tend to be more favourable in countries where fiscal policies were more transparent. If the electorate believe that politicians may spend money on prestigious projects or on particular interest groups, in ways that are hard to monitor, it may put pressure on governments to cut taxes to avoid money being wasted in this way (Alesina et al. 2008, and Andersen and Westh Nielsen 2010).

If deficit bias is due to politicians exploiting a lack of information by the electorate, then the problem may be tackled by improving the information available, rather than by taking decisions away from policy makers. If the electorate is made aware, by a fiscal council, that a tax cut is not a free lunch, it may make a more rational, informed judgment about the merits of that tax cut.

4.2. Impatience

Another possible explanation for deficit bias is impatience. This can work at the level of individuals or governments. An example of the former is where agents have hyperbolic discount functions rather than conventional exponential discount functions (Laibson 1997) With hyperbolic discounting, individuals may be reasonably patient when comparing alternatives over medium- to long-term horizons, but as choices move to the much shorter term, impatience increases. As a result, individuals' preferences are time inconsistent. Bertelsmann (2010), and Rogoff and Bertelsmann (2010) apply this idea to explain deficit bias.

A simple analogy is that we know we are overweight and should therefore eat less (the budget deficit is too high), but when a waiter offers us tempting desserts at a restaurant (a tax cut or additional spending today), we cannot resist. To pursue this analogy, just as the presence of a partner at the restaurant reminding us that we are overweight and how we had resolved to eat less can be effective in changing our decision, so a fiscal council may be useful in helping the electorate resist the short-term temptations of tax cuts or additional spending. Such a story on its own is not enough to justify a fiscal council, because governments could equally well play such a role. Perhaps they do not do so because of elections: a government that persuades us to resist short-term temptations may not be popular and may therefore get voted out of office, while a fiscal council does not have the same concern.

A more common explanation for why impatience might lead to deficit bias involves governments discounting at a higher rate than the electorate. The underlying reason why governments might be more impatient is the possibility of individual politicians losing office in elections. As noted in Section 3, a benchmark result is that optimal long-run debt follows a random walk. What if the fiscal policymaker is a little more impatient than the private sector? Box 2 shows how this can lead to a steady increase in debt following an adverse shock to the public finances.

While this particular account of deficit bias is appealing because it implies, after a shock that has increased debt, a gradual rise in debt of the type that has occurred over the last few decades, it requires something more to become a complete explanation. This is because using the same analysis, a shock reducing debt would produce steadily declining debt. This problem of symmetry may be overcome by starting the analysis from a distorted situation, where there is an underlying temptation to reduce taxes. To be complete, such a theory would also need some reason why the electorate cannot discipline impatient politicians by voting them out of office. Here we may simply note that elections are fought over a multitude of issues, of which aggregate fiscal policy is just one, so possible discontent with fiscal policy may not be enough for the electorate to vote for a change in government.

4.3. Exploiting future generations

One argument examined by Maskin and Tirole (2004) for delegating decisions to unelected representatives is that it might avoid minorities being exploited. In the case of fiscal policy there is an obvious group who could play the role of a minority, and that is children and the unborn. If the existing electorate does not care sufficiently about future generations, then they may elect governments that behave in the mildly myopic manner illustrated in the simulations in Box 2. Debt allows the current generation to take resources from future generations (Musgrave 1988).

The exploitation of future generations may be direct or indirect. It is direct if taxes are cut today, and paid for by future generations. It is indirect when additional government debt crowds out capital. Although the latter will not occur if agents internalise the welfare of future generations (agents are Ricardian), it is still possible to argue that direct exploitation can happen in this case, because the utility of future generations is being discounted relative to the current generation. Stern (2006) argued in the context of climate change that the utility of future generations should only be discounted because there was a probability that they would not exist.

Why would delegating fiscal decisions to unelected representatives help avoid this intergenerational transfer? Maskin and Tirole (2004) argue that officials want to leave a legacy. In that sense, they will care about what future generations will think of them. This motive does not apply to the current generation as a whole, because each member of a generation is small, and therefore their contribution to a generation's legacy is inconsequential. Equally a politician's legacy will be multi-faceted, and therefore her interest in any particular aspect of it is limited, compared to the members of a fiscal council.

4.4. Electoral competition

Implicit in the impatient government story is that the electorate is unable to elect a more patient government. A story that looks similar, but where government preferences are perfectly aligned with those of a section of the electorate, concerns competition between two political parties in a democracy. Here, parties can differ in their preferences either over types of public goods or over the size of government, and these parties fully reflect the preferences of their section of the electorate. This set-up was originally formalised by Alesina and Tabellini (1990) and Persson and Svensson (1989).

In this theory, governments do not fully internalise the cost of debt, because those costs may be borne by an opposing party if the government is not re-elected. It may be advantageous for a government to increase debt to constrain the actions of a future government with different political preferences. In this framework, each party would show no undue impatience if it could be certain to be in power forever. The apparently short-sighted behaviour comes from the fact that it might not be in power in the future. But here the apparent impatience entirely reflects the wishes of the section of the electorate that the party in government represents.

An issue with these original formulations is that they used real models, so that all government debt was in real terms. In reality most government debt is in nominal terms. This fact could fatally undermine these models of deficit bias if prices were not sticky, because governments could simply alter the level of debt by using surprise inflation (assuming monetary policy was not delegated to an independent central bank). Then, debt cannot be used strategically to influence spending by future governments, so no debt bias will arise on this account. Of course inflation is not costless, so an important question is whether the combination of nominal debt and sticky prices can recreate the use of debt as a strategic variable. Leith and Wren-Lewis (2009) suggest the answer is yes, but the size of the resulting deficit bias may not be large. Instead the main costs involved in having competing political parties appears to involve a political business cycle, where in particular alternating between governments that like a big or small state causes significant costs to social welfare through cyclical movements in inflation and output designed to influence the level of debt.

Although Roubini and Sachs (1989) find some empirical support for the idea that uncertainty of re-election is associated with deficits, Krogstrup and Wyplosz (2010) suggest that common-pool theories (see, for example, Weingast et al. 1981, von Hagen and Harden 1995, Eichengreen et al. 1999, and Velasco 2000), to which we now turn, have greater empirical backing.

4.5. Common-pool theory

As public projects or tax cuts may favour relatively small groups, those groups lobby for these with insufficient regard to the full budgetary costs now as well as in the future. Often common-pool theories focus on the fact that many decision makers (e.g. spending ministers) may be involved in formulating budgets, and these decision makers fail to internalise the overall costs of higher spending and debt. Tornell and Lane (1999) suggest that this effect may become stronger in ‘good times’, thereby linking deficit bias with pro-cyclical fiscal policies.

One of the potential strengths of this theory is that it suggests a direct link between different types of institutional set-up within government and the extent of deficit bias. Several studies have found empirical support for the idea that common-pool problems play a role in deficit bias. Roubini and Sachs (1989) found a tendency for more fragmented government coalitions to run larger budget deficits. This result finds support in Fabrizio and Mody (2006), although they also find that arrangements that provide checks to these pressures can be effective. A number of studies of US states have found public spending pressures associated with political fragmentation (see Besley and Case 2003, for example).

Representative electoral systems are likely to be more subject to common-pool problems than those based on majority rule. Persson and Tabellini (2004) do indeed find that majoritarian systems are associated with greater fiscal discipline than are proportional systems. In countries with ideologically dispersed coalitions, Hallerberg et al. (2009) find that multi-year targets increase fiscal discipline.

Although the empirical evidence that common-pool problems encourage deficit bias is strong, it would probably be a mistake to conclude that institutional environments that address these problems would be immune to deficit bias. Hallerberg and von Hagen (1999) outline how a strong finance ministry can reduce deficit bias. Over the last decade, the UK had a period in which the finance minister (Gordon Brown) had unprecedented power and imposed strict fiscal rules, all within a majoritarian system of government. Despite this, the UK has also been subject to apparent deficit bias.

Common-pool theory suggests how a fiscal council with no formal power might nevertheless be effective at reducing deficit bias. The recommendations of a council could strengthen the authority of a finance minister in any negotiations. In more fragmented political systems, the recommendations of a fiscal council could form the basis of contracts between political actors that in effect internalised fiscal discipline. (This is discussed in Section 6 in the context of the fiscal councils in Belgium, Netherlands and Austria.)

4.6. Time inconsistency and inflation bias

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

If fiscal policy can be used to raise output and inflation in the short run, does this necessarily also lead to deficit bias alongside inflation bias? If inflation is forward-looking and agents are rational, simply the possibility of government action can lead to an equilibrium where there is no longer an incentive for governments to try and increase output. At that equilibrium, we have inflation bias but output is at its natural rate. There is no requirement that the policy instrument has actually moved in a more expansionary direction.

If demand is a function of both real interest rates and fiscal policy, the combination of a fiscal authority that desired higher than natural output and a more conservative central bank might lead to an outcome where budget deficits were offset by high real interest rates. As Castellani and Debrun (2005) note, institutional change that reduces inflation bias through monetary policy might encourage inflation bias through fiscal policy with an associated deficit bias. In Agell et al. (1996), a discretionary equilibrium exists where both inflation bias and deficit bias are present, and the government would be better off committing to budget balance and inflation at target.

If we move away from fiscal policy as a stabilisation tool to optimal debt policy, is there a link between inflation bias and deficit bias? Leith and Wren-Lewis (2007) show that the random-walk long-run debt policy is time inconsistent, if either debt is nominal or prices are sticky. The source of the time inconsistency with sticky prices is the forward-looking Phillips curve, just as it can be for inflation bias. However, they also show that this time inconsistency does not lead to deficit bias: instead, the time-consistent optimal debt policy can involve a rapid return to a debt target.

4.7. The potential contribution of fiscal councils

The discussion above suggests there is no shortage of explanations for deficit bias. Equally, there is reason to expect that in reality different stories may apply at different times or in different places. This may be important in assessing what contributions fiscal councils can make. One of the points we will note below is that such bodies differ substantially across countries, and in some cases (see the UK case study in Section 7.2) this clearly reflects views about what was important in generating deficit bias at a particular time.

Evaluating which explanations for deficit bias matter may be important for another reason. At present, as shown in Section 6, all existing fiscal councils are advisory, but a number of economists have suggested that such bodies could go a stage further, and impose overall deficit levels on governments. (Debrun et al. 2009 describe such bodies as ‘Fiscal Policy Authorities’, and they are also sometimes referred to as ‘Fiscal Policy Committees’, with obvious parallels to the delegation of monetary policy.) The extent to which 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, it would not change anything. Hence, there is a strong argument for giving an independent fiscal policy authority decision-making power, so that it can implicitly represent the welfare of future generations. But if bias reflects deficiencies in information, then a fiscal council playing a watchdog role may be sufficient. The nature of the informational problem may also have implications for what the fiscal council does, as the contrast between our two case studies in Section 7 suggests.

Box 2. The implications of an impatient fiscal policy maker*

Suppose both monetary and fiscal policy makers have as an objective to maximize social welfare, but whereas the monetary authority discounts at the same rate as the private sector at 4% per annum, the fiscal authority is more impatient, discounting at 6% per annum. We consider only one fiscal instrument, government spending, but deviations away from the initial level of government spending are costly for welfare because of over/under provision of public goods. Figure 3 plots the reaction of the fiscal instrument and debt to a cost-push shock, starting from an efficient steady state, and compares it to the reactions to the same shock when the fiscal authority has the same rate of time preference as the private sector.** The solid line represents the latter case, and this outcome follows the random-walk result, discussed in Section 3. The dashed line represents the outcome in the case when the fiscal policy maker has a higher discount rate. In this case, debt steadily increases, and does not (and will not) reach a stable long run level. ***

* This analysis is taken from Kirsanova et al. (2007), and uses the closed-economy model of Leith and Wren-Lewis (2007).
** The technical assumption is one of a Nash game, where each player optimises taking the actions of the other player as given.
*** Although this solution is explosive (as inspection of eigenvalues confirm), the rate of increase in debt is less than the rate of discount, so welfare costs are still finite. As a result, optimal paths can be computed, although with qualifications related to linearisation. With stronger discounting, the increase in debt and other macro variables would explode more rapidly, and the social costs of this could be infinite.

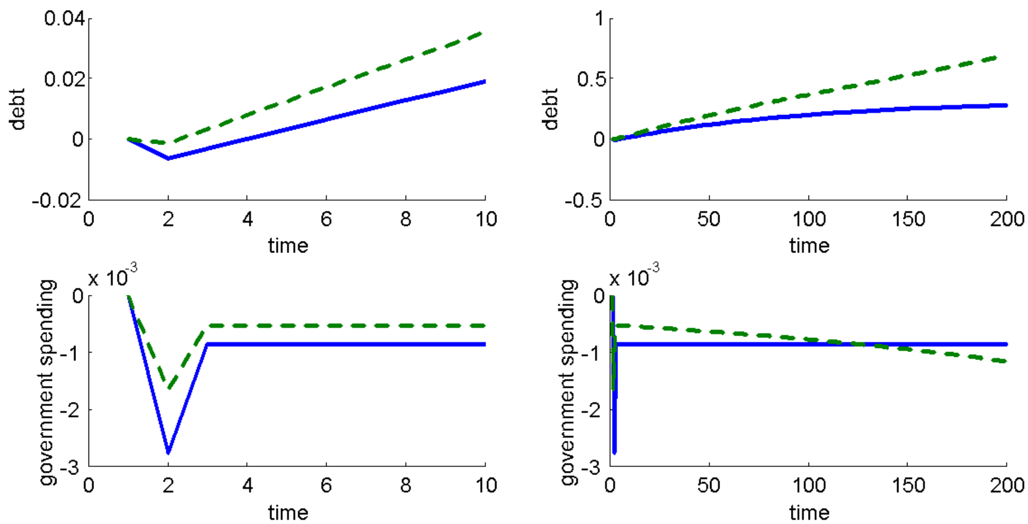
The reason is straightforward. The cost-push shock raises inflation, and the monetary policy maker raises interest rates to moderate this increase. This raises debt interest payments, and government debt increases as a result. Government spending needs to fall to provide funds to service the higher debt level. Impatience by the fiscal authority means that it cuts spending by less than is required to prevent the debt stock exploding. Although larger spending cuts will eventually be implemented, mild myopia means that these future cuts are valued less than smaller cuts in spending in the short term.

Although this result seems natural once it is recognised that the socially optimal response with a non-myopic fiscal policy maker is a random walk in debt, the simple intuition ignores the actions of the monetary policy maker. For the latter, explosive debt is costly, because it is maximising social welfare. In principle, it can use monetary policy to influence the budget deficit to prevent the explosion in debt happening. However, when the fiscal authority is short-sighted, it is not optimal for the monetary authority to reduce interest rates *sufficiently to prevent* an explosion in debt. (Of course, any attempt by the monetary authority to do so would encourage an even looser fiscal policy, so it is a game it may not be able to win.)

Kirsanova et al. (2007) also show that the welfare cost of the cost-push shock when the fiscal policy maker is impatient is almost double that under a completely benevolent policy (i.e. with random-walk long-run debt). However, a policy that imposed a debt target that had to be achieved quite rapidly could involve an even greater social loss. So, strict debt targeting to disarm a mildly impatient fiscal policy maker could produce a cure worse than the disease.

Could we incorporate a fiscal council into this analysis? Suppose we could approximate the political pressure exerted by a council by introducing a term in excess debt into the objective maximised by the fiscal authority. Kirsanova et al. show that if the council could exert just the right degree of pressure, this could make the fiscal authority act almost as if it had the same rate of time preference as the private sector, and so come very close to producing the first-best outcome. This is one illustration of the point made in Section 3 that by applying greater discretion a fiscal council can produce better outcomes than simple rules.

Figure 3 Debt following a cost-push shock under optimal cooperative policy and under a non-cooperative (Nash) game with myopic fiscal policy makers



Note: Solid line = cooperation, dashed line = Nash. Time is measured in quarters.

5. Issues when setting up a fiscal council in practice

The preceding section has analysed *theoretically* why independent fiscal institutions can contribute to more fiscal discipline. Setting up such institutions, however, raises a number of *practical* issues, which are discussed in this section. We focus on fiscal councils, i.e. institutions without decision-making power, as these are the only ones that have been established so far.

5.1. The remit of a fiscal council

A first question is how exactly to define the remit of a fiscal council. Our analysis in Sections 3 and 4 suggests the following list of possible tasks:

- Ex-post evaluation of whether fiscal policy has met its targets in the past.
- Ex-ante evaluation of whether fiscal policy is likely to meet its targets in the future.
- Analysis of the long-run sustainability and optimality of fiscal policy.
- Analysis of fiscal transparency.
- Costing of various individual government policy initiatives.
- Macroeconomic forecasting.
- Normative recommendations on fiscal policy.

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

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

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

Another contentious issue is whether a fiscal council should do macroeconomic forecasting. An obvious argument in favour of this is that overoptimistic government forecasts have often been used to mask profligate fiscal policy, as discussed by for example Jonung and Larch (2006). But forecasting is resource-intensive, so this task increases the resource requirements for a council considerably. There is a potential risk that forecasting crowds out other activities at the council. Another problem might be that forecasts are wrong most of the time – and sometimes very wrong – so engaging in this activity could weaken the council's credibility and make it harder to fulfil other tasks (Wren-Lewis 2010a, Calmfors 2010b). An alternative is that the council only monitors the government's forecasts (possibly both ex ante and ex post). How desirable it is that a council should do forecasting will depend in part on whether there exist other independent institutions performing this task.

Should a fiscal council undertake only positive analysis or should it also engage in normative analysis? The minimum positive analysis is to analyse the consequences of the policy chosen by the government only. A more ambitious approach is to spell out the consequences of alternative policies as well. Finally, a council could give outright recommendations on which policies to follow. These issues involve difficult trade-offs. On one hand, normative recommendations could compromise the positive analyses and thus reduce their credibility. 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 normative policy conclusions, thus lessening the impact of the council's analysis on actual policy (Debrun et al. 2009). Normative recommendations give a clear benchmark with which to compare government policy. Clearly, it would be inappropriate for a council to give normative recommendations based only on its own members' value judgements. But it is another matter if the political sphere has specified clear objectives and the council strictly bases its recommendations on them. There might still remain a problem if political objectives conflict, but then a council could still make a useful contribution by making normative recommendations based on a transparent weighting of different objectives.

5.1.1. Broader tasks for a fiscal council?

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

But there are also good arguments in favour of broader tasks. A first argument has to do with the strong interaction between fiscal sustainability and employment. To the extent that employment can be raised, fiscal policy is more likely to be sustainable. Future employment increases lessen the need for budget cuts now (pre-funding) to prepare for future age-related increases of expenditures and reductions of the tax base. Indeed, it has been shown that assumptions on future employment developments is a key factor in fiscal sustainability calculations (Finanspolitiska rådet 2008, Swedish Fiscal Policy Council 2009).

A second argument is that deficit bias can be seen as a manifestation of the more general problem of too little analytical input, or at least of too little attention being paid to such input, in the political process at large (Calmfors 2009). This motivates efforts to increase the amount of such input also in other economic-policy areas than fiscal policy. If a fiscal council with a solid reputation is established, there might be more policy impact from letting the council evaluate also other policies than from having a host of different evaluating agencies in various areas which the public may have difficulties to identify. At least in a small country, it might also be difficult to fill a multitude of independent evaluating institutions with sufficiently competent staff (Calmfors 2010b).

5.2. Independence

There is a consensus in the academic discussion of fiscal councils on the need for independence from the political system. This follows directly from the starting point that deficit bias arises from distortions in the political system that a council should be designed to counteract.[7]

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

- Outright prohibitions, both against the government interfering with the institution's on-going work, and against the institution taking such instructions from the government.
- Long and non-renewable periods of office for the institution's decision-making body.

[7] See, for example, von Hagen and Harden (1994), Blinder (1997), Wyplosz (2002, 2005), Calmfors (2003, 2005, 2010b), Wren-Lewis (1996, 2003) and Kirsanova et al. (2007).

- Restrictions on the government's freedom to fire the members of the institution's decision-making body.
- A long-term budget so that budgetary pressures cannot be used to influence the institution in an improper way.
- Appointment procedures that seek to guarantee professionalism – and not political preferences – as the ground for appointments.

The choice of principal for a fiscal council can also be of importance for its independence. The council could formally be an agency under the government, but it could also be an agency under the parliament. The latter arrangement is a way of signalling independence from the government. But this arrangement could cut two ways. On the one hand, it would make 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 who are more exposed in the media.

The composition of a fiscal council can also influence its independence – as well as of course its professional capacity. The argument for excluding active politicians is obvious. There are at least four possible pools of people from which council members could be recruited:

- Academic researchers
- Public-finance experts from various parts of the government administration
- Analysts in the financial sector
- Ex-politicians

Because academics' main arena is another one than politics and government administration, their judgements are likely to be less affected by political concerns than those of most other groups. There would be a high reputational cost in the academic arena for researchers who were seen to be acting in a political way in a fiscal council rather than making research-based judgements.[8]

Academics may not, however, have the expert knowledge of government budgets and government accounting necessary to make detailed assessments of budget bills. This is an

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

argument for also including public-finance experts with a background in government administration. But there is a risk that they are to a larger extent than academics influenced by concerns over future career possibilities in government administration. An alternative are analysts from the financial sector. They are not likely to be influenced by concerns regarding a future government administration career (since this would in all likelihood involve a drastic pay cut). A disadvantage with them might, however, be loyalties to earlier or (expected) future employers in the financial sector.

A final possibility is to include a minority of ex-politicians with practical experience of economic-policy making. The presence of well-known former politicians, in addition to economic experts, may be important for the legitimacy of a fiscal watchdog, and thus for its independence. This presupposes, of course, that the ex-politicians are really ex.

The amount of resources and the tasks of a fiscal council are also of importance for the actual independence of a council. Independence could be jeopardised if the council is not provided with sufficient resources but has instead to draw on the resources of the ministry of finance. If a council has forecasting tasks, the way they are executed can also have implications for its independence. There could be a risk in particular if the council provides the official forecast in the government's budget bill, as this requires continuous interaction with the ministry of finance.

Another risk derives from the fact that, especially in a small county – almost – everybody in a field such as economic policy analysis knows each other. When evaluating government policy, council members are thus likely to be evaluating people they have worked or studied together with. This may create a psychological bias to be "too kind". A partial remedy to this problem may be to recruit some foreign members to the council.

5.3 Why does a watchdog need official status?

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

1. Having an official status does give more influence. Since there are many players competing for media attention, an official status gives an edge. It is more difficult for a government to ignore a body it has itself set up than bodies set up by others. Influence in the long term must, however, mainly build on the reputation that can be

built up over time only through analysis that is perceived as impartial and of high quality.

2. An official council can be given a formal role in the budget process, such that an arena for repeated exchange between politicians and civil servants on the one hand and council members on the other hand is created. This can be done in several ways: through the provision of forecasts and analytical input to be used in the preparation of the budget, through explicit policy recommendations to the government at some stage, through evaluation of government proposals or through regular hearings in the parliament.
3. Another motivation for having an official fiscal watchdog may be to commit independent academics and other economic experts to a sustained and consistent participation in the fiscal policy discussion. With increasing research specialisation and increasing requirements on academic publishing, it is becoming gradually more difficult to get academics to set aside time for participation in the economic policy debate. The establishment of a fiscal council can be seen as an institutional arrangement to re-direct academic talent to fiscal-policy evaluation (Calmfors 2010a, b). An analogy is the increased academic interest in monetary policy associated with, and partly following, the establishment of independent central banks.

6. Overview of existing fiscal councils

This section analyses how the trade-offs discussed above have been handled by existing fiscal councils. We give an overview of key features of these institutions. There exists a multitude of institutions involved in fiscal analysis in various countries. It is not obvious which should qualify as fiscal councils. We have used three requirements for qualification:

- The institutions should not just be public research or forecasting institutes, but have a clear fiscal watchdog function.
- The institutions should have macroeconomic competence, which means that pure auditing institutions are excluded, even though they fulfil an important watchdog function regarding fiscal reporting and transparency.
- The institutions should have a high degree of independence and not just be part of the ordinary government administration working under usual political control.

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

6.1 Tasks of fiscal councils

The tasks of the eleven fiscal councils are summarised in Table 2. They are all involved in the core activities of ex-post and ex-ante evaluation of fiscal policy and in fiscal sustainability analysis. The institution with the least activity of this type is the German CEE: it does monitoring of 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.

A key issue – which we discussed in Section 4 – is whether a fiscal council should act as a substitute for a fiscal rule (allowing more discretion in fiscal policy making, as suggested by Wyplosz 2002, 2005) or as a complement to it (monitoring the adherence to the rule). The table indicates that fiscal councils in practice serve as complements to rules. The only exception is the US where no fiscal rule is currently in place.

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

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

The risk that forecasting on the part of a fiscal council could expose it to government pressures 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. In the UK, the forecasts of the interim OBR in connection with the first budget of the new government that took office in 2010 were criticised for being too benign to the government. This is discussed in more detail in Section 7.2.

The breadth of the remit varies considerably. The remit is limited to fiscal policy in Austria, Belgium, Canada, Hungary and the UK. But in the majority of cases the remit includes other issues as well. In Slovenia these additional issues only play a minor role, but evaluation of employment, growth and other structural policies are major tasks in Denmark, the Netherlands and Sweden. So are they in Germany, but this is to be expected since fiscal policy evaluation was not mentioned as an important task in the original remit of the CEE. 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 and the PBO in Canada undertake fiscal analysis of particular spending projects, which can be highly influential (such as the CBO's analysis of the recent US health care reforms). The Swedish FPC represents an outlier in the sense that it is instructed also to examine the explanations provided by the government for its policies (see Section 7.1).

The practice with respect to normative recommendations is also diverse. It is the explicit policy of six out of the eleven councils only to provide positive analysis and not to give normative recommendations. One example is the CBO in the US, which on its website specifies its remit as providing the Congress with “objective, non-partisan and timely analysis to aid in economic and budgetary decisions” and “the information and estimates required for the Congressional budget process”. Another example of only positive analysis is the Dutch CPB, which states on its website that “the result of an analysis will never be a straight recommendation on a particular course of action”. Like the CBO, the CPB sees its task as describing policy trade-offs. The most extreme case of positive analysis is the OBR in the UK, which is explicitly forbidden to undertake any analysis of policy options. In contrast, the councils in Austria, Belgium, Denmark and Sweden make normative recommendations (on the basis of the economic objectives decided by the political system). Germany is an in-between case: the CEE is instructed not to give recommendations on specific policy measures, 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 performed. They may include forecasting, analysis of broader issues and normative recommendations in addition to strictly positive analysis. There is no clear-cut pattern in how these additional tasks are combined. Forecasting may be done by a council making normative policy recommendations (Denmark) or by ones confining themselves to only strictly 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). It seems reasonable to relate the great diversity on the task of existing fiscal councils to the range of possible reasons for deficit bias discussed in Section 4.

6.2 Resources, composition and independence of fiscal councils

Table 3 gives information on resources, composition and independence of fiscal councils. The amount of resources varies to a very large degree. At one extreme are the councils in Slovenia (with no staff of its own but with the right to draw on the resources of the government) and Sweden (with a secretariat of only four persons). At the other extreme are the CBO in the US (with a staff of 230 persons) and the CPB in the Netherlands (with a staff of 170 persons). Most of the other councils have secretariats of the order of magnitude of 15-40 persons. There is no clear relationship between the scope of the remit and the size of the staff. The CBO's remit focuses mainly on fiscal policy but it has the largest staff, the FPC in Sweden has perhaps the broadest remit but one of the smallest secretariats. This should not be surprising since assessment of broader policies can be made in both a more overall manner and a more detailed way. Possible conclusions are that when macroeconomic forecasting and costing of individual government initiatives are among the tasks, a minimum level of staff is required and that the size of this staff can expand very much depending on how detailed judgements are being made.

The number of council members differs among the various institutions. On one hand, there are institutions that are managed like ordinary government agencies with a director or board of directors at the helm (the CBO in the US, the PBO in Canada and the CPB in the

Netherlands). On the other hand, there are "proper" councils consisting of a number of members. These range from three or four in Hungary, Denmark and the UK, over seven or eight in Sweden and Slovenia up to twelve in Belgium and 14 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 and they did so previously in Hungary.[9]

Austria and Belgium differ from the other countries since the academic element is much smaller there. Instead, councils in these countries are dominated by public-finance experts from the government administration. This could be related to the fact that these councils do not only fulfil a fiscal watchdog function but also play a role in providing an input to political consensus building. Academics may be less suited for this task when the remit also includes giving normative recommendations, as is the case in Austria and Belgium. If the remit only includes positive analysis, academics may be more suited to contribute to consensus building. This is illustrated by 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. It is to be noted though that having Parliament as the principal did not shield the PBO from political interference in Canada: according to Page (2010) the budget of the PBO 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. Similarly, as noted below, after having criticised the government's budget Hungary's Fiscal Council was transformed into a more toothless body in 2010 despite being an agency under the parliament.

An important observation from Table 3 is that formal arrangements to guarantee independence from the political system are far less common for fiscal councils than for central banks. Periods of office are in most cases much shorter for council members than for members of the executive boards (monetary policy committees) of central banks. The period of office is five years in Belgium, Canada, Germany, Slovenia and the UK. In Denmark the period of office is three years, which it also was initially in Sweden (but where the period of

[9] This was not, however, the case in the initial interim OBR in the UK working between May and October 2010.

office applying at the moment is only one year). One possible motivation for the shorter periods of office for fiscal council members than for members of central banks executive boards could be the strong arguments for recruiting active academics (see Section 5.2) and the difficulties of making them sign up for long periods of office.

Another possible reason for short periods of office is that the issue of independence may not have been given as much attention for fiscal councils as for central banks. This interpretation receives some support from the fact that there are in most cases no restrictions on the renewability of periods of office. Moreover, council members can formally be fired at will by the principal. (The only exception is the OBR in the UK where the consent of the Treasury Select Committee in the Parliament is required). Independence in several countries is also undermined by the fact that the Ministry of Finance provides staff: this is the case in Belgium, Slovenia and (initially) the UK. In Austria, staff is instead provided by the central bank, which ensures independence from the Ministry of Finance but instead raises the potential problem of too close a relationship with monetary policy makers.

The lack of formal safeguards for the independence of fiscal councils means that they – much more than central banks – have to rely on the *informal* independence they can acquire through building a reputation for impartial and well underpinned analysis. This will usually take time. For this reason, it is no surprise that various surveys point to a large degree of such informal independence combined with large influence 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). It is also interesting that both The CBO and CPB have advisory boards. Such a board can act as a useful buffer between the government and the council, protecting its independence, and it can also help evaluate the activities of the council itself. The success of the German CEE, which is also an old institution, however appears much more in doubt.[10]

An instructive example of the precariousness of newly established fiscal councils is provided by the Fiscal Council in Hungary. After only two years of existence, it had its secretariat taken away and was transformed into a more toothless body (composed of a chair nominated by the President of the Republic, the governor of the central bank and the director of the National Audit Office). This occurred after the council had criticised the government's budget for overoptimistic assumptions and lack of transparency.

[10] For example, von Hagen (2010) provides the harsh judgement that the German council lacks visibility and respect by the government and professional peers with the result that reports and recommendations do not catch much public attention.

Table 2 Tasks of fiscal councils

	Forecasting	Costing of policy initiatives	Evaluation of fiscal transparency	Ex-post evaluation of fiscal policy	Ex-ante evaluation of fiscal policy	Complement to fiscal rules	Evaluation of fiscal sustainability	Normative recommen-dations	Analysis of broader issues
Austria (Government Debt Committee 1997)	X			X	X	X	X	X	
Belgium (Public Sector Borrowing Requirement Section of the High Council of Finance 1989)[1)]				X	X	X	X	X	
Canada (Parliamentary Budget Office 2008)	(X)[2)]	X[3)]	X	X	X	X	X		
Denmark (Economic Council 1962)	X			X	X		X	X	X[4)]
Germany (Council of Economic Experts 1963)	(X)[5)]		(X)	(X)[6)]	(X)[6)]	(X)[6)]	(X)[6)]	(X)[7)]	X[6)]
Hungary (Fiscal Council 2008)	X	X	X	X	X	X	X		
Netherlands (Central Planning Bureau 1947)	X	X	X	X	X	X	X		X[8)]
Slovenia (Fiscal Council 2010)	(X)[9)]		X[10)]	X	X	X	X		(X)[11)]
Sweden (Fiscal Policy Council 2007)	(X)[12)]		X	X	X	X	X	X[13)]	X[14)]
UK (Office for Budget Responsibility 2010)	X			X	X	(X)[15)]	X		
US (Congressional Budget Office 1975)	X	X		X	X		X		X[16)]

Notes: The year given in the first column indicates when the institution was first set up. 1) The Public Sector Borrowing Requirement Section forms part of the High Council of Finance, which was established already in 1936. The council as a whole is chaired by the Minister of Finance, but the Public Sector Borrowing Requirement Section has an independent standing. 2) Not own forecasts, but analysis of government forecasts. 3) On request from a parliamentary committee or a parliamentarian. 4) Analysis of tax, employment and other structural policy as well as environmental policy. 5) Not own forecasts but description of current economic situation and its foreseeable development. 6) Fiscal policy is not specifically mentioned in the mandate, which is to assess overall economic developments and to help economic policy makers at all levels as well as the general public to arrive at informed judgements on economic matters. The economic-policy objectives explicitly mentioned in the Council's mandate are stability of the price level, a high rate of employment and equilibrium in foreign trade and payments together with steady and adequate economic growth. The analyses should also focus on distribution of income and wealth. 7) According to the Council's mandate recommendations of specific policy measures should not be given. But in practice this seems often to de done. 8). Analysis of a broad range of economic.

issues including tax, employment and regulatory policies as well as resource depletion and financial crises. 9) 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. 10) This includes an explicit remit to provide an assessment of the adequacy of set fiscal objectives with the median-term fiscal framework. 11) In addition to other tasks, 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. 12) Not own forecasts but the Council is instructed to evaluate the quality of the government's macroeconomic forecasts and the models on which they are based. 13) The Council's formal remit does not include normative policy recommendations, but the Council itself has established the practice of sometimes giving such recommendations on the basis of the policy objectives formulated by the government and the parliament. 14) In addition to the task of assessing whether the government's fiscal objectives are being achieved, the terms of reference include the tasks of evaluating whether economic developments are in line with healthy long-run growth and sustainable high employment, and of examining the clarity of the government's budget proposals and the grounds given for various policy measures. The council should also work to increase public discussion in society of economic policy. 15) At present there exists no policy rule like the earlier golden rule and the sustainable debt rule, but the government has specified a multi-annual budget consolidation plan. 16) In addition to fiscal and budgetary analysis, the CBO has recently adopted, for example, labour market developments, employment policy and climate policy.

Table 3 Members, independence and resources of fiscal councils

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

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

7. Two case studies

To further highlight how fiscal councils can work we do two case studies: of the FPC in Sweden and of the OBR in the UK. Section 6 showed that the two councils differ in a number of respects. The FPC does not make forecasts, it has a broad remit, it gives normative recommendations and works at arm's length distance from the Ministry of Finance. In contrast, the OBR makes forecasts, it has a narrow remit limited to fiscal policy only, it does not analyse alternative policies and it has been 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.

Figure 4 General government net lending in Sweden, per cent of GDP

Source: 1980-1993 OECD, 1993-2012 NIER.

Sweden faced a fiscal (and financial) crisis in the first half of the 1990s of similar proportions as the ongoing crises in, for example, Ireland, Spain, the UK and the US (see Figure 4). Sweden got out of its crisis through a tough consolidation programme which turned a fiscal deficit of 11.2 per cent of GDP in 1993 to a surplus of 3.7 per cent in 2000 (see, for example, Henriksson 2007).

The budget consolidation was followed up by the establishment in the late 1990s of a new fiscal framework with four pillars:[11]

- A *top-down approach* for the central government budget. The Parliament first decides overall expenditures and their allocation among different expenditure areas. Once this is done, it is not possible to increase a particular expenditure without cutting down other expenditures within the same area.
- A *surplus target* for government net lending of one per cent of GDP over a business cycle.
- An *expenditure ceiling* for central government, which is set three years in advance.
- A *balanced budget requirement* for local governments.

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

The idea of a fiscal council in Sweden was first raised in the discussion on whether the country should join the euro. The issue was – for the foreseeable future – settled in a referendum in 2003, which decided against the euro. Before the referendum, a government commission analysed the requirements on fiscal policy in the event of euro membership. The commission worried that fiscal policy would be too lax in upswings, leaving no room for stimulus in downturns. To counter that risk, the establishment of an independent council, which would give the government recommendations on fiscal policy, was proposed (Swedish Government Commission on Stabilisation Policy in the Event of EMU Membership 2002).[12]

The idea of a fiscal council did not go down well with the Social Democratic government at the time. It was received more positively by the liberal-conservative opposition. The then chief economist of the Moderates (the Swedish Tory Party), Anders Borg, endorsed the proposal (Borg 2003). When becoming Minister for Finance after the liberal-conservative election victory in 2006, Borg was the driving force behind the setting-up of the FPC. The council was presented as an important addition to the already existing fiscal framework that would help further safeguard fiscal discipline. Hence, one can see the establishment of the council as resulting from the same

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

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

determination to avoid fiscal crisis in the future as explained the introduction of the fiscal framework in the late 1990s.

As discussed in Section 6.1, the FPC's remit is very broad, encompassing not only analysis of fiscal policy, but also of employment and growth as well as monitoring of the motivations given by the government for its policies. The tasks are specified in Box 7.1. Why was this broad remit chosen? It was probably important that employment ten years after the 1990's crisis was still far below earlier levels and that the liberal-conservative parties had made employment their main issue in the 2006 election campaign. The government may also have seen a likely political gain from an expected endorsement by the council of its employment policies, since they included several measures recommended by Swedish economists (some of them being appointed members of the FPC). Among these measures were the introduction of an earned income tax credit, reform of unemployment insurance, more focus on job search activities and less on labour market training in active labour market policies, a narrower gateway into sickness insurance and early retirement, and tax deductions for household services.

It is more difficult to explain why the FPC was given the task of examining the transparency of the government's policy documents and the grounds for policy proposals. This had not been proposed in the international academic discussion and was not one that any of the earlier existing institutions with fiscal watchdog tasks had. A possible explanation might have been a desire to "institutionalise" the strong Swedish tradition of heavy involvement in the economic policy debate and monitoring of policy proposals by academics. The focus on evaluating the government's analysis and explanations of its policies can also be seen in the light of the small resources given to the council (see Section 6.2), which preclude doing own major model work and instead confines the role to supervising the work by the Ministry of Finance.

Box 7.1 The remit of the Swedish FPC

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

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

The council should also "work to achieve an increased public discussion in society of economic policy". The only output formally required is an annual report, which is addressed to the government. Although the council has no formal relationship to the Parliament, its Finance Committee organises a public hearing on the basis of the report.

7.1.1 The FPC's analyses

The FPC in Sweden has so far produced three annual reports. They were written in three very different economic situations.

The 2008 report

The council's first report in 2008 (Finanspolitiska rådet 2008) appeared in a boom with large budget surpluses. The report had a strong focus on the appropriateness of the fiscal rules. The council wanted the government to motivate better the choice of one per cent of GDP as the intermediate, medium-term fiscal target. According to the council, this would require an explicit weighting of more fundamental, higher-level objectives as discussed in Section 5. In addition, the council asked for a clarification of the formulation that the budget should show a surplus *over a business cycle*. The council also criticised the government's fiscal sustainability calculations for lack of transparency. More open discussion of basic assumptions, explanations of why calculations differed fundamentally between years and reporting of alternative scenarios were demanded.

The council judged the new government's labour market reforms, mainly the earned income tax credit and lower unemployment benefits, to be effective in raising employment in the long run. Some policies were also criticised. These included a rise in employee contributions to income-related unemployment insurance, which, since it is voluntary in Sweden, led to a mass exodus from it. The council was also critical of the abolition of the property tax.

The 2009 report

The next report was produced at the trough of the recession in the spring of 2009, when GDP in Sweden was forecast to fall by more than four percent in this year and unemployment to rise by around five percentage points from 2008 to 2010. In this situation, the report focused on the room for fiscal stimulus. The council recommended a more expansionary fiscal stance (of the order of magnitude of 0.5-1 per cent of GDP in terms of the structural budget balance) than the government had proposed. (According to the government's ex-post calculations in the 2010 Budget Bill there was a structural fiscal surplus in 2009 of 2.1 per cent of GDP and an actual deficit of only 1.2 per cent of GDP.) At the same time, the council stressed that stimulus measures should be strictly temporary so as not to endanger fiscal sustainability. The government's attempts to circumvent the expenditure ceiling for 2010 by timing payments to local governments for this year so that they could instead be recorded in 2009 (when there was more room under the ceiling) were condemned.

The analysis of policies to counter the recession was complemented with a lengthy analysis of fiscal sustainability. The council again urged the government to clarify the higher-level, fundamental objectives behind the surplus target and improve the sustainability calculations. In particular, the council wanted a clearer analysis of the trade-off between *pre-funding* (fiscal surpluses once the recession was over) and a gradual increase in the *retirement age* as methods to deal with the fiscal challenges from an ageing population. The council advocated an automatic adjustment of the retirement age to changes in longevity as a method of ensuring both tax smoothing and fair intergenerational distribution (see also Andersen 2008).

As to employment policies, the emphasis here, too, was on the appropriate design in the recession. The council endorsed the shift of active labour market policies towards more job search activities, but argued that this shift had gone too far, as job search activities could not be expected to be as efficient in a deep downturn as in a more normal situation (see also Michaillat 2010). For similar reasons, the council proposed making unemployment insurance cyclically dependent with more generous unemployment benefits in recessions than in booms (as in the US and Canada; see Andersen and Svarer 2010 a, b).

The 2010 report

The 2010 report was published during an emerging recovery, but emphasised the risk of a double-dip international recession and argued for fiscal caution, i.e. to avoid tax and expenditure changes that would involve permanent budgetary costs. There was no recommendation on further temporary stimulus measures: the report only noted that the strong public finances compared to other countries (an expected actual fiscal deficit of only 1.3 per cent of GDP in 2010) gave room for manoeuvre, but that the trade-off between the objective to restore higher resource utilisation and the objective to reserve "dry gun powder" in the event of a strong future decline was a political choice.

In addition, the report analysed employment developments for various groups, active labour market programmes, the earned income tax credit and the changes in sickness insurance. It was again concluded that the earned income tax credit is an efficient way of raising employment in the long term. But the government was criticised for not being transparent about how rises in labour supply are likely to restrain wages and this way create the labour demand necessary for actual employment to increase. Finally, it was argued that the reforms of sickness insurance - narrowing the gateway to it – probably have had large positive employment and budget effects, but the implementation was criticised for causing unnecessary adjustment problems.

Common themes

In addition to the policy analyses, all the reports have contained proposals on improved transparency of fiscal and employment policy. The council has requested that the Budget Bill should report on the development of total government net worth (and not only net financial worth) and provide more information on investment and capital stock in the government sector. A recurring theme has been the difficulties of getting an overview of the balance between different labour market programmes and understanding what activities actually take place in them.

The experiences of the Swedish FPC will be used below to highlight three issues:

- What impact can a fiscal council have?
- How does the scope of the remit affect the impact?

- What threats to the survival of a fiscal council are there?

7.1.2. The FPC's impact

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

- The first example concerns the degree of fiscal stimulus in 2009/10 which was gradually increased relative to the government's original plans. It may seem odd that a fiscal council tries to push the government to more stimulus. But it is not so surprising if one recalls that both the government fiscal stance and the establishment of the council have the same likely cause: a shift to a culture of fiscal discipline after the traumatic fiscal experiences in the 1990s (see Section 7.1.1). If there is no deficit bias, different cyclical forecasts can, of course, lead a council to the conclusion that the government does not provide enough stimulus in a recession. In addition, a government may feel inhibited to undertake stimulus because this could be wrongly interpreted as reneging on its medium-term fiscal target. Here, an independent council may have more credibility and thus provide "cover" for the government.[13]
- Our second example is 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. This advice received widespread media attention and may have strengthened fiscal discipline.
- Finally, the council was likely instrumental in inducing the government to clarify its position on the motives for the fiscal surplus target, its numerical value and how adherence to the target is followed up.[14] The government has also responded to the calls for improving the fiscal sustainability calculations.

The council's proposals on labour-market reforms have been less influential. The government did not revise the planned balance between job-search activities and labour market training in the recession, and it has been against making unemployment insurance cyclically dependent. It has,

[13] 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.
[14] Clarifications were made in the 2010 Spring Fiscal Policy Bill. They were based on a report by a working group in the Ministry of Finance (Finansdepartementet 2010).

however, appointed a government commission studying, among other things, the possibility of introducing mandatory state-run unemployment insurance. It has also announced that it is seeking a broad political agreement on raising the right for employees to stay on in a job (that is extending employment protection) from 67 to 69 years with the aim of raising the effective retirement age.

Somewhat surprisingly the council has had only a small impact in the politically less controversial areas of the transparency of fiscal and employment policy. There have been only small improvements in the reporting of the government's total net worth and real capital assets. Government investment receives only scant attention in the government bills. No improvements have been made in the reporting of active labour market programmes.

7.1.3. The scope of the remit

The FPC's broad remit raises the question whether the council's analyses in other areas crowd out the public's interest in its analyses of fiscal policy (see Section 5.1). To highlight this, Table 4 compares the amount of analysis devoted to various issues in the council's reports with the questions asked by MPs in the parliamentary hearings regarding the reports and the press coverage.[15]

Fiscal policy has featured much more prominently in the council's reports than in both the parliamentary hearings and the press. On average, 55 per cent of the text in the reports have been devoted to fiscal policy, whereas only 35 per cent of the questions in the hearings and 30 per cent of the press coverage have. Employment policy has dominated the hearings and in the press coverage (58 per cent and 54 pr cent, respectively), whereas it has accounted for only 38 per cent of the space in the reports. In the reports, fiscal sustainability has played an important part (19 per cent of the text), whereas this issue has not at all been raised by the MPs and played only a small role in the press. MPs have, however, devoted about as much interest to the fiscal framework as the reports (20 versus 17 per cent), but been considerably more interested in the framework for stabilisation policy rather than in the formulation of long-term objectives (9 versus 4 per cent).

[15] A possible objection to our analysis is that MP's questions may reflect more the need for clarification of various parts of the reports than political emphasis. In our view, this is less likely as the hearings are open (broadcast in state television) and therefore seem to be used as an opportunity to signal political priorities.

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

	Council	Parliament	Press
Fiscal policy	55.1	35.0	29.6
Fiscal framework	17.2	19.6	11.1
Long-term objectives	13.7	11.0	7.3
Stabilisation policy	3.5	8.6	3.8
Long-term sustainability	19.0		4.4
Stabilisation policy	18.9	15.4	14.2
Forecasts	4.3	3.9	0.7
Employment policy	37.7	57.5	54.3
Employment developments	7.2	10.6	11.5
Unemployment insurance	5.5	16.4	16.6
ALMPs	9.0	4.0	7.2
Tax policy	11.0	17.6	13.5
Sickness insurance	4.0	4.6	5.4
Other tax policy	2.5	4.2	8.0
Other	0.7		7.2

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

The table gives some support for the view that assigning broader tasks to a fiscal council may crowd out public interest in fiscal issues, viz. long-run sustainability issues. But this conclusion should be interpreted with caution. Since the public finances in Sweden have been so strong, it may be natural that interest in fiscal sustainability has been low.

7.1.4. Dangers for a fiscal council in a political environment

The experiences of the Swedish FPC can also highlight the dangers for an independent watchdog operating in a political environment. When the council was established in 2007, all three opposition parties – the Social Democrats, the Left Party (the former Communists) and the Greens – voted against. The fear seems to have been that the council would play the political role of providing "scientific" support for the government. The Left Party expressed its concerns in the following way:

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

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

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

	2008	2009	2010
Attitude to the government			
Positive	6.1	13.7	21.3
Neutral	72.7	54.8	49.3
Negative	21.2	31.5	29.3
Reported council attitude to the government			
Positive	9.1	8.2	26.7
Neutral	57.6	57.5	56.0
Negative	33.3	34.2	17.3

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

There has been an increasingly critical government attitude to the council. In the parliamentary hearing regarding the first report in 2008, the Minister for Finance, Anders Borg, stated:

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

and

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

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

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

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

How should one explain this change in attitude? A possible explanation is that, to be useful, the analyses of a government watchdog must focus 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 and recommendations on what is seen as better ways of achieving the set goals. 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 will learn 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 also of the opposition's proposals. In the Netherlands a practice has developed according to which the political parties submit their election platforms to the CPB for evaluation (Bos and Teulings 2010). Acting as such a "scientific referee" in the political debate would, however, be a much larger task than the current one and might place the council even more in the political "hot air".

In one sense the opposition is likely always to benefit more than the government from the FPC's analyses. This is because a government has access to more "research" resources than the opposition, which therefore must rely more on other analyses.

The FPC's experiences also illustrate the potential importance of formal rules to safeguard the independence of a fiscal council. It 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 working time at universities and research institutes to council work. In November 2010, the council sent an open letter to the government arguing for more resources. The letter also raised the issue of whether independent evaluation of government policy is consistent with being an ordinary government agency. This means that at the same time as the council evaluates the government, the government also evaluates how well the council performs, i.e. how well it evaluates the government. The government's evaluation forms the basis for budget appropriations. The FPC's view is that its sometimes critical analyses of government policies have not been helpful in the budgetary discussions with the Ministry of Finance (Finanspolitiska rådet 2010). The Minister for Finance’s reaction to the council’s letter was that the government would instead examine whether the council’s budget should be cut. The letter also triggered a series of critical remarks from the Minister on the quality of the council’s work. It remains to be seen what this will lead to, but fears that the council’s existence is in jeopardy have been raised in the press.

7.2. The Office for Budget Responsibility in the UK

The UK fiscal council, the Office for Budget Responsibility, was only set up in an interim form in May 2010, and legislation establishing it on a permanent basis is currently passing through Parliament. Despite its youth, the OBR represents an interesting case study for three reasons. First, its structure and remit are very different from Sweden’s Fiscal Policy Council. As its primary role is to provide the forecast on which fiscal decisions are based, it is much more integrated within government decision making. This has already raised questions about how independent and critical the OBR can be. Second, it is also precluded from formally examining the consequences of alternatives to current government policy, which raises questions about how effective a ‘watchdog’ it can be. Third, by examining the circumstances in which the body was set up, we can see how institutional structure may depend on the particular events that preceded the establishment of the institution.

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

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

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

Just before and after the election 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 as a result the Treasury continued to predict that the two fiscal rules would be met. However, independent forecasters began to argue that the Treasury's forecasts were too optimistic, and that as a result the rules would be broken.[16]

The financial crisis of 2007-8 and the subsequent recession led to the ratio of government debt-to-GDP rising well above the 40% figure. The Labour government abandoned its fiscal rules, and argued that to combat the recession fiscal policy should be used. As an example, the level of VAT was reduced by 2.5 percentage points for one year at the end of 2008. Partly as a result, government net debt rose above 50% of GDP, and was expected to reach a peak of around 70% of GDP.

Although there had been occasional earlier proposals for some form of UK fiscal council[17], calls for institutional reform of some kind increased as the fiscal crisis developed. While the Conservative Party proposal in 2008 drew on both international experience and specific proposals for the UK (such as Kirsanova et al. 2007), it naturally emphasised the culpability of the then government for the rapid expansion in government debt. The suggestion was made that the government had put pressure on civil servants in the Treasury to make over-optimistic projections before the financial crisis. (In the UK, Treasury forecasts are ultimately the responsibility of the government, not civil servants.) As a result, it was suggested that an independent body - the proposed OBR - should undertake budget forecasts.

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

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

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

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

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

The current remit of the OBR is:[19]

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

Two features of the remit stand out. First is the emphasis on forecasting. The second is that, while issues of sustainability should be examined, the OBR should not examine alternative policy scenarios. We consider each point in turn.

7.2.1. Forecasting and independence

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

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

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

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

changes in forecast assumptions between pre- and post-budget forecasts.[20] The measures announced in the budget would themselves substantially reduce public-sector employment.

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

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

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

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

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

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

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

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

[21] Financial Times 21/9/10. John Kay was a former director of the Institute of Fiscal Studies.

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

7.2.2. Policy analysis

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

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

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

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

[22] Clause 5.3, Budget Responsibility & National Audit Bill.
[23] This is confirmed by subsequent clarification of the differences between the interim OBR's pre- and post-emergency budget forecasts, and its evidence to parliament. Concerns about the possibility of markets worrying about default, and whether future policy is credible, are difficult to incorporate into a single forecast projection.

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

The inability to do policy analysis becomes particularly problematic when long-term sustainability calculations are presented. One of the tasks the OBR is required to perform is an assessment of long-term sustainability. Suppose those projections indicated a lack of sustainability in the form of growing public debt. Without subsequent analysis, it would be quite possible for policy makers to respond that this long-term problem would be something they addressed at a later date, and to keep postponing action in this way. It would clearly be much more informative if projections of unsustainable debt were accompanied by some policy analysis that indicated the costs and benefits of taking action sooner or later to avoid this outcome.

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

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

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

7.3. Comparison between the FPC and the OBR

The differences in design between the OBR in the UK and the FPC in Sweden can to a large extent be explained by the different situations in which they were established. The OBR was set up in an acute fiscal crisis coming on top of earlier deficits that probably represented de facto breaches of the existing rules masked by over-optimistic forecasts. Hence the narrow remit to fiscal policy and the emphasis on macroeconomic 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 also 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 influence on the budget by working out the macroeconomic forecast in it. At the same time, these close contacts – which by definition cannot be transparent – imply risks for both the actual and the perceived independence of the OBR, and thus for the credibility of its analyses. As shown by the debate around the OBR's first post-budget forecast, the risk that the office is seen as providing support for the government is real. One way of offsetting this would be to allow the OBR to analyse different policy options, which would also add to the quality of the public debate.

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 on policies to achieve the government's set goals. This implies a larger risk for open conflicts with the government which also 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 will be some disagreement with all political parties.

8. Summary and conclusions

One striking feature of existing fiscal councils is their diversity. 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 Sweden and the Netherlands). Some produce forecasts, while others do not. A common feature of all fiscal councils established so far is that they only play an advisory role, with none having the power to determine the size of budget deficits.

This diversity may in part reflect the variety of explanations advanced in the literature for ‘deficit bias’, ranging from asymmetric information to common-pool problems, and also including different types of impatience, electoral competition and time inconsistency. In the UK, for example, a view that fiscal forecasts produced by the government were too optimistic was important in giving the OBR in the UK a key forecasting role, while in Sweden a desire to institutionalise the strong national tradition of academic involvement in the economic policy debate may have helped give that fiscal council a very wide remit. However, while some of this diversity may reflect national differences in political structures (with, for example, the CPB in the Netherlands providing macroeconomic and budget estimates that serve as a basis for the negotiations among coalition partners), in other cases it may reflect particular circumstances of the time that may not persistent. 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. At the same time, flexibility must not mean that remits are changed for reasons of political convenience to disarm councils critical of government policies.

Although the recent growth in the number of fiscal councils in part reflects a failure of fiscal rules on their own to adequately discipline public finances, in most cases fiscal councils operate alongside such rules, rather than as a replacement for them. They may help evaluate whether rules are likely to be met (for example in the UK, by providing fiscal forecasts), suggest when simple rules can be broken (for example in Sweden where the FPC argued for greater scope for temporary fiscal stimulus during the recession), or propose improvements to those rules. This complementarity between rules and councils makes sense once it is recognised that good fiscal rules are likely to be complex, and conditional on cyclical and other shocks to public finances. In addition, a lack of consensus in both the academic literature and among policy makers about the appropriate level and form of long-term fiscal targets may emphasise both the need for advice from fiscal councils, and a reluctance to give such councils statutory power.

While some councils make policy recommendations (including in Austria, Belgium, Denmark and Sweden), others are explicitly precluded from recommending particular courses of action (e.g. the CBO and the CPB). However, the councils that are mandated not to give policy advice still analyse the pros and cons of alternative policies, such as the impact of different speeds of fiscal consolidation. Here the UK is an outlier, with the OBR being prohibited from considering any policies other than those currently pursued by the government. The danger of political conflict between councils and government is clear, as the recent experience in Sweden, Canada 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, and here lessons from central banks may be useful in ensuring that fiscal councils can resist such pressure. This could include a prohibition against firing the council at will and a long-term budget. Such stipulations would seem particularly important in countries where fiscal council have been established only recently, and where they have not yet been able to build a reputation that protects them.

While our analysis can suggest reasons for some of the diversity in the form and remit of different fiscal councils, it may also be the case that some differences are more accidental or contingent. Initial diversity may be helpful from an experimental perspective, as long as lessons from success or failure are learnt. Given the similarity in many of the problems fiscal councils have to address, there seems to be a strong case for establishing some formal networking among councils, of the type that has become well established among central banks. Continuing comparative analysis of fiscal councils may throw further light on some particular questions. Two in particular arose from our two case studies, as well as our wider analysis. First, are councils with a narrow remit, focusing on macroeconomic fiscal assessment, more effective in that role than those with wider scope? Second, can councils that produce the forecasts that the government uses in fiscal planning (e.g. as in the Netherlands and UK) remain sufficiently independent from government, and could analysis of policies proposed by opposition parties as well as government be useful in promoting independence?

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