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What can Fiscal Councils contribute?

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Delaying decisions on fines for Portugal and Spain for deficit breaches added to concerns about politicised decisions under the Stability and Growth Pact. Also, it reinforced calls for 'independent fiscal watchdogs'.

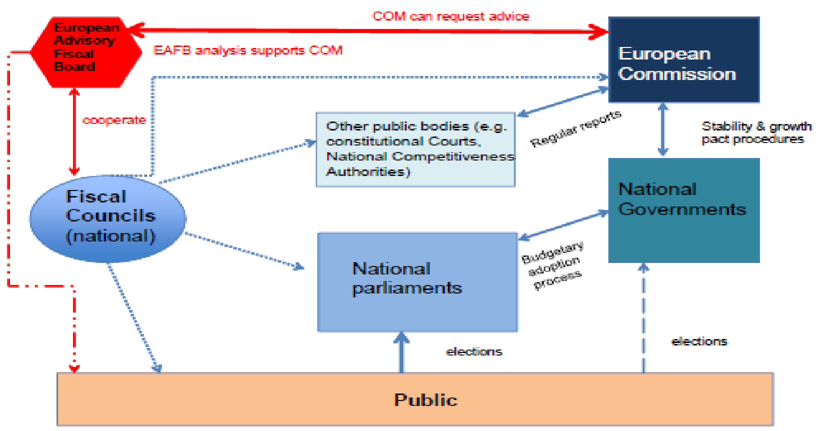
Fiscal councils (FCs) can improve the sustainability of public finances. They can increase transparency and accountability of fiscal policymaking by providing unbiased information to the public and stakeholders in the budget process. The design of their mandates, independence, and their public role are key conditions determining effectiveness.

FCs are institutional complements and can help to ensure implementation of fiscal rules. The combination of rules and institutions to foster fiscal discipline has become more prevalent in recent years – particularly in Europe against the background of the Euro and debt crisis. Notably, the European fiscal framework requires independent national FCs to be set up to support fiscal governance in the euro area.

The new European Advisory Fiscal Board (EAFB) can be a valuable addition but is unlikely to be a game changer. Far-reaching reforms on the Union's fiscal framework remain contingent on political will. Nevertheless, the EAFB could help to foster consistency in the application of fiscal rules and help to mitigate perceptions of politicised SGP decisions. Also, it can play a role in the debate about reforming fiscal governance and further development of Fiscal Union.

Independence is crucial for FCs to have an impact. This holds for both the EAFB and national FCs. In addition, cooperation between the new EAFB and national bodies is a necessary requirement for a "European System of Fiscal Boards" to work effectively.

A European system of Fiscal Boards – increasing accountability in Fiscal policy 1



Sources: European Commission (2015), Commission services, Deutsche Bank Research

Introduction

Sound public finances are indispensable for public goods provision and macro-economic stabilisation. Also, they are indispensable for the functioning of EMU. Yet, how to get and maintain them in Europe?

The typical approach has been to draw up rules to foster fiscal discipline. But rules remain an incomplete answer. They remain void if not followed. At the same time, they often require assessment and interpretation to actually judge compliance. Here is where Fiscal Councils come in: By providing independent and public assessment of fiscal policies, they are an institutional feature that can complement fiscal rules and improve budgeting.

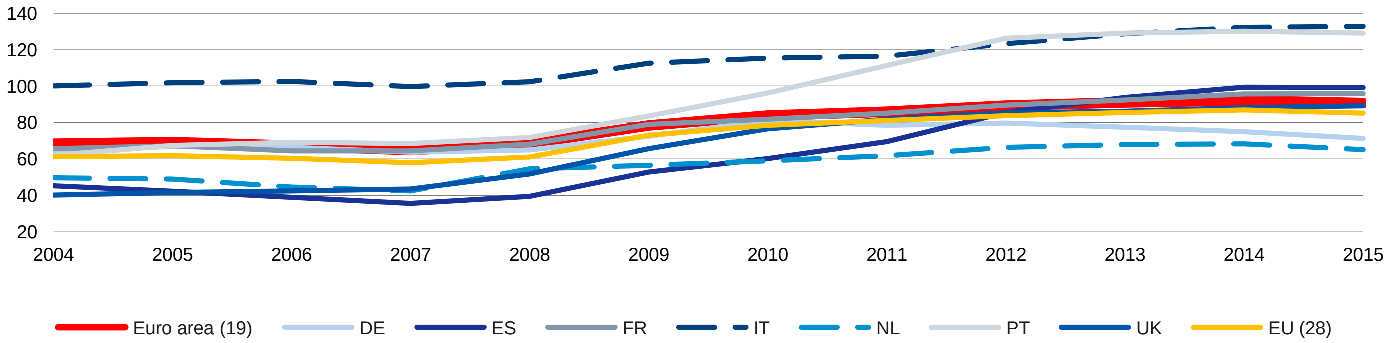
Information is the central mechanism here. First, FCs can provide information as input to budgetary planning, for instance by preparing budgetary forecasts or assessing projections and their underlying assumptions. Second, FCs can increase transparency of fiscal policymaking, for instance by discussing policy trade-offs, emphasizing a longer-term perspective and highlighting risks to fiscal sustainability. In particular, they can provide warning signals to the public if budgetary targets have been missed or are unlikely to be met in the future. In doing so, FCs can help to foster greater transparency around fiscal policy, increase accountability and thereby compliance.

Fiscal Councils are nothing new but against the background of persistent public debt problems, they have become much more popular in recent years. In Europe in particular, a number of new “fiscal watchdogs” have been set up or existing bodies have been reformed. Also, common rules to promote fiscal discipline now envisage a role for FCs in member states as part of fiscal governance.

In addition to FCs at national level, a new body, the European Advisory Fiscal Board (EAFB), is currently being established. This follows last year’s five presidents’ report, which suggested the creation of a fiscal board at European level as a near-term step towards Fiscal Union. Hopes are that a new body which provides impartial expertise on fiscal matters beyond national perspectives could help to improve European fiscal governance, suffering from excessive complexity, politization and limited compliance.

Rise of government debt in Europe 2

General government gross debt, percentage of GDP



Sources: Eurostat, Deutsche Bank Research

This analysis focuses Fiscal Councils in Europe. It reviews their theoretical rationale, discusses conditions for their effectiveness and looks at how FCs have recently evolved. The second part discusses the new EAFB as the latest addition to the institutional framework for fiscal governance. Is the EAFB going to be a useful complement? Can it mitigate key problems with current fiscal governance arrangements in Europe?

Fiscal Councils: A look at the theory

Defining Fiscal Councils

What is a Fiscal Council? 3

"A permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government's fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances, short-medium-term macroeconomic stability, and other official objectives." (Debrun 2013)

Independent fiscal institutions:

– are non-partisan public bodies, other than the central bank, government or parliament
– prepare macroeconomic forecasts for the budget, monitor fiscal performance and/or advise the government on fiscal policy matters
– primarily financed by public funds and
– are functionally independent vis-à-vis fiscal authorities. (European Commission).

Courts of Auditors are included in this definition if their activities go beyond the accounting control and cover any of the tasks above.

Fiscal Councils are institutions that inform the public about fiscal policy. In doing so, they help to increase accountability and provide advice but they do not determine fiscal policy or enforce decisions directly.[1] Nevertheless, they can have considerable soft power by influencing the public debate on fiscal policy matters.

FCs' main task is monitoring and assessment of fiscal policies. In addition, they can also

i) contribute to the use of budgetary and macroeconomic forecasts used to prepare budgets

ii) facilitate the implementation of fiscal policy rules

iii) cost new policy initiatives

iv) identify sensible fiscal policy options and possibly formulate recommendations.[2]

FCs are permanent bodies – not ad hoc committees – and they are typically defined by function rather than organisational form. How FCs are organised, reflects country characteristics and fiscal policy traditions. Also, not all bodies engage in the full set of activities. Depending on how far the definition of FCs is stretched, it can include research institutes or Courts of Auditors, doing some of the tasks above.

Independence is a crucial characteristic of FCs and arguably a necessary precondition to properly fulfil their functions (signalling value!). To that effect, independence often forms part of FCs' definition.

Problems in fiscal policymaking

Typically, it is a mix of weak management of public finances and distorted political incentives that drive excessive deficits. The political economy literature has extensively discussed problems in fiscal policymaking,[3] including

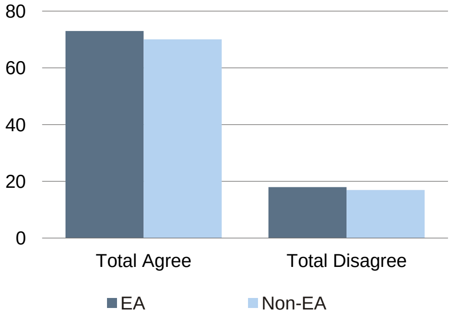
— *Political business cycles* – policymakers focus on keeping office. This may lead incumbents to increase spending and/or decrease taxes before elections, resulting in fluctuations and short-sightedness for fiscal planning. It can also provide incentives for obfuscation, making deficits and debt appear smaller than they would actually be for instance by using vague assumptions for calculation or taking out some elements of the calculations.

— *Common pool problems* – interest groups can advocate for specific government spending but neglect (long-term) costs because these are

[1] See Debrun et al (2009) who distinguish between Fiscal Councils and independent fiscal authorities. The latter would also have hard powers e.g. setting fiscal targets that governments
[2] See Debrun et al. (2013).
[3] For a recent review see Alesina and Passalacqua (2015).

Fiscal discipline: "yes, in principle..." 4

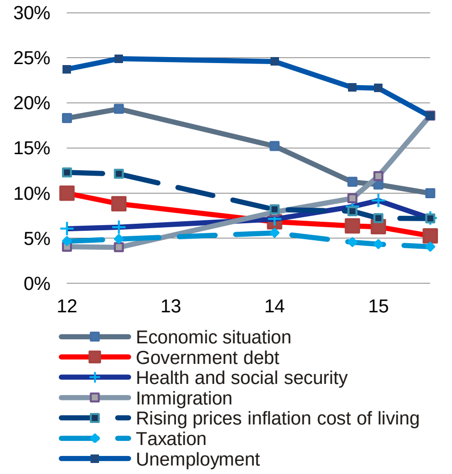
"Measures to reduce the public deficit and debt in our country cannot be delayed" - respondents' share in percent



Sources: Eurobarometer (2015), Deutsche Bank Research

...but it's other issues that are (perceived) greater concerns 5

"What do you think are the two most important issues facing your country at the moment?" (Total EU)



Source: Eurostat, Deutsche Bank Research

shared with other groups in society. Similarly, incumbents have an incentive to cater to their voters. This leads them to increase services to their constituents without passing on the costs of expansion to them, resulting in debt piling up. This problem can be aggravated by *moral hazard*. If for instance a local government can assume that it is going to be bailed out, this reduces incentives for fiscal prudence. Similarly, this can be a problem in a Monetary Union with decentralised fiscal policies.

— *Overoptimism and procyclicality* – behavioural biases – separately or in combination with political incentives – can lead to overoptimistic assumptions and forecasts for budget projections. Working on the assumptions that “good times are going to last”, excess revenues are spent rather than used for debt reduction. This comes at a cost in terms of foregone fiscal resilience and more limited ability to act countercyclically in recessions.

— *Fiscal illusion* – policymakers and voters may have insufficient understanding or awareness of the long-term constraints for fiscal policy, which encourages overspending in the short-term.

Finally, discretionary fiscal policy often suffers from credibility problems. Even if there is widespread agreement that a balanced budget and debt reduction would be the right thing to do, fiscal consolidation fails to be implemented because regional or electoral interests dominate ex post.[4] Thus announcements to pursue prudent fiscal policy lack credibility in the first place.

Two approaches to address these problems that are suggested in the literature are i. the introduction of binding rules for fiscal policy and ii. the delegation of fiscal policy decisions to independent authorities. However, both come with drawbacks.

Why rules and delegation have limits

Fiscal rules, such as numerical targets on deficits and debt, are meant to provide simple yardsticks and limit policymakers’ discretion.

Critique of fiscal rules focuses on the rules being too simplistic, too mechanically applied – or not being sufficiently followed. Debt and deficit criteria for instance provide clear yardsticks at first sight but when it comes to what exactly counts towards deficit and debt, the devil is in the details. Examples are accounting for cyclical components of deficits or considering the impact of unforeseen events on public finances. Arguably, part of the implementation problems with fiscal rules is often rooted in complexity of fiscal policymaking, making monitoring more difficult, coupled with political tradeoffs when applying the rules.

Delegation to independent experts has sometimes been suggested as an alternative to rules.[5] Independent experts could overcome rules’ rigidities by taking changing circumstances competently into account – but not losing track of the fiscal sustainability as a long-term goal, thus helping to maintain credibility. Monetary policy is an area where the delegation logic has been applied.

However, the strong and direct redistributional effects and its interaction with multiple policy domains limit possibilities for delegating fiscal policy.[6] There is a strong case on legitimacy grounds to have elected politicians in charge of fiscal policy decisions. Compared to monetary policy, fiscal policy is typically considered less suitable for delegation also because of greater problems to

[4] Reasons include political pressure, lack of information, or misaligned incentives.
[5] See earlier work by Wyplosz (2005).
[6] See for instance Alesina/Tabellini (1990, 2004) and Coeuré (2016).

How rules and FCs can work as complements 6

1. *Addressing fiscal illusion* – fiscal illusion implies that the public has a poor understanding of budget constraints and the impact of today's fiscal choices on tomorrow's policies. If fiscal illusion is prevalent, the costs of non-compliance with fiscal rules are low. To the extent that a lack of information is the problem, FCs can raise the costs of violating rules by providing it and contributing to better align incentives between voters and policymakers.
2. *Limiting obfuscation and biases* – FCs can close technical loopholes in rules that may be exploited by uncommitted governments, for instance by providing or assessing forecasts or projections of revenues and expenditures that may be overoptimistic.
3. *Providing quality inputs* – more sophisticated numerical fiscal rules in particular (e.g. structural balance rules) rely on high quality and unbiased input, which FCs can provide. Also, they are in a better position to evaluate compliance with the terms of the rules.
4. *Promoting acceptance* – to the extent that FCs can increase unbiased application and enforcement of rules, they may also contribute to greater acceptance.
5. *Rules serving as benchmarks* – monitoring of fiscal rules provides for a dedicated task and benchmark. To that extent numerical rules can help to depoliticise individual FCs work as they have to apply and specify rather than define the rules. At the same time, this is only an advantage if FC experts consider them sensible by and large.

Sources: Debrun et al (2013), Deutsche Bank Research

define its goals, measurement for success and implementation difficulties. For example, a central bank with a clearly defined mandate could set an inflation target and focus on achieving it. On fiscal policy, targets and measurements for success are likely to be controversial ex ante which makes it difficult to design a mandate for delegation. The steps and timing to achieve budgetary goals is likely to be disputed (even among experts) also because goals such as fiscal sustainability and growth might conflict in the short-term. Finally, even if the design of fiscal policy were to be delegated, it would still need to be implemented. Implementation in turn is based on legitimacy and political accountability.

Neither rules nor delegation provide perfect solutions to all problems associated with fiscal policymaking. A combination of rules providing a (long-term) commitment device and delegation of specific tasks to experts could mitigate some of the issues above though. To that extent, rules and institutions are increasingly seen as complements.

Fiscal Councils with a complementary but important role

The brief look into theory explains why FCs have soft rather than hard powers but suggests that they can nonetheless be useful. Information asymmetries between an expert Council and those directly in charge of drafting and implementing fiscal policies are likely to be lower, putting experts for instance in a better position to scrutinise the assumptions used in forecasts and for budgetary planning. Thus, they can directly add value to fiscal governance by providing quality input, support monitoring fiscal policy and the application of fiscal rules as part thereof.

At the same time, FCs can help to increase transparency on fiscal policy, informing the public debate and adding to accountability (indirect effect). To that extent rather than reducing (monitoring) competences of other bodies, "limited delegation" of specific tasks (analysis, assessment, information) can support other bodies, such as parliaments, and facilitate their monitoring.[7] Ideally, FCs act as a multiplier adding accountability.

Theoretically, the financial markets can also play a signalling and disciplining role, i.e. charging higher interest rates for governments that pursue less prudent fiscal policies and revealing information. At the same time, the experience of the financial and euro crisis suggests that sentiment can be volatile and assessment is sensitive to expectations about politics, e.g. forming beliefs about bailouts.

In fact, institutional elements that help to increase credibility of fiscal rules and provide information could even help to reduce sensitivity of markets to politics and better price risks. Thus, FCs as institutional elements could be complementary to both fiscal rules and financial markets to foster greater fiscal discipline.

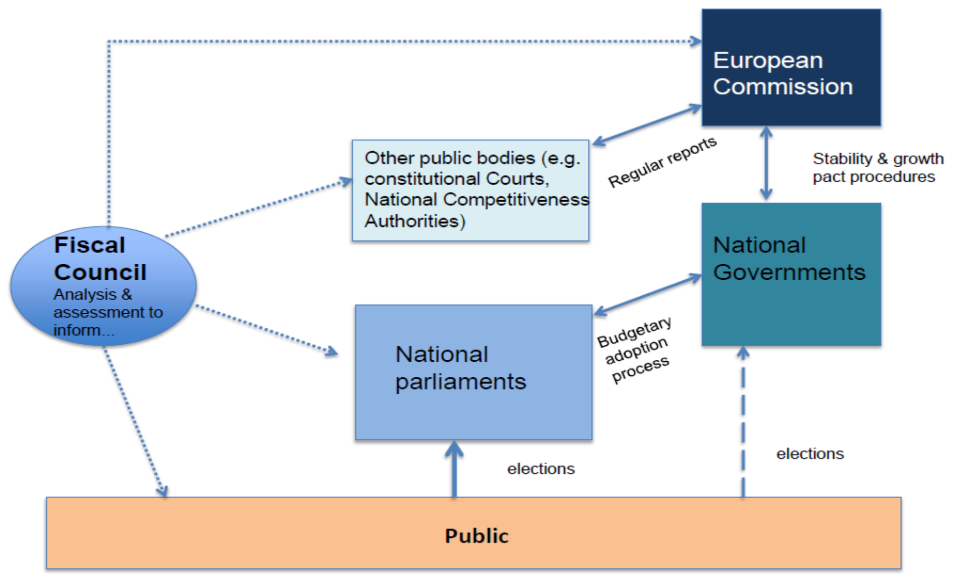
[7] Historically, the emergence of some fiscal institutions in the form of parliamentary budget office, also suggests complementarities.

Fiscal Councils in Europe

From different origins …

FCs have become more popular in recent years reflecting countries' growing concern about public debt beliefs that FCs can be a useful institutional feature to contain it. While not unique to Europe – countries as different as Canada, Chile, Uganda and the US feature fiscal watchdogs – FCs in Europe account for a considerable global share. For example, out of the 39 institutions recently identified by the IMF, 27 are located in EU member states.

How Fiscal Councils in Europe can contribute to accountability 7

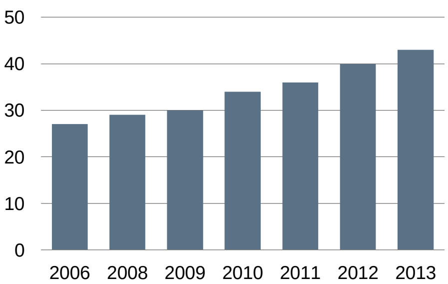


Source: European Commission (2015), Commission services, Deutsche Bank Research

Also, FCs are nothing new here. Independent expert groups or institutions charged with fiscal matters have existed in a number of countries for decades. Depending on how far the definition of a FC is stretched, early examples of independent fiscal institutions can be found in the 1920s (e.g. Austrian WIFO) or even in the 19th century when counting the French Court of Accounts.[8]

Growing number of fiscal institutions in Europe 8

Number of institutions in the Commission services database on Fiscal Governance



Source: European Commission (2014)

The European Commission, which has been collecting information on independent fiscal institutions for about a decade, lists 27 bodies in Europe that were established before 2008 (total of 45).[9] The IMF, looking at a narrower sample, lists eight European FCs founded prior to that date (out of 27).[10] Early institutions (pre-2008) include for instance the Dutch Central Planning Bureau, the Danish Economic Council or the High Council of Finance in Belgium. Overall, independent fiscal institutions had been more common in "old" EU member states until recently.

Early institutions often focused on research and macroeconomic forecasting (e.g. WIFO or Kiel Institute) and differ from most "modern fiscal watchdogs". The later typically have a greater role with regards to monitoring compliance with

[8] Established in 1807. See European Commission database on independent fiscal institutions.
[9] The dataset's most recent version contains 45 institutions in total, covering 25 European member states (no information on BG, CY, and CZ).
[10] The dataset contains information on 27 bodies. Country coverage is global, including information on 24 European member states. Last update of the database: 2015. For further information and definition see Debrun/Kinda (2014).

fiscal rules. Some of the older institutions also have evolved, with changes in structure or the function of experts reflecting economic and political developments. For example, some of the earlier FCs were set up with the intention to plan the post war economy (e.g Dutch Central Planning Bureau[11]), others were established to check opportunistic spending behaviour reflecting concerns about political business cycles,[12] or to support other bodies' capacity for fiscal monitoring. Most recently though FCs have been established or adapted with a view to complement fiscal rules in Europe.

Independent fiscal institutions have been set up with similar aims, i.e. better budgeting – but entities across member states have been organised differently. Some countries feature several entities performing (parts of) the tasks typically associated with FCs. Austria for instance has traditionally had multiple independent fiscal institutions, the WIFO and Fiskalrat (former Staatsschuldenausschuss) being prominent, a Court of Auditors, a Parliamentary Budget office and the Institute for Advanced Studies.[13]

Based on a broader concept of independent fiscal institutions (as used in the data collection by the European Commission), there are ten member states with multiple entities. These tend to be old member states, with Hungary being an exception. Country size only seems to matter up to an extent: While a number of smaller member states list only one institution, Austria and Belgium have multiple ones. Germany also has a tradition of multiple bodies contributing to fiscal policy (monitoring).

In terms of organization, FCs can be attached to other bodies or operate as standalone entities. Part of the first category are parliamentary budget offices (e.g. IT: Ufficio Parlamentare di Bilancio), bodies attached to the executive (e.g. DE: Stabilitätsrat), or to other independent institutions such as audit offices (e.g. FR: Haute Conseil des Finances Publiques). Member states with standalone institutions include Germany, Hungary, Ireland, Portugal, Romania, the Slovak Republic and Sweden.[14] Some analyses have suggested a tendency of smaller states to opt for the attachment model, which provides the advantage of concentrating skills in public finances.[15] However, organization likely reflects a mix of resources and different traditions with regards to tasks, i.e. if a body was set up to provide dedicated support to another institution, e.g. parliament, attachment seems like the obvious choice, compared to more research-oriented bodies (e.g. WIFO or German Council of Economic Experts) for which a detached status could add to reputation.

With regards to staff, most current European FCs tend to be rather small (staff about 5-25 in most cases), compared for instance to the US Congressional Budget office (approx. 235)[16]. Larger bodies typically take on more tasks than fiscal surveillance, including for instance general economic analysis or auditing of public accounts.

Setup, resources and tasks of fiscal institutions in Europe have reflected country characteristics, fiscal policy traditions, and bodies' historical development.[17] Two notable points where there have been differences are their independence (legal, operational as well as with regards to budget and staff) and their public visibility.

Fiscal institutions in Germany | 9

Typical FC-tasks are split among different bodies and reflect both a longstanding tradition to involve experts in fiscal policymaking as well as the country's federal tradition. The main current institutions are:

The working party on tax and revenue forecasting has been established in 1955 as an advisory board to the ministry of finance. It involves the federal ministry of finance, the Ministry of economics and technology, finance ministries of federal states as well as a number of leading German research institutes and other representatives. Its work has traditionally been included in budget plans and medium-fiscal planning.

The stability Council (2010) monitors the sustainability of federal and federal states' finances. It consists of representatives of the federal ministry of finance, the Länder finance ministry and the federal ministry of Economic Affairs and Energy. Due to its composition and organization, the stability Council would not be counted as an independent FC.

The stability council is supported the advisory board to the stability council and comprised of representatives from Bundesbank, German Council of Economic experts, research institutes and further experts appointed by representatives of the Federation and Länder on the stability Council, the national association of local authorities and the national organisations of the social security funds.

The Sachverständigenrat (1963) is an expert council consisting of five academics and provides regular assessments of the German economy including recommendations.

Source: Deutsche Bank Research

[11] See http://www.cpb.nl/en/history (CPB History).
[12] Outside Europe, the formation of the Congressional Budget Office in 1974 provides an example, also reflecting the prominence of the issue in economic theory and policy discussions at that time. See https://www.cbo.gov/about/founding (CBO History).
[13] See European Commission database on independent fiscal institutions (2013).
[14] See Debrun and Kinda (2014) and Debrun et. al. (2013).
[15] See European Commission (2014).
[16] See CBO at https://www.cbo.gov/content/organization-and-staffing.
[17] For further research on characteristics of FCs see for inter alia Debrun et al (2008), Hagemann (2011), Kopits (2011), Debrun / Kinda (2014), von Hagen (2010). These try to analyse the reasoning behind FCs, their specific design as well as categorising them according to their functional remits.

Not all bodies have been legally and organisationally independent in the past, an example being German Stabilitätsrat, a joint committee of federal government and federal states and comprising the federal minister of finance together with Länder ministers.[18] The advisory board to the Stabilitätsrat and consisting of experts and having independence legally grounded would meet independence definitions though.[19]

With regards to their visibility, basically all institutions have been issuing some form of public reports.[20] Publicly available public output is only one element of visibility and provides not much evidence on impact. While it is sensible to assume that visibility and impact, particularly of FCs are conceptionally linked visibility of FCs remains difficult to compare across countries and over time.

During past years, many existing FCs have been reformed, often taking on new tasks, or new bodies have been set up (e.g. in SE, HU, SI or UK). This reflects rising concerns about fiscal sustainability against the background of the euro debt crisis as well as recent reforms in the fiscal governance framework at European level that envisage a role for FCs. Often, the establishment of new FCs has followed the adoption of numerical rules.

Six Pack, Fiscal Compact, Two Pack 10

EU rules to foster fiscal discipline contain various references to FCs, describing and strengthening their role in recent years:

Six Pack (2011)

- 5 regulations and one directive covering fiscal surveillance and macroeconomic surveillance as part of the macro-economic imbalances procedure.
- Applies to all member states with some provisions specific to EA (sanctions); aims to reinforce the Stability and Growth Pact i.a. by (i) adding specification on what counts as “significant deviation” from medium-term (MTO) budget objectives and how adjustments should proceed, (ii) providing operationalisation of the debt criterion, and (iii) introducing reverse qualified majority voting for most sanctions under the excessive deficit procedure (EDP).

Treaty on Stability Convergence & Governance (TSCG) and Fiscal Compact (2012)

- Intergovernmental treaty signed by all MS except the UK and CZ; fully binding for signatories since January 2014
- To further strengthen SGP requirements, i.a. through (i) a balanced budget rule incl. automatic correction mechanism, (ii) EDP, (iii) enshrining numerical benchmark for debt reduction for member states with government debt > 60% GDP.
- Monitoring institutions at national level as an element to help meeting balanced budget rule (Art.3(2)TSGC).

Two Pack (2013, only euro area)

- Further strengthening surveillance and monitoring draft budgetary plans
- Replicates TSCG common requirements on structural features for FCs
- Requires medium-term fiscal plans and draft budgets of EA-MS to be based on independent and public macroeconomic forecasts.

Sources: European Commission, ECB, Deutsche Bank Research

… to increasing convergence?

Legislative developments at European level during recent years have set out new requirements with regards to the status and the tasks of FCs, also affecting their structure. Through changes in legislation, national FCs have increasingly become part of European fiscal governance.

Fiscal Councils at national level and European rules

1. “Six-pack”: As part of the “Six pack”, the Directive on requirements for national budgetary frameworks contains a reference to independent bodies. Their role is mainly with regards to monitoring of national fiscal rules.[21] While the directive describes tasks, it does not contain details on structure or further specifies the status of FCs.
2. Fiscal Compact: The Fiscal Compact (part of the Treaty for Stability, Coordination and Governance, TSCG) emphasised the balanced-budget rule as a key commitment of EA member states to fiscal sustainability. It also provides for monitoring institutions as part of national correction mechanisms.[22] In addition, TSCG charged the Commission to develop common principles for monitoring institutions.

   The follow-up communication on national fiscal correction mechanisms (2012) then set out rules, tasks and status of monitoring bodies.[23] It provides for a stronger role of FCs in ongoing monitoring of compliance with budgetary rules (in addition to ex-post assessment) and emphasises the “comply or explain” principle, i.e. if member states deviate from assessment or recommendation of independent bodies, they have to state why they did so.

   In addition to defining and deepening tasks, the communication sets out characteristics to foster independence of FCs. These include i) a statutory regime for FCs grounded in law, ii) freedom of interference, i.e. FCs shall not take instructions and be in a position to communicate publicly and

[18] See Debrun/Kinda – Fiscal Council Dataset (2015) and Debrun et. al (2014).
[19] See § 7 Stabilitätsratsgesetz.
[20] Leaving aside audit offices to which this may not be applicable.
[21] See Dir 2011/85/EU and in particular Art 6(1) (b).
[22] See European Commission (2014).
[23] See COM(2012)342

timely, iii) nomination procedures to ensure qualified staff, i) adequate resources and access to information so that FCs can fulfil their mandates.

3. "Two pack": The regulation on enhanced budgetary monitoring that is part of the two-pack basically reaffirmed the requirements on key features for independent fiscal bodies. It connects with previous regulations by requesting that independent bodies assess compliance with national numerical fiscal rules (TSCG) and the two-pack balanced budget rule that is inspired by the one described in the fiscal compact.[24]

   Also, the two-pack specified on the requirements for forecasts used in fiscal planning, draft budgets and national medium-term fiscal plans of EA countries need to be based on independent and public macroeconomic forecasts (Dir 2011/85/EU required them to be "up to date" and "realistic").

By and large, recent changes in European rules to bolster fiscal discipline strengthened FCs in member states by making them a required part of the fiscal governance architecture and providing for specific tasks related to (common) rules. Notably, these are monitoring compliance with national fiscal rules and endorsing or producing forecasts that serve as basis for governments' budget proposals. Recent changes also strengthen FCs by defining their status as independent bodies and necessary criteria. To that extent, there has been some convergence via rules.[25] While European rules specify basic requirements and tasks to be fulfilled by independent bodies, they do not fix how FCs should be organised.

The tasks FCs perform as part of the European fiscal governance framework also vary somewhat – depending on the extent the member state is integrated here (see table 12 and box 10). In addition, FCs may still have tasks that are part of their national mandates or which reflect the expertise they have built up over a long time. Tasks not directly derived from European rules are for instance normative comments on policy or general research on public finance topics.

Forecasting: Different traditions and current practices 11

EA member states' draft budgetary plans are assessed in autumn as part of the European Semester. While the process is similar for all countries, the involvement of independent fiscal institutions in forecasting differs.

In the 2015 autumn examination, some had their forecasts produced by entities separate from the ministry of finance but a majority of MS had them endorsed. Examples of FCs involvement include

- FR: High Council of Public Finance published two opinions on the draft budgetary plan and on the overall budget strategy as part of the national endorsement procedure. The HCPF was established as a monitoring body with guaranteed formal independence in 2012.
- ES: The macroeconomic forecast underpinning the draft budgetary plan was endorsed by the Autoridad Independiente de Responsabilidad Fiscal – a new entity created in 2013.
- DE: Federal budget based on government's own forecast involving the joint economic forecast (Gemeinschaftsdiagnose) which is issued twice a year by leading research institutes. The forecast is not endorsed by a third party.
- NL: The CPB produced the macroeconomic forecast. This has been a longstanding-practice formalised in law in 2013. While the CFB remains functionally attached to the Ministry of Economic Affairs, the institution has built up a strong reputation over time.
- AT: The macroeconomic forecast has been produced by WIFO. WIFO, one of the oldest and more research-oriented independent fiscal bodies originally founded by F. A. Hayek has a longstanding tradition of being involved in forecasting.

Sources: European Commission (2014), Deutsche Bank Research

What applies to whom? Summary of legal requirements for FCs based on EU legislation and intergovernmental treaties 12

AT, BE, CY, DE, EE, EL, ES, FI, FR, IE, IT, LT, LU, LV, MT, NL, PT, SK, SI	- Independent bodies to monitor national fiscal rules - Enhanced monitoring for Fiscal Compact balanced-budget rule - Production or endorsement of macroeconomic forecasts used in annual budget and medium-term fiscal plans
DK, RO, BG	- Monitoring of national fiscal rules to be based on independent analysis - Enhanced monitoring for the Fiscal Compact balanced-budget rule
HR, CZ, SE, PL, HU	- Monitoring of national fiscal rules to be based on independent analysis
UK	- No requirements

Sources: European Commission services, Deutsche Bank Research

Common rules and their impact on the FC landscape in Europe

Changes in European rules are likely to impact on fiscal institutions landscape in member states in different ways. First, they are likely to encourage more "consolidated" institutions, performing multiple tasks and bundling expertise, particularly where fiscal watchdogs do not have a longstanding history already. Second, for older or "veteran" institutions mainly charged with forecasting, the impact of EU rules may be somewhat ambivalent. On the one hand, their contribution to budgetary processes may become more visible and is now explicitly recognised. On the other hand, this might also lead to greater external pressure on existing bodies. Also, with greater emphasis put on monitoring fiscal rules, the bodies doing that may come to be seen as "the" main FC over time. The recently established network of national FCs for instance does not include

[24] See European Commission (2014).
[25] A second driver of convergence is the emergence of international "best practices" for FCs (e.g. OECD). In turn these inform European rules.

some of the traditional bodies mainly charged with forecasting such as WIFO. To that extent, even without mandating a specific structure, there might be some (further) convergence among European FCs over time even if not directly mandated by rules.

At present, current FCs also continue to differ with regards to staff and financial resources. Again, this reflects differences in tasks as for example the Dutch CPB, which has engaged in more resource-intensive activities like policy costing has a larger staff accordingly.

Finally, while the new bodies start with independence criteria, they may still face a greater challenge in terms of public impact because they cannot yet rely on reputation that has built up over time. For example, while independence has been established legally for most bodies and a majority would classify as operationally independent, FCs still differ when it comes to safeguards on own budgets, which matters for day-to-day management independence.[26]

Against this background, one question is to what extent FCs are going to be able to perform on their tasks (similarly) well. Notably, this matters for member states fiscal sustainability individually as well as for the Eurozone at large. A recent development is greater cooperation among national independent fiscal bodies in Europe. In 2015, EU-IFIS, a network of independent fiscal institutions formed including 23 institutions from 21 EU countries.[27] Sharing views and expertise among European bodies is part of the network's purpose. In addition, it also keeps relations with other international organizations, non-European FCs and the new European Advisory Fiscal Board.

[26] Debrun and Kinda list only 11 institutions with safeguards on budgets whereas 7 had none in place as of 2015. For some institutions, the criteria may not be directly applicable or the information is not available (yet), also reflecting ongoing reforms.

[27] See http://www.euifis.eu

Fiscal Councils in Europe – a snapshot 13

			Other tasks							
Type I : Established bodies often involved in forecasting & more research-oriented focus			Forecast Prepar-ation	Forecast Assess-ment	Monitoring of Fiscal Rules	Recom-mend-ations	Long-Term Sustain-ability [a]	Optimality [b]	Costing of Measures [c]	FC Network (Q1 2016)
AT	WIFO (Österreichisches Institut für Wirtschaftsforschung)	1927	X	0	0	X	X			0
SE	Konjunkturinstitutet	1937	X	0	0	X	0	0	X	0
DE	German Council of Economic Experts	1963	X	0	0	X	X	X	0	0
BE	Federal Planning Bureau	1959, 1994	X	X	0	0	X	X	0	0
SI	Institute of Macroeconomic Analysis and Development	1991	X	X	0	0	X	X	0	X
Type II: Monitoring FCs – includes new and adapted bodies										
AT	Fiscal Advisory Council (Fiskalrat, former Staatsschuldenrat)	2002, reformed 2013	X	0	X	X	X	X	0	X
BE	High Council of Finance	1936, reformed 1989 and 2013	0	0	X	X	X	0	0	0
HR	Fiscal Policy Commission	2013	0	X	X	0	X	X	0	0
CY	Fiscal Council	2014	X	X	X	X			0	X
DK	Danish Economic Council	1962	X	X	X	X	X	X	0	X
EE	Fiscal Council	2014		X	X	X		X		X
FI	National Audit Office of Finland	2013	0	X	X	X	X	X	0	X
FR	High Council of Public Finance	2013	0	X	X	0	0	X	0	X
DE	Stabilitätsrat / Independent Advisory Board of the Stability Council supporting the work of the Stability Council	Predecessors 1960s; 2010, 2013 (reformed)	0	0	X	0	X	0	0	X [e]
GR	Parliamentary Budget Office	2010	0	X	0	X	X	X	0	X
HU	Fiscal Council	2009	X	X	X	0	0	X	0	X
IE	Irish Fiscal Advisory Council	2011	0	X	X	X	X	X	0	X
IT	Parliamentary Budget Office	2014	0	X	X	0	X	X	X	X
LV	Fiscal Discipline Council	2014	0	X	X	X		X	0	X
LT	Budget Policy Control Institution (State audit office designated)	2015	0	X	X	X			X	X
LU	Conseil national des finances publiques	2014	0	X	X		0	0	0	X
MT	Malta Fiscal Advisory Council	2015								X
NL	Central Planbureau	1945, reformed 2012	X	0	X	0	X	X	X	X
PT	Portuguese Public Finance Council	2012	0	X	X	X	X	X	0	X
RO	Fiscal Council	2010	X	X	X	X	X	X	X	X
SK	Council for Budget Responsibility	2011	0	0	X	0	X	X	X	X
SI	Fiscal Council [d]	2009 / 2015/6	0	0	X	0	X	X	0	0
ES	Independent Authority of Fiscal Responsibility	2013/4	X	X	X	X	X	X	0	X
SE	Swedish Fiscal Policy Council	2007	0	0	X	X	X	X	0	X
UK	Office for Budget Responsibility	2010	X	X	X	0	X	X	X	X

[a] Long-Term Sustainability is defined as the long-term forecast of government balance and debt level.
[b] "Optimality" is defined as the assessment of government budgetary and fiscal performance in relation to fiscal objectives and strategic priorities.
[c] "Costing of Measures" is defined as the quantification of either short-term or long-term effects, or both, of measures and reforms.
[d] Slovenia had a Fiscal Council from 2009-2012 with a consultative remit. The new reformed Fiscal Council has been formally established but is not fully operational yet.
[e] The Independent Advisory Board to the Stability Council is a member.

Sources: Debrun/Kinda (2014), Debrun et.al (2013), European Commission, Network of Fiscal Councils, Deutsche Bank Research

What do we know about FCs effectiveness?

There is some empirical evidence that FCs can contribute to better fiscal governance. However, effectiveness also depends on FCs' characteristics and standing. First, the mandates and tasks need to be defined in a way to actually allow FCs to address the most relevant sources of deficit bias (von Hagen 2013, Debrun et. al 2013 and Beemtsma/Debrun 2016). Second, FCs contribution via accountability only works if they can send credible signals to the public.

Case studies that analyzed fiscal performance before and after the introduction of FCs or changes to their operation suggest that there have been some improvements for instance in the case of Belgium and the UK.[28] Most recent work that looks at FCs across countries assesses the combination of FCs and numerical rules and find that they can be effective together (Debrun et. al. 2008, Debrun/Kinda 2014).

There is some empirical support that FCs improve fiscal performance, for instance measured by looking at adjusted primary balance (Coletta et. al 2015) and the quality of forecasts (Frankel and Schreger 2012, Debrun/Kinda 2014). However, most research suggests that "just" having an FC is not enough. With respect to characteristics that make them work (better), independence is crucial. Also, FCs are considered to be more effective if they are well-established and have public standing, as for instance reflected in media impact.

Recent changes in the European fiscal governance architecture – strengthening i. fiscal institutions as complements to rules, ii. FCs role in forecasting, iii. their institutional independence – thus point into the right direction in principle. At the same time, they do not guarantee (FCs') success. Notably, this is because independence can be established de jure but also needs to be respected de facto for institutions to operate effectively and a strong public role may partly build up over time. To that extent, it is simply too early to assess the effectiveness of recently transformed or newly established FCs in Europe. Finally, a basic methodological problem when analyzing FCs remains to establish causality between fiscal institutions and outcomes. Critics have argued that there are other factors such as history, different norms and the broader institutional context that affect both FCs and fiscal outcomes and actually drive the results.

Measuring the effectiveness of FCs: Methodological challenges 14

Cross country analyses of FCs face several methodological challenges when assessing FCs' effectiveness:

- There may be selection effects in the sample because some countries may be more likely to set up (strong) FCs than others.
- While FCs can somewhat differ, cross country analyses need to establish a sample of „relevant FCs". Characteristics can be selected and combined to account for differences in strength.
- Relevant performance measures need to be defined. Theoretically, their performance should be assessed in connection to their tasks. One approach is to look directly at FCs' output (e.g. analyses they have produced or precision of forecasts). However, these may only partially capture their impact. Alternatively, analyses can try to establish a connection between FCs and fiscal outcome measures such as (adjusted) primary balance.
- Other country characteristics for instance general transparency around fiscal policymaking, or norms, historical and cultural factors could affect fiscal policymaking as well as FCs. If this is the case, then FCs are endogenous and any effects of FCs on other variables would just reflect other factors.

Source: Deutsche Bank Research

Examining the effectiveness of independent fiscal institutions involves several methodological challenges. Also, changes to FCs in Europe are often only recent which limits possibilities to assess their impact or track record. By and large, there is a sound theoretical case – based on FCs providing unbiased quality input and assessment to the budgetary process and via their signalling role – and a growing number of analyses that suggest positive effects.

The empirical analyses mostly focus on independent fiscal institutions and their effectiveness from a comparative perspective, i.e. examining where they exist, what they look like and how well they work. There is an additional case for having FCs in a currency union, though. Lacking the option for individual adjustments via the exchange rate, fiscal space is more important to absorb shocks. To the extent that FCs promote "better budgeting" in EA member states, they can help to increase resilience to shocks – individually and for EMU at large.

Another argument focuses on compliance and the perception of (common) fiscal rules. Fiscal rules and decisions about their enforcement are often perceived as "being done in Brussels". Strengthening FCs could be a way to foster local ownership, increase acceptance of rules (and thereby also compliance) and

[28] See Lebrun (2006) and Coene (2010), also Hagemann (2011) for a survey.

help to add a (local) expert voice to an often polarised debate about fiscal policies.

The new European Advisory Fiscal Board

The five presidents' report and the EAFB 15

The five presidents' report contains a mix of short and long-term suggestions to complete EMU. It envisages four Unions, i.e.

i) Economic Union

ii) Financial Union

iii) Fiscal Union

iv) Political Union

Short-(2015-2017) and longer term suggestions (2017-2024) for each area include

- The proposal to create a new European Advisory Fiscal Board is a short-term measure to complete Fiscal Union.
- For the medium to long-term, a macroeconomic stabilisation function for the EA is suggested.

Source: Five presidents' report (2015), Deutsche Bank Research

The European Advisory Fiscal Board (EAFB) is the latest addition to the "European System of Fiscal Councils". Its establishment follows up on a recommendation put forward in the five presidents' report 2015 which suggested the creation of a new advisory fiscal body to strengthen EMU and take a short-term step towards fiscal Union. In October 2015, the European Commission proposed further details on the new Boards' task, its working relationship with the Commission and national fiscal Councils.[29]

The EAFB is going to be composed of five members – i.e. a chair and four additional experts – and a secretariat to support their work. While the Board's secretariat is going to be attached to the Secretariat General, the board members shall be independent in performing their tasks.

The main task of the board is to support the functioning of fiscal governance in Europe and help to improve it. To this end, the EAFB is going to focus on four core activities:

1. Provide an evaluation of the implementation of the Union's fiscal framework, notably including
   a. consistency of decisions and implementation of budgetary surveillance,
   b. cases of particularly serious non-compliance,
   c. and appropriateness of the Union fiscal stance.
2. Advise the European Commission on a prospective fiscal stance for the EA and possibly also on national fiscal stances that would be consistent with the aggregate.
3. Provide ad-hoc advice on request of the President
4. Cooperate with national FCs.

Currently, the EAFB is still in the process of becoming fully operational. What can be expected of the new body? To what extent is the European FC going to be different from national ones? Is it going to be a valuable addition and what is going to determine success?

Potential "added value" – but also some caveats

The tasks of the new body have been set out in the legislation. However, this necessarily leaves some scope and therefore much is going to depend on the initiative of the EAFB, how the new body is going to interpret and live its' role. For example, a task such as 'providing advice' can take different forms ranging from internal discussions with the European Commission and policymakers to public and published analyses. In terms of content, it could range from methodological and detailed analysis on specific questions to intellectual blueprints for fundamental Eurozone reforms.

To some extent, any newly established institution would have a certain scope in defining and building up its role. However, the case of the EAFB is a bit different and arguably its scope is even wider. First, there is no blueprint or model for a Fiscal Council in a currency union. Second, national FCs have a natural "target

[29] See also ECB Economic Bulletin, Issue 7 / 2015 for an overview and Commission decision 2015/1937.

audience” to address, i.e. policymakers and the public in their respective countries (see graph 7). Again, for the EAFB the situation is a bit different and it arguably has to do more work on building up an audience – particularly beyond Brussels.

(How) Would a European Fiscal watchdog be added value?

First, it is worthwhile noting that the EAFB is not a duplicate of national FCs. The later for instance could hardly play an advising role to the European Commission and while national FC’s may also put forward views for example on the future evolution of the Union’s fiscal framework, the EAFB’s perspective as a paneuropean body is different and could add value to fiscal policy discussions. Second, the EAFB would not duplicate but could complement the work of the Commission. The routine monitoring of fiscal governance clearly remains with the latter. Where the EAFB could add value though are crucial cases that require assessment and by providing conceptual work. Third, the EAFB could add value by helping to promote expert discussion among national FCs, strengthen technical expertise and development of best practices.

While there is potential added value, this is unlikely to materialise automatically. Rather, the tasks outlined for the EAFB entail quite some challenges for the new body.

Tasks envisaged with some challenges

On the first point, i.e. the evaluation of the Union’s fiscal framework, there is in fact considerable agreement on the core problems. The framework is too complex and compliance is limited. Analyses have stressed this repeatedly. For instance, Darvas and Leandro (2015) examined the implementation of country-specific recommendations issued as part of the European semester and conclude that the overall implementation record has been rather poor.[30] Their analysis suggests implementation rates of recommendations under SGP at about 44 percent (2012-14) with even lower compliance under MIP. Also, compliance worsened over time. Gros and Alcidi (2015) similarly point out a declining trend in compliance and suggest that follow-up with recommendations is more likely for smaller countries and those facing greater market pressure. Earlier assessments by the European Commission and the European Parliament similarly support the view that compliance with country recommendations remains limited at best and uneven.

The excessive complexity of the Union’s fiscal framework and economic policy coordination is part of the compliance problem because it undermines acceptance and limits accountability.[31] In addition, the European Commission has been subject to repeated critique on the application of the rules. In particular, it is increasingly seen as bowing to political realities. For example, the recent decision to postpone fines for Spain and Portugal for exceeding deficits was partly justified by pointing out upcoming elections by the Commission. At the same time, the decision sparked again criticism in Germany leading to calls for an independent watchdog to depoliticise decisions.[32]

Against this background, the EAFB is not going to be a silver bullet. On its own, its possibilities to remedy key problems with the Union’s fiscal policy framework in the short term remain very limited. Nevertheless, the EAFB could be a useful institutional complement.

[30] See Darvas/Leandro (2015) also for measurement of recommendations’ implementation.
[31] See for example five presidents’ report: “(…) the addition of numerous ‘packs’, ‘pacts’, ‘procedures’ and manifold reporting requirements has blurred its rationale and effectiveness”.
[32] See Financial Times May 18: Spain and Portugal win reprieve over breaking EU fiscal rules.

First, given its current form, the EAFB would take an advisory role, i.e. it would not be in a position to take decisions for example on making a proposal to step up sanctions. Enforcement of the SGP would remain with the Commission. However, independent assessment by the EAFB could still increase consistency because it would make it more difficult for the Commission to deviate from the views of the EAFB. In an upside scenario, this would help to increase consistency in enforcement and take off some pressure from the Commission. In turn, if enforcement comes to be seen as less politicised, this could make it easier to reform the current framework. Arguably, part of complexity results from a lack of trust in enforcement institutions and to the extent that the EAFB could help to mitigate this, it might facilitate reforms. However, this would rather be a mid-to longer term perspective as the EAFB would have to demonstrate its impact first. Key risks for the new body are that it gets subject to political pressure and that its advice is being more or less ignored.

Second, the EAFB could contribute to a common understanding of the euro area fiscal stance. Currently, the euro area's fiscal stance is a concept that remains vaguely defined and there is disagreement on what fiscal stance would be adequate for the euro area. Disagreement over definition makes it difficult to put forward policy recommendations for adjustments to member states because the reference point remains fuzzy. To that extent, a clearer definition of the concept would be a step towards greater consistency with policy recommendations and could help to improve coordination.

In addition, the work on the fiscal stance is linked to suggestions for further EA development.[33] In the current setup possibilities to steer the EA's fiscal stance remain very limited given the lack of a central fiscal capacity and difficulties with economic policy coordination. To that extent, the EAFB could also provide work on a conceptual level, presenting an economic assessment of the different options for a Union's fiscal capacity.

Third, the EAFB's evaluation of the current framework's implementation can help to (again) point out some flaws and make the case for further reforms. But any more far-reaching changes ultimately remain contingent on political will. This applies to reforms of the current treaties as well as steps towards further Fiscal Union. The possibility for the EAFB to make suggestions on the Union's fiscal framework should not be underestimated though. In particular, these could be an important contribution to the discussion about the second stage of the five president's report to start in 2017.

What is going to affect the EAFB's success?

Two factors are going to be key. First, its impact remains contingent on being perceived as a credible independent voice. Second, developing relationships with national FCs is going to be important for effectiveness.

Basically, the stronger and more visible the EAFB is going to be, the greater its indirect contribution, i.e. to raising accountability and transparency. Given that it is a new body, much of its "reputational seed capital" and potential impact on discussions is going to come from its members, their expertise and academic credentials. Who gets to be part of the EAFB is going to be a key determinant affecting its visibility and public perception (including by financial markets).[34] Similarly, it is going to affect its working relationship with the European Commission, other policymakers also beyond Brussels and the national FCs.

[33] See Coeuré (2016).
[34] A call for expression of interest has been launched in April 2016 but members for the EAFB have not been announced yet.

The EAFB's impact on the public fiscal policy discussion

2017 is going to be a crucial year for the EAFB. It has to establish a reputation as an independent body of expertise quickly in order to make a strong contribution to the debate about reforming fiscal governance likely to gain pace next year with suggestions on stage two of the five presidents' report to be presented.

Given that the EAFB has not started to work yet, its impact on policy debates and public reach cannot be assessed yet. According to the current rules, the meetings of the Board shall not be public. While the board shall publish an annual report on its activities – including summaries of the work it has provided to the European Commission – there is little indication on how transparent the work of the EAFB is going to be. The supervisory board of the SSM for instance is required to present an annual report in public to the European Parliament. Nothing comparable is envisaged for the EAFB – which is somewhat surprising given that part of FC's value comes from a public role and fostering fiscal policy discussions. To that extent, participating in public debates on fiscal policy in the parliament or presenting its work there could be useful for the board to strengthen its public role.

Towards a European System of FC's

Establishing working relationships with the national FCs is going to be important, particularly in the initial phase. The task of the EAFB is to foster cooperation – not coordination – of national FCs. Thus, expert discussion and exchanging best practices is going to be a major part. However, this could be useful and help to build capacity, particularly given that a number of new FCs have recently been set up.

Beyond the exchange of best practices, cooperation shall also involve "facilitating common understanding on matters related to the Union's fiscal framework". Arguably, this part remains somewhat vague and notably it remains unclear how for example disagreement between a national FC and the EAFB would be dealt with. In principle, having experts with different views on the same matter, is not a problem and a natural part of discussions. However, given the already polarised debates on fiscal policy in the Union (perceptions of) disagreement could easily be counterproductive to both national FCs and the EAFBs work.

In an upside scenario though, both the EAFB and national FCs would complement each other. While the EAFB would emphasise horizontal consistency in the application of the Union's framework, the national FCs would contribute to 'local ownership' promoting greater fiscal discipline.

Fiscal governance in a multi-level system is naturally more complex and how FCs are going to best work together in this setup still remains to be defined. However, their relationship is going to be important for both the EAFB and FCs in member states.

All in all, the EAFB has the chance to become a valuable addition to the Union's fiscal governance framework – but it is unlikely to be a game-changer. There remain certain tensions between its role of advising the Commission – i.e. more internal – and the idea of having an independent body with a strong public role. The EAFB cannot change the basic setup of fiscal governance in EMU – but it can make suggestions on how to improve it, thereby influencing the policy debate and eventually the future development of EMU.

Concluding remarks

Fiscal Councils can play a useful complementary role to strengthen fiscal governance. The theoretical case for FCs is valid as an independent expert body can help to highlight trade-offs inherent to budgetary decisions, draw attention to deviations from stability-oriented fiscal policies, increase transparency and thereby accountability in fiscal policymaking. As such, FCs are an institutional element that helps to make (more) credible commitment. In practice, fiscal councils need to be independent and develop standing in the public discussion to work effectively.

The case for Fiscal Councils in Europe is a particularly strong one given the inherent tensions between fiscal policies at national level and joint monetary policy and doubts about the current fiscal governance framework to ensure sustainable public finances. Strengthening FCs offers a way to improve fiscal policymaking in the Union without facing a fundamental discussion about sovereignty. This makes it politically feasible and worthwhile trying.

Strengthening national FCs can be a step towards better budgeting in member states. On a European level, the EAFB can help to increase consistency and mitigate perceptions about increased politicisation. Both national FC and the EAFB can contribute to an informed fiscal policy debate. However, fiscal policy is always going to be political due to its strong distributional implications and FCs cannot make the basic tension between national fiscal policy and joint monetary policy disappear. Thus, FCs should rather be seen as an “additional precaution” that can make EMU work better but they are no panacea.

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