

# What are fiscal councils, and what do they do?

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*Fiscal councils are independent bodies set up by governments to evaluate fiscal policy. As problems with debt and deficits have taken hold, they have become increasingly popular. This column looks at what existing councils do and what dangers they face. It argues that, with the right guarantees of their independence in place, independent fiscal councils can make a significant positive contribution to fiscal policy.*

The delegation of monetary policy to independent central banks is now commonplace. Could delegation also play a role in controlling government deficits and debt? A number of academics have proposed this (e.g. von Hagen and Harden 1995; Wren-Lewis 1996; Calmfors 2003; Wyplosz 2005). In the last few years, five countries (Sweden, Canada, Hungary, Slovenia, and the UK) have established independent organisations, generally called fiscal councils, to provide macroeconomic fiscal advice. A few similar bodies have existed for some time, the largest being the Congressional Budget Office in the US and the Central Planning Bureau in the Netherlands. Proposals for new such bodies have been advanced in other countries, and their establishment has been encouraged by the IMF, OECD, and the European Commission.

What exactly are these fiscal councils meant to do? Are these new institutions similar in structure? Are they an alternative or a complement to fiscal rules?

In a study to be presented at an Economic Policy panel in Budapest on April 15-16, we compare the activities of eleven existing fiscal councils (Calmfors and Wren-Lewis 2011). At first sight, these bodies appear very diverse. The US and Dutch councils have over 150 staff, but some others largely consist of council members. Around half focus only on fiscal policy, while others also provide analysis of employment, growth and other structural policies. While most just consider macroeconomic issues, the two councils in North America also undertake analysis of particular spending projects. However there are some interesting commonalities.



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# Common features: Advice and fiscal rules

All the fiscal councils we examined provide some form of ex-post and ex-ante evaluation of fiscal policy and longer-run fiscal sustainability. Unlike independent central banks, no fiscal council has any formal power to decide the national deficit. Instead, they provide advice of various kinds, by producing forecasts or evaluating government policies. There are a number of possible reasons why these bodies have no formal power over policy. One is summed up in the phrase “no taxation without representation”. However, interest rate decisions can have as much influence on individual incomes as tax changes, so this explanation is not compelling. A more important factor may be the lack of consensus about what the long-term goals for government debt should be. The speed at which those goals should be achieved is equally controversial. Delegation to unelected representatives works best when there is substantial consensus about the aims of policy, and there seems to be a much greater consensus with monetary policy compared to fiscal policy.

If fiscal councils only provide advice, can they be effective in preventing the “deficit bias” that appears to have characterised OECD debt over the last few decades? Unfortunately the diversity of councils, the novelty of many of them and the difficulty of controlling for the many other influences on fiscal outcomes makes an empirical analysis very complex. The one comprehensive econometric analysis in the literature (Debrun and Kumar 2008) contains mixed results. However there are a number of reasons in theory why a fiscal watchdog could be effective. If deficit bias stems from deficiencies in information, then a fiscal council can correct those deficiencies, either by providing more realistic forecasts of the public accounts, or by simply reminding the public of the government’s intertemporal budget constraint. If deficit bias stems from common-pool problems, then a fiscal council can provide a coordination role, for example by enabling spending ministers (or coalition partners) to internalise the aggregate effects of spending decisions.

One interesting finding is that the majority of councils work alongside national fiscal rules. Fiscal councils can complement fiscal rules in at least two ways.

- First, they can help monitor whether fiscal rules are being met. For example, most fiscal rules attempt to allow for cyclical influences on government deficits, but undertaking this correction is complex in practice. Governments may be tempted to distort corrections or forecasts, and a fiscal council can act as a watchdog to alert the public if this is happening.

- Second, even fairly complex rules may be a poor approximation to optimal policy, and a fiscal council can advise when it is sensible to depart from these rules. For example, the Swedish Fiscal Policy Council argued that the government could implement more discretionary fiscal expansion after the 2008 recession. In principle fiscal councils could also advise governments on how to improve fiscal rules, but only a minority of fiscal councils have attempted to address how existing rules relate to “higher level” social and economic objectives.

## **Diversity: Forecasting, policy advice and vulnerability**

There is an interesting divide amongst councils when it comes to forecasting, with only around half producing their own macroeconomic forecasts. Two councils, in the Netherlands and in the UK, produce the official forecasts on which government decisions are made. While this could remove deficit bias caused by governments producing over-optimistic forecasts, it also has the potential to compromise the independence of the fiscal council. This problem is partially mitigated in the Netherlands by the fiscal council preparing fiscal projections for opposition parties before an election.

Fiscal councils also differ in the amount of normative advice they provide. About half provide only positive analysis. The Congressional Budget Office, for example, is mandated to provide non-partisan advice. However in these cases the councils generally produce some assessment of the impact of alternative policies. A good example is the Congressional Budget Office’s 2010 report on the long-term budget outlook, which looks at the impact of alternative paths for debt stabilisation. Only in the case of the UK does the fiscal council appear to be constrained not to analyse any alternative to current government policy.

This diversity among fiscal councils may in part reflect the variety of explanations advanced in the literature for deficit bias. In the UK, for example, a view that government fiscal forecasts were too optimistic was important in giving the Office for Budget Responsibility 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 wide remit. Sometimes diversity may reflect permanent differences in political structures. For example, the council in the Netherlands provides estimates that serve as a basis for the negotiations among coalition partners. However in other cases diversity may reflect particular issues that were prominent at the time the councils were established, but which may not be persistent. In this 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. In this sense, fiscal councils may have a lot to learn from each other.

Although fiscal councils are clearly becoming more popular, they also face severe dangers from the governments that they may end up criticising. We argue that it is in the long-term interest of governments to establish independent fiscal councils. But there is also a strong temptation for governments to constrain the actions of a council to avoid criticism in the short run. This was illustrated by the fate of the Hungarian Fiscal Council. After only two years in existence, the council had its secretariat taken away and was transformed into a far less effective body. This occurred after the council had criticised the government for making overoptimistic assumptions and for a lack of transparency. The fiscal council's budget in Canada was significantly reduced after it published critical reports. In Sweden, the Ministry for Finance has been pushing for changes that would restrict the activities of the Fiscal Policy Council.

New councils, which have yet to establish a public reputation, may be particularly vulnerable to political interference. In our view, more attention has to be given to formal provisions that ensure both the independence and survival of fiscal councils, with the example of central banks providing useful lessons. International monitoring could play an important role in raising the political cost of interfering with the independence of fiscal councils. This would also help make fiscal councils more accountable, which may be crucial for long-run legitimacy. All in all, we believe that independent fiscal councils can make a significant contribution to good fiscal policy provided that they are established in a form which guarantees their independence.

## References

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