

Asatryan, Zareh et al.

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Making the most of the European Fiscal Board

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ZEW^{SEEK-ENBI} policy brief

Zareh Asatryan, Xavier Debrun, Friedrich Heinemann, Michal Horvath,
L'udovít Ódor, Mustafa Yeter

Making the Most of the European Fiscal Board

1. Introduction

Following numerous reforms of fiscal governance in the eurozone since 2011, the year 2016 saw another important innovation: the founding of the European Fiscal Board (EFB) with the selection and appointment of its five members. The EFB was one of the elements envisaged by the Five Presidents' Report in June 2015 (Juncker et al., 2015) for a future "Fiscal Union". It is the only element among those in the report to have been established within such a remarkably short time span. The decision to create this new institution was taken by the European Commission (EC) in October 2015¹. The Board began operating shortly after its members were appointed in October 2016.

The EFB's broad mandate includes the following main tasks (European Commission, 2015, Article 2):

1. To evaluate the implementation of the European Fiscal Framework²:
 - In particular, to ensure horizontal consistency of decisions with respect to budget surveillance and non-compliance with fiscal rules, to pinpoint unequal treatment in cases of violations of the Framework, and to make suggestions for the future evolution of the Framework.
2. To advise the Commission:
 - On the actual and prospective fiscal stance appropriate on both the national level and the eurozone as a whole.
3. To cooperate with national fiscal councils:
 - Through the exchange of best practices and through facilitating common understanding on matters related to the fiscal rules of the EU.

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Disclaimer: The views expressed here are those of the authors and do not necessarily represent the views of the institutions they present.

¹ Commission Decision 2015/1937 (European Commission, 2015), amended through Commission Decision 2016/221 with respect to Head of Secretariat (European Commission, 2016a)

² As defined by articles 121 (common and coordinated economic policy), 126 (surveillance and prevention of excessive deficits), and 136 (increased surveillance and coordination within the Euro zone) TFEU.

The EFB is unique in that it is set up at the supranational level. This is in contrast to the numerous independent fiscal councils that have been established at the national level in individual European countries over recent years. Despite this major typological distinction, there are conceptual parallels between the EFB and these national councils. In fact, the Five Presidents' Report points to the national councils as examples of how an independent advisory body could be designed at the EU level ("it should [...] conform to the same standards of independence", Juncker et al. 2015, Annex 3).

The number of countries with fiscal councils has increased from 1 in 1945 to 12 in 2007 and 37 in 2015 (Debrun, et al. 2017). Increasingly, these independent fiscal watchdogs are established to complement fiscal rules, and often have the explicit mandate to monitor compliance with these rules. By the end of 2015, only 3 countries – Canada, South Korea, and South Africa – had a fiscal council but no fiscal policy rules. The need for countries to reaffirm their commitment to fiscal responsibility in the aftermath of the global financial crisis of 2008-9 offers a partial explanation for the rise in fiscal councils worldwide. In the EU, the Fiscal Compact requires assigning "independent bodies" at the national level (although not necessarily to a new fiscal council) with the task of monitoring compliance with the deficit rules and assessing the macroeconomic and budgetary forecasts underlying commitments under the rule (TSCG, 2012, Article 3).

The basic rationale of councils in any federal context is to bring more political independence and unbiased (academic) expertise into budgetary debates. Contrary to monetary policy where independent central banks have the executive power to make decisions on monetary policy, fiscal councils lack this kind of decision power. However, a successful council can influence fiscal outcomes by providing parliaments, governments and the general public with reliable information on the budgetary situation, its prospects, and the potential impact of certain policy initiatives.

While governments are becoming increasingly familiar with the growing number of councils at the national level, the EFB is nonetheless unique given the multi-level context of its tasks. Unlike national councils, it does not directly address budgetary decision makers. Instead, its main task is to advise the European Commission on its responsibility to implement the European fiscal framework. Whereas a national council typically serves as the immediate watchdog for the budgetary actors (i.e. the national parliament and government), the EFB is rather a "watchdog for another watchdog," although the Commission is admittedly a special watchdog, one that can bite through enforcement powers).

Given this peculiar role in the universe of fiscal councils, the EFB is expected to support the Commission in its multilateral fiscal surveillance of Member States and their budgetary policy. One obvious interpretation is that this board of experts shall serve as a neutral and well-informed monitor of the Commission to dispel perceptions or deter the temptation to let political motivations taint its even-handedness in implementing the EU-wide fiscal framework.

One striking feature (and a major difference compared to a typical national fiscal council) is that the EFB's remit does not cover the EU budget itself. There is indeed no mandate to assess fiscal decisions

made by the EU budgetary authorities themselves (e.g. on the Multiannual Financial Framework, the annual EU budget or other European level fiscal instruments like the European Stability Mechanism or the growing number of budgetary entities like the EFSI or the new trust funds in the context of asylum and refugee policies).

In light of this unusual setting, we explore the prospective effectiveness of the EFB and propose potential avenues for its further improvement. Our point of reference is a set of principles and best practices for independent fiscal institutions as they have emerged in the literature on national councils.³ Before taking a thorough look at the setup of the EFB we briefly summarise the lessons from the scholarly literature on the basic rationale of fiscal councils and their potential main channels of impact. Although that recent literature has been inspired by the post-crisis proliferation of national fiscal councils, it is the natural starting point.

2 Fiscal Councils: Rationale and Impact

As early as 1788, James Madison, the 4th President of the United States, famously observed: “A dependence on the people is, no doubt, the primary control on the government; but experience has taught mankind the necessity of auxiliary precautions.” In today’s words, Madison was warning that democratic accountability was often not enough to effectively limit policymakers’ budgetary discretion in democracies (see, e.g., Fatás et al., 2003). Historically, two institutional solutions – or “auxiliary precautions” – have been proposed to discourage the misuse of fiscal policy discretion: i) budgetary rules, such as general procedural rules or numerical rules for deficits or debt brakes, or ii) independent fiscal institutions with certain budgetary responsibilities or at least oversight duties.

The obvious weakness of a rule is that even in its most sophisticated form, it will hardly be able to anticipate all contingencies or offer guidance on the best possible fiscal stance. Unlike monetary policy, fiscal policy is too complex to be boiled down to simple numerical rules (Debrun, Hauner and Kumar, 2009). And even though simple “Taylor-rules” have been advocated in the monetary realm, they have never been used as a tool to tie the hands of policymakers. Consequently, a dilemma emerges: Discretion is indispensable and at the same time prone to myopic political abuse. Well-designed independent fiscal institutions could alleviate this dilemma. For a discussion on the role of fiscal councils in easing several trade-offs in fiscal rules design see Research Note 6.3.

Since the mid-1990s, difficulties with designing and implementing fiscal policy rules have led economists to think about how non-partisan fiscal watchdogs could affect policymakers’ incentives in a more credible and effective way than through arbitrary and inflexible caps on deficits, debts or other budgetary aggregates. By influencing the public debate on fiscal policy through independent assessments, forecasts, and opinions, fiscal councils could better inform voters on the short-term and long-term effects of given policy decisions, helping them support desirable options and oppose undesirable

³ For instance Debrun et al. (2013) or von Trapp, Lienert and Wehner (2015).

ones (Kopits 2013; Debrun et al. 2013). Although fiscal watchdogs would not be expected to bite, their barking in the face of bad fiscal policy could be sufficiently loud to discourage potentially harmful measures. Unlike rigid fiscal rules, analysis from fiscal councils could lead to more adequate policy responses in virtually any circumstances while preserving confidence in long-term sustainability. The argument is of course particularly relevant when tail risks disrupting almost any fiscal rule materialise, as occurred in 2008.

While this line of arguments could help explain the increased appetite for independent fiscal institutions after the global financial crisis, fiscal councils share with fiscal rules a vulnerability to governments' fickle incentives to take them seriously. Unlike independent central banks, fiscal councils do not have the power to set a specific instrument to fulfil a certain mandate for which they can be held directly accountable. Fiscal policy discussions are inherently less consensual, and more prone to ideological pronouncements than monetary policy, making open conflicts between a watchdog and its political master more likely. In addition, fiscal councils do not have the financial independence that comes with the power to conduct monetary policy. Politically motivated threats to their capacity to operate or even to their existence are *a priori* more credible and more likely to materialise than in the case of central banks. Experience confirms that public conflicts, including sometimes retaliatory budget cuts, can significantly undermine the capacity of a council to influence the public debate on fiscal policy.

The above comparison with independent central banks shows the importance of distinguishing between two types of independent fiscal institutions commonly discussed in the economic literature (Debrun, Hauner and Kumar, 2009): While an "independent fiscal authority" has decision power similar to that of independent central banks, a "fiscal council", in contrast, lacks any executive budgetary authority. The fiscal council is limited to advisory and oversight roles in which it provides independent analysis and in some cases forecasts and opinions. Independent fiscal authorities that can make binding decisions, for instance, on debt, deficit or expenditures have simply never existed barring post-conflict situations characterised by the absence of functional political institutions. From a normative perspective, the public finance literature is also highly sceptical whether this infringement on parliamentary prerogative can be justified on normative grounds (Alesina and Tabellini, 2007; Debrun, Hauner and Kumar, 2009). In some mostly isolated cases, however, fiscal councils can be directly integrated into the budget process, for example, to make macroeconomic and budgetary forecasts,⁴ to slow down or halt the budget process,⁵ to make decisions related to fiscal rules,⁶ and to set deficit tar-

⁴ In the UK, for instance, projections of the Office for Budget Responsibility are used in the budget.

⁵ The most extreme version is assigning veto power to a fiscal council. Currently, only the mandate of the Hungarian fiscal council involves this formal mandate.

⁶ For instance, a fiscal council might play an important role in triggering escape clauses.

gets.⁷ Apart from these rare examples of rather direct (“biting”) influence, fiscal councils predominantly influence budgetary outcomes through indirect (“barking”) channels of impact.

The most important indirect channels involve:

- **Better fiscal analysis (research) and identification of risks:** The mere presence of a well-designed council can significantly increase the quality of publicly available fiscal analysis. Moreover, policy proposals might be better prepared if the ministry knows in advance that major reforms will be cross-checked by the fiscal council. Regular policy surveillance by international monitoring institutions (such as the EC, the IMF or the OECD) might also benefit from the analysis carried about by the independent fiscal institutions. The importance of credible and evidence-based advice in fiscal policy is highlighted by Research Note 6.2 on the example of estimated fiscal multipliers. As detailed in the note, this central parameter in the design of fiscal policy has a very wide range and may be biased towards researcher-specific preferences.
- **Overcoming information asymmetries:** As described by Debrun and Kinda (forthcoming) and Beetsma and Debrun (2016) politicians deciding on the budget may have disincentives to provide voters with full information on the actual fiscal environment (e.g. growth), the state of the public sector balance sheet and the risks surrounding it (e.g. hidden debt) and its prospects (both short-term budgetary forecasts and long-term sustainability issues). By concealing such information, politicians can gain more leeway for a myopic agenda or obscure their own lack of effort or ability. Furthermore, it is often hard for voters to distinguish between bad luck and bad policies or between good luck and good policies. In line with this view, fiscal councils can mitigate this asymmetry of information and provide the media, voters or other players (e.g. the political opposition) with unbiased information conducive to a more substantive public debate. For instance, a council may detect over-optimistic growth and revenue projections or reveal the true structural current budgetary situation, reducing the risk of pointless and paralysing arguments about numbers.
- **“Comply or explain” principle:** This principle can ensure more robust and coherent policy making. When this principle is applied, governments cannot simply ignore the opinions of fiscal councils. Instead, they either have to comply with the propositions made by the fiscal council, or publicly justify why they are not implementing them or are pursuing a different policy measure from those initially suggested by the fiscal council. In order to maximise the impact of this principle, it is crucial to set a legally binding time frame within which a government has to explain why it has disregarded suggestions made by the fiscal council.

So far, only a few studies have assessed the aggregate effectiveness of fiscal councils in improving budgetary prudence. As described in Table 1, these studies present a mixed picture. For example, the available evidence points to a reduced bias in forecasting on the part of governments when fiscal

⁷ A somewhat weaker integration of fiscal councils in this respect is present in some countries (e.g., Ireland), where the fiscal council has to judge the appropriateness of the current fiscal stance.

councils are present, but a direct link between the existence of councils and fiscal aggregates cannot be substantiated.

An ongoing ZEW study, summarised in Research Note 6.1, explores the interplay between fiscal councils and fiscal rules when the former has the explicit mandate to monitor fiscal rules. The results indicate that fiscal councils with a mandate to monitor the adherence to fiscal rules, on average, do not strengthen the impact of the latter when looking at the cyclically adjusted primary balance. On the other hand, the study provides evidence for reduced yield spreads on long-term government bonds if fiscal rules are supported by fiscal councils with a mandate to monitor the former.

Overall, the existing literature paints a mildly optimistic picture. Obtained empirical estimates are in line with the indirect channel of impact through which fiscal councils can help reduce information asymmetries and in so doing contribute to fiscal decisions more in line with sound public finances. Such an effective impact, however, will depend greatly on the details of the institutional set-up of fiscal councils, a point discussed more in detail in the following section.

Table 1 - Summary of empirical papers on the effectiveness of fiscal councils

| Study | Sample | Method | Result |
|-------------------------------------|---|--|---|
| <i>Effects on fiscal aggregates</i> | | | |
| Debrun & Kumar (2007) | EU-15 (excl. LUX), 1990-2004 | Dynamic panel estimation | Negative and statistically significant effect of fiscal councils on the cyclically-adjusted primary balance |
| Debrun, Gérard & Harris (2017) | 7 EU Member States, ⁸ 2003-2010 | Least-squares dummy variables approach and pooled OLS | A stronger media presence of the fiscal council is associated with a larger planned change in the cyclically adjusted balance |
| Nerlich & Reuter (2013) | EU-27, 1990-2012 | Dynamic panel estimation using bias corrected least squares dummy variables approach | Evidence for an improved balance as well as reduced expenditures when fiscal rules are supported by fiscal councils. This effect is more pronounced with the increasing independence of councils with respect to resources and staffing decisions. |
| Maltritz & Wüste (2015) | EU-27, 1991-2011 | Dynamic estimation of repeated cross-sections | Positive and statistically significant effect on the primary balance of the interaction effect between fiscal rules and fiscal councils. Conditional effects for both rules and councils are positive and statistically significant |
| Debrun & Kinda (forthcoming) | 58 (advanced and emerging countries), 1990-2011 | Dynamic panel estimation using bias corrected least squares dummy variables approach | Overall, no statistically significant effect of fiscal councils on the primary balance. However, individual properties such as the monitoring of fiscal rules, costing of policy measures, or a strong media impact exert a positive and statistically significant impact on the primary balance. |
| <i>Effects on forecasting error</i> | | | |
| Frankel & Schreger (2013) | 17 European countries ⁹ , 1999-2011 | Repeated cross-section estimation | Evidence for reduced budget balance forecast errors when fiscal councils are present |
| Gilbert & de Jong (2014) | EU-27, 2001-2012 | Probit 2SLS IV approach for the probability to pass the 3% | Reduced upward bias in European Commission's fiscal forecasts if a national fiscal council is present |

⁸ AUT, BEL, DEU, DNK, NLD, SVN, SWE.

⁹ AUT, BEL, CHE, DEU, DNK, FIN, FRA, ESP, GBR, GRC, IRL, ITA, LUX, NLD, NOR, PRT.

| Study | Sample | Method | Result |
|------------------------------|-----------------------|---|---|
| | | threshold of the SGP | |
| Debrun & Kinda (forthcoming) | 26 European countries | Panel estimation including time fixed effects | Forecast error in primary balance is reduced when a fiscal council is present, or has a high media presence, or monitors fiscal rules |

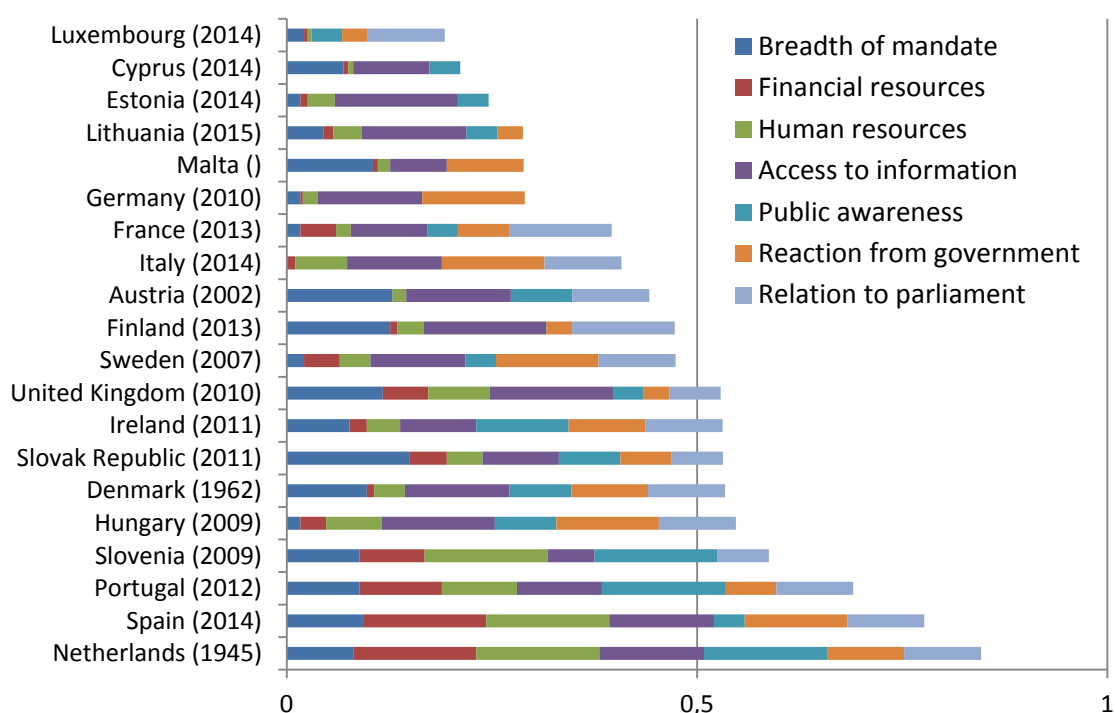
Source: Own compilation.

3 Principles for Independent Fiscal Councils

Experience with national fiscal councils and their particular strengths and weaknesses has led to an understanding of the importance of specific design features of fiscal councils (see Calmfors and Wren-Lewis, 2011; Debrun et al., 2013; Beetsma and Debrun, 2016; Horvath, 2017). These lessons have been condensed most prominently in the OECD Principles for Independent Fiscal Institutions (IFI), adopted by the OECD Council in February 2014 (for details see von Trapp, Lienert and Wehner, 2015).

Assessing the effectiveness of different national councils in light of these criteria reveals great heterogeneity. Looking at both pre-crisis fiscal councils as well as those induced by the Fiscal Compact reveals substantial differences with respect to their remit as well as organisational structure. While the Fiscal Compact only required the formal establishment of a fiscal council, the treaty gave leeway for Member States with respect to details of their institutional design. By the same token, this also applies to purely home-grown councils established prior to the crisis. This leeway in the institutional design of councils, however, can have direct repercussions on their potential effectiveness. Figure 1 summarises these potential repercussions by ranking national councils according to their aggregate scrutiny effectiveness based on seven design features.

Figure 1 - Ranking of fiscal councils according to aggregate scrutiny effectiveness



Notes: The index is a weighted average of 7 sub-categories (where the first five and the last two get a weight of 0.75 and 0.25, respectively) and can range from 0 (lowest) to 1 (highest effectiveness). *Source:* Horvath (2017).

The OECD Principles for Independent Fiscal Institutions (IFI) involve:

- **Local ownership:** An IFI requires ownership, commitment, and consensus across the political spectrum in the respective jurisdiction. For that purpose, the institution should be a good fit for the environment and not just be an artificial copy of an outside organisation or the result of an external obligation.
- **Independence and non-partisanship:** Legal and factual independence is a defining characteristic of an IFI intended to enrich the fiscal setting as a depoliticised institution. The selection of its members based on professional merit and competence supports the council's independence. Term lengths should be independent from an electoral cycle with clear criteria for dismissal. Ideally, the leadership of an IFI should have full freedom to hire its staff and without reference to political affiliation.
- **Mandate:** The tasks should be clearly defined in higher-level legislation including the required reporting obligations. IFIs should have leeway to provide analyses consistent with the mandate on their own initiative. To contribute to an effective reduction of information asymmetries, a council's mandate should involve a watchdog function with respect to all sources of budgetary opacity like the government's budgetary forecasts, long-term implicit debt, or the costing of policy initiatives.
- **Resources:** Even the broadest mandate and a wealth of legal rights cannot make a fiscal council influential if it lacks the necessary monetary and human resources. That is why the legal provisions always have to be assessed in the light of the institution's available staff and capacities including its access to information. Ideally, a fiscal council would exhibit its own independent and non-negotiable line in the budget.
- **Relationship with the legislature:** Besides the general public, a council can improve the level of information available to budgetary decision makers and also challenge them in hearings or other interactions if it has the right or occasion to do so. A habitual or even obligatory reaction ("comply or explain") from the scrutinised institution to IFI statements would signal a higher impact.
- **Access to information:** An effective IFI needs to have access to budgetary information (including methodologies and assumption used) in a timely manner at no cost. This should ideally be codified as a legal right of the fiscal council.
- **Transparency:** IFI reports and analysis must be published in their own name and be made freely available. Release dates of major report should be formally established and correspond to the timing of budgetary decisions.
- **Communications:** IFIs must have (and make use of) comprehensive rights and capacities to communicate with media, the general public and stakeholders. This also requires the media to take

notice of the council's existence and statements. Naturally, new institutions will be at a disadvantage compared to institutions with a long tradition.

- **External evaluation:** IFIs should develop a mechanism for external evaluation of their work e.g. through evaluations of the quality of their analyses. For that purpose, instruments like a peer review system or an advisory board can be used.

The relevance and importance of these properties become even more striking when looking at national fiscal councils. For instance, the Canadian fiscal council illustrates the risks associated with a low level of legal and operational independence from the executive branch, leading to political pressure. Following a critical analysis of a government program, the council faced a significant threat of budget cuts. Furthermore, the Canadian fiscal council's lack of a legal right to access information led to a legal battle before a federal court to obtain the necessary information (Curristine, Harris and Seiwald, 2013).

A regular but well-timed media presence throughout the year is crucial for a successful fiscal council. In fact, communication can be an integral part of the mandate of a fiscal council. For instance, the Swedish fiscal council is explicitly tasked with explaining the economic foundations of policy proposals and their motivations to the public (Curristine, Harris and Seiwald, 2013). The Dutch fiscal council has achieved a high media presence by engaging in policy costing. This is part of its mandate boosts media presence especially in the run up to parliamentary elections when the Dutch fiscal council provides costings of the reform proposals put forward by all major electoral platforms (Curristine, Harris and Seiwald, 2013). More generally, it is important for effective fiscal council communication to remain focused and predictable. A pre-announced schedule of communication avoids the risk of a running commentary that fails to add value to the public debate, and it mitigates perceptions of politically motivated media interventions.

While the EFB is distinct from most national fiscal councils given its federal nature, it bears some resemblance to the Spanish fiscal council, which has the key task of monitoring fiscal discipline at all federal levels of government. That said, the EFB remains unique in that it monitors and assists a supranational entity instead of national budgetary authorities. All in all, there is enough commonality with national fiscal councils to apply the general principles for IFIs and draw lessons from the development and activities of national fiscal councils.

4 The Potential Effectiveness of the EFB

4.1 General considerations

The EFB is conceptually similar to IFIs at the national level in that its role is limited to a monitoring and advisory role. This approach had been made clear in the Five Presidents' Report: "It should advise, not implement policy. Enforcing the rules should remain the task of the European Commission

[...]” (Juncker et al., 2015, Annex 3). Consequently, the EFB does not have a say on budgetary decisions at the national or European level. Furthermore, it does not have an executive role with respect to the application of enforcement rules and sanctions of the Stability Pact. Enforcement remains the full responsibility of the European Commission (in its interplay with the Council).

Yet the EFB is fundamentally different from national fiscal councils because, as discussed above, it does not monitor the Commission as a budgetary authority itself but rather as an enforcer of the European fiscal framework. Against this background, the establishment of the EFB itself increases the complexity of the institutional set-up. In the future, national budgetary policy will be under the scrutiny of the following authorities:

- National budgetary authorities (i.e. national parliament and government, court of auditors),
- National fiscal councils,
- European Commission and
- European Fiscal Board.

This enriched set-up creates opportunities and risks.

Depoliticisation: European governance has evolved into a highly complex system whose details are by no means fully understood by more than a few experts (see Research Note 6.3). This leaves the Commission ample room to make decisions that the public can scarcely understand. The Commission president Jean-Claude Juncker’s ambition to lead a “political Commission” (Juncker, 2015) can be interpreted in this light. In the context of fiscal rules, politicisation is potentially toxic. It might imply pandering to political considerations in the interpretation of fiscal rules, effectively disconnecting enforcement from the ultimate objective of preserving fiscal sustainability throughout the economic and monetary union. Juncker’s famous justification for accepting further French delays in consolidation just “because it is France” (Guarascio, 2016) illustrates almost to the point of absurdity the perception of undesirable discretion on the part of the Commission. Moreover, the fiscal framework has failed to avoid pro-cyclical policies and to ensure fiscal sustainability (see Research Note 6.3). In this environment, a fiscal council could be an important countermeasure against myopic political considerations and could foster more politically neutral and objective long-term surveillance of fiscal policy.

Risk of higher noise-to-signal ratio: Adding another watchdog to an already complex system of fiscal governance may not necessarily improve public information. As a new and untested institution, the EFB might, at least initially, be perceived as an added source of noise to the public debate on budgetary policies in Europe. The EFB’s messages and communication would indeed be adding to those of national treasuries and independent national fiscal councils, the European Commission, and international organisations (not to mention rating agencies and private analysts). In the absence of reasonable ex-ante cooperation among independent official bodies commenting on fiscal policy, the risk of cacophony looms large, undermining the public’s ability to send the right messages to their policymakers.

ers through established accountability mechanisms. The risk of a rising noise-to-signal ratio can be mitigated by the intrinsic quality of EFB work and by its ability to cooperate with other official institutions by providing surveillance on national fiscal policies.

4.2 EFB and OECD principles

Assessing the set-up of the EFB in light of the OECD criteria is difficult. A new institution has no track record meaning that, for the time being, any judgment is inevitably speculative in nature. Nevertheless, some cautious first assessments based on the principles described above are possible (and necessary) already at this early stage of this new institution's existence.

Local ownership

Ownership does not seem to be a fundamental concern. The EFB has been established following the blueprint of the Five Presidents' Report chaired by the President of the Commission. The proposal has been consensual. The short time-span between the Report and the actual establishment of the EFB is a further indicator that this building block of a Fiscal Union has been one of the least controversial ones.

Independence and non-partisanship

Formal independence is guaranteed in the Commission Decision (Article 4): "the members of the Board shall act independently and shall neither seek nor take instructions from the Union's institutions or bodies, from any government of a Member State or from any other public or private body." All five members are appointed by the Commission on the proposal of the President. This strong role of the Commission in member selection is unfortunate given that the Commission is the object of the Board's scrutiny. In the case of three ordinary members, there are consultations with national fiscal councils, the European Central Bank and the Eurogroup Working Group (Article 3). The initial selection of members (see box 1) clearly reflects a great focus on academic merit and expertise. The term length of Board members, set at 3 years (with one possible renewal), is fairly short compared to best international practice and well below the 5 year term of the Commission. This weakens actual independence further. Another obvious imperfection is the Board's lack of its own staff. The EFB has to rely primarily on the Commission's staff for its secretariat. This integration of the EFB and its staff into the Commission's institutional structure might reduce its credibility as an independent advisory body (European Central Bank, 2016, International Monetary Fund, 2016).¹⁰ The lack of organic independence is also in stark contrast to most of the national councils, which are either stand-alone institutions with functional autonomy and formal independence from budgetary authorities or benefit from specific guarantees on their operational independence if they are embedded in other institutions (executive, parliaments or audit courts). Some observers, therefore, classify the EFB as merely an "internal advisory body of the Commission" (Claeys et al., 2016, p. 16) rather than an IFI-type institution.

¹⁰ Media reports about internal Commission disputes on the choice of a head of the secretariat already suggest political infighting over the selection of a crucial staff member (Carretta, 2016, Marks and Saltmarsh, 2016).

Box 1 - EFB Members¹¹



Chair: Niels Thygesen (Denmark): Professor Emeritus of International Economics at the University of Copenhagen; formerly: Danish Government, OECD, Nationalbank, Danish Economic Council (chair), member of Delors Committee.



Roel Beetsma (The Netherlands): Professor at the University of Amsterdam; formerly: University of California at Berkeley, University of British Columbia, and DELTA (Paris).



Massimo Bordignon (Italy): Professor of Public Economics at the Catholic University of Milan; formerly: International Monetary Fund, Italian Treasury.



Sandrine Duchêne (France): General Secretary of AXA France in charge of audit and compliance; formerly: Deputy Director General and Chief Economist of the French Treasury, Adviser to President Hollande, Head of the Economic Forecasts Division at INSEE.



Mateusz Szczurek (Poland): former Finance Minister of Poland. PhD University of Sussex. Associate Director, Lead Regional Economist in EBRD. Chief Economist of ING Poland and ING Group for Central Europe and Eastern Europe.

Mandate

The mandate with respect to the European fiscal framework, the national and European fiscal stances and the cooperation with national fiscal boards (see introduction) is defined in a Commission Decision, as a legal instrument that, in the hierarchy of norms, does not carry the weight of a Regulation and is as such easily reversible. The mandate is broad although it excludes typical tasks of national fiscal councils (e.g. assessment of draft bills and forecasts, assessment of long-term sustainability). However, these exclusions seem appropriate given the specific role of the EFB as a watchdog of the Commission in its surveillance role (and not to a budgetary authority directly). On the other hand, the mandate for analysing and commenting on the “fiscal stance” is rather untypical for national councils.

The “fiscal stance” dimension could potentially conflict with surveillance carried out under the Stability and Growth Pact. The former could be interpreted as a discretionary demand management approach whereas the latter is a set of (imperfect) operational rules and last-resort ceilings that aim to reconcile long-run sustainability and countercyclical considerations. Arguably, the recent increasingly politicised implementation of the Stability and Growth Pact blurs the distinction between the two. The mandate to advise on fiscal stance is an opportunity to restore the distinction and revert to a transparent, rules-based evaluation of fiscal policy in the EU. At the same time, as a part of its mandate to

¹¹ Own compilation. Source of pictures: http://ec.europa.eu/economy_finance/graphs/2016-10-20_european_fiscal_board_en.htm

make suggestions for the future evolution of the fiscal framework, the EFB has a legal basis to reflect on the appropriateness of the relative importance assigned to fiscal sustainability and countercyclical considerations in the Stability and Growth Pact.

Analyses of the interplay between the fiscal stance and fiscal sustainability are, however, analytically challenging and raise many questions for which no consensus exists. In combination with the resource constraints of the EFB (see below), this constitutes a major problem.

Regardless of how board members interpret their mandate concerning assessments of national and eurozone fiscal stances, there is a clear danger that the EFB might get involved in discussions about fiscal stances without a solid analytical foundation. This could damage its reputation and the Board might easily be dragged into ideological debates between demand- and supply-side views.

The task to cooperate with national fiscal councils (aiming at “exchanging best practices and facilitating common understanding on matters related to the Unions fiscal framework”, Article 2) corresponds to its position on the European federal layer. Here, an interesting change in terminology has occurred from the Five Presidents’ Report to the Commission Decision. The Report announced the Board to “coordinate” the network of national fiscal councils, which the Commission Decision has changed to “cooperate with”. This change serves as a response to concerns about a threatening European (Commission) intervention in the work of national councils and their independent assessment.

Resources

Financial and human EFB resources are limited: The chair and the members are expected to dedicate not more than 20 and 10 full working days a year respectively to their role on the Board.¹² The members of the EFB are supported by a secretariat with a staff of six persons seconded from the Commission staff but who take instructions only from the Board. In comparison, the top third of the national boards in Europe (excluding the Dutch Central Planning Bureau) have on average 20 employees and have an annual budget of 2-2.5 million Euros at their disposal.

This relative scarcity of resources raises questions as to how the EFB can convincingly carry out its tasks. Given that the five academic members are the guarantors of institutional independence (and not the Commission staff in the secretariat) their limited availability is a key problem. Tasks like relations with European institutions, national fiscal councils, the media and stakeholders are time consuming and seem unlikely to be feasible in such a straightjacket. Also, unless board members are willing to engage voluntarily with the EFB agenda beyond the daily remuneration set by their contract, there is a risk of EFB output bearing the fingerprints of EFB staff rather than board members. This can be seen as detrimental if the EFB’s analytical and secretarial staff are not perceived to act independently from the Commission (e.g., because of career ambitions within the Commission). In addition to the physical

¹² See call for expressions of interest for the selection of the members of the European Fiscal Board Official Journal (European Commission, 2016b).

capacity of staff to scrutinise Commission decisions, there is thus also a question of culture and incentives to criticise the EU fiscal framework and its implementation.

Relationship with the legislature

The Board is accountable to the Commission, not the Council or the Parliament. For national councils, well-defined relations with the legislature are crucial. An integration of council expertise in parliamentary budgetary procedures clearly fosters their impact. However, in this regard, best practices from national councils cannot be simply transferred to the EFB which has no mandate to monitor EU budgetary decisions made in the European Parliament. Nevertheless, a firm link to both the Council and the European Parliament is desirable. The Council, alongside the Commission, is a crucial player in the European fiscal framework so it is important that the EFB's views are also directly communicated to the Council. And the Parliament, in its hearings, could offer a prominent platform to the EFB and thus strengthen the Board's emancipation from the Commission.

Access to information

According to Article 5 of the Commission Decision the practical modalities for access to relevant information are laid down in a memorandum of understanding (MoU) signed between the Board and the Commission. Practical experience gained in the first months of the EFB's operations will show whether information flows are sufficient. In this respect, the integration of the Board's secretary into the Commission, which is problematic in terms of its independence, could be beneficial here.

It must be stressed that the resource constraints also imply an information constraint. If the EFB lacks the capacity to replicate the Commission's analyses and to experiment with new ones (e.g. on output gap estimations) this amounts to a fundamental information problem.

Transparency

On transparency, the Commission Decision is brief, only requiring (Article 6) the publication of an annual report. No precise date is indicated, meaning that the Board has leeway in this regard. While integrating the EFB work in the already overcrowded European Semester would seem desirable, it is hard to see how the EFB could overcome its resource constraints to provide timely and effective communication.

Full transparency provides the greatest protection of independence and credibility for fiscal councils. The EFB was set up as an *advisory* body and the Commission Decision implicitly assumes that the EC will be the main recipient of the Board's analyses and recommendations. It is not entirely clear at this stage whether all reports of the EFB will be publicly available or just a subset of them. The OECD Principles also stress that fiscal councils should release their reports and analysis in their own name. Since the EFB is not a standalone institution with a clear identity (logo, website, etc.), publishing reports under the Commission's logo might create confusion and impair the effectiveness of communication of the most important messages.

Communications

As a new institution, the EFB has the natural handicap of low public awareness in the beginning. While generally older and more experienced boards tend to have a stronger public reputation (such as the Dutch CPB established in 1945), several recent cases have been very successful and quick to establish a reputation (such as the fiscal council of Portugal established in 2012). Such success, however, may also be conditional on the initial design of a board. Here, some concerns are warranted with respect to the contents of the Commission Decision defining the EFB. One public annual report is definitely insufficient to establish broad public awareness. Moreover, the Article 2 statement, that on “the request of the President, the Board shall provide ad-hoc advice” could be understood as the Board not being able to produce (and immediately publish) analyses at its own initiative. The European Central Bank (2015) reads these regulations as if the EFB were not given the right to provide assessments of Commission decisions in real-time and would be constrained to the annual publication. If this interpretation prevails and is applied, the impact of the Board on public debate will likely be negligible.

External evaluation

So far, nothing is known about any plans for external evaluation of the EFB’s analytical work.

Table 2: EFB vs Principles for independent fiscal institutions (OECD)

| Principle | EFB | Evaluation |
|--|--|------------|
| Local ownership | Consensual proposal in the Five President’s Report | + |
| Independence and non-partisanship | Decision of the EC. Selection process by the EC. Staff from the EC. Part-time positions. | - |
| Mandate | Mandate embedded only in a Commission’s decision. Contrast between “fiscal stance” and SGP-framework is problematic. | - |
| Resources | Significantly under-resourced compared to the mandate. | - |
| Relationship with the legislature | No links to Council or European Parliament. | - |
| Access to information | Access to information directly via Commission. Scarcity of resources a handicap for information as well. | +/- |
| Transparency | Question marks over full disclosure of information. Not a standalone institution with clear identity. | - |
| Communications | Open communication is expected. Not yet clear how regularly. Noise to signal problem – “on request problem”. | +/- |
| External evaluation | Not planned yet. | - |

Table 2 summarises our assessment. The overall conclusion is that the EFB – compared to features of strong national councils – is rather weak. A lot depends, of course, on the actual implementation of the Board, which is still to be developed with further possible adjustments and corrections. In Section 5 we summarise suggestions for that avenue.

4.3 Towards a European System of Fiscal Councils

The presence of the Network of EU IFIs is an opportunity for more efficient communication between the EFB and national councils. Moreover, strong common positions of national councils communicated via the network would also mitigate the problem of a potential loss of perceived independence due to direct interference from Brussels.

As explained in Research Note 6.3, there are important arguments as to why cooperation between the EFB and local fiscal councils would be beneficial for all parties involved. On the one hand, the EFB might use the output of a local IFI when judging individual country circumstances and measures. There are at least three important areas where local IFIs can have a significant comparative advantage: the calculation of structural budget balances, the costing of discretionary measures and the identification of ex-ante risks in draft budgets (especially on the expenditure side, including creative accounting techniques). Local fiscal councils might also benefit from the presence of a eurozone fiscal watchdog. Firstly, the EFB might be an important additional channel (besides the Network of EU IFIs) to amplify the messages of local fiscal councils. Secondly, by ensuring horizontal consistency, the EFB might help to strengthen the position of the most vulnerable national councils in Europe. In this regard, a definition of minimum standards for national fiscal councils might be beneficial.

Box 2 - A European System of Fiscal Councils: Rationale and Architecture

As discussed in the main text, the lack of ex-ante coordination among independent fiscal institutions at the national and supranational level creates a risk of cacophony which would undermine the signalling role that these non-partisan players are expected to provide. For instance, confusion could stem from contrasting assessments of macroeconomic and budgetary forecasts if the Commission and the national fiscal councils do not communicate in sync and/or use divergent methodologies. Recommendations made by certain national fiscal councils could also conflict with the country-specific recommendations put forward by the European Council at the end of the European semester.

Establishing clear lines of communication among national fiscal councils, and between them and the Commission is a key step towards avoiding confusion. On an EU-wide level, a formal club such as the Network of EU Independent Fiscal Institutions can help disseminate good working practices, harmonise standards, and provide a forum for policy dialogue and peer reviews. Such dialogue can produce beneficial peer pressure (Calmfors and Wren-Lewis, 2011), further cement the independence of each council from national and EU-wide politics, and raise awareness on cross-border fiscal spillovers. The network can also be useful in identifying common problems experienced in the implementation of budgetary surveillance and bring it to the Commission's attention.

Between the EU level and the member states, regular exchange of information is essential. While the Commission should routinely update national fiscal councils on its evolving approach to and practice of budgetary surveillance, national fiscal councils could keep the Commission abreast of country specificities requiring special attention in the implementation of the EU fiscal framework.

By design, the EFB is expected to play a role in fostering such vertical coordination, and it is ideally placed to do so if it can avoid the perception of being a channel of influence of the supranational authority on national fiscal

councils. The Board could then envisage making efficient use of the existing EU network, possibly through signing a memorandum of understanding on information exchange which could lead to deeper forms of cooperation. Ultimately, the EFB together with a network of national fiscal councils could form a fiscal variant of the European System of Central Banks.

5 The Way Forward

The EFB can potentially make a substantial contribution as a critical check on a Commission which, as a political entity, may be biased in its budgetary surveillance and cannot be regarded as an independent guardian of the fiscal soundness enshrined in the EU fiscal framework. However, this analysis has discussed potential weaknesses of the new institution. These weaknesses can and should be addressed. Overall, the early phase of the EFB will be crucial in this respect when the Board establishes its analytical credentials, communication with the public and cooperation with national fiscal councils. Based on our discussion above, we have formulated the following eight recommendations:

- 1. Operational independence:** The integration of the EFB's secretariat into the Commission is the major flaw of the new institution. This architecture undermines the credibility of the Board as an independent advisor and reduces its potential as a counter-weight against the politicised application of European fiscal rules. Therefore, this set-up should be considered an interim arrangement that should quickly morph into a more robust body fully in line with good international practice. In particular, organisational and financial independence and full freedom of the Board in staff selection are indispensable requirements for any truly independent fiscal institution. For the time being, the Board should dispel the perception of any influence from the Commission on its activities. For instance, the Commission Decision envisages different types of staff including seconded national experts. A stronger role for the latter or possibly new recruits might help reduce dependence on staff with future career considerations within the Commission.
- 2. Rules versus discretion in countercyclical policy:** The mandate as defined in the Commission Communication must be taken as given for the time being. However, the EFB could and should develop a way to deal with the tension and possible conflicts between compliance with the existing rules and its views on possible future modifications of the EU framework to provide a more distinct role for fiscal stance considerations.

It should declare full material compliance with the Stability and Growth Pact as the guiding principle for its recommendations and avoid making statements on discretionary (i.e. those not embedded in the current legal text of the Stability and Growth Pact) fiscal stance-related actions. The Board's purpose should distance itself from the Commission's (and the Council's) generous considerations of economic and political trade-offs in their implementation of the Stability and Growth Pact. It should thus avoid providing new creative interpretations of EU and international law on fiscal policy in EU member states. Any such messages would seriously damage the Board's reputation, the

potential added value of its existence for Europe's fiscal credibility and indeed further damage the credibility of the Stability and Growth Pact.

At the same time, there is a potentially important role for the EFB to play in making suggestions on how to move towards a simpler, more transparent EU fiscal framework. As a part of this agenda, it could provide an assessment of the relative weight of countercyclical considerations in such a future framework based on sound analytical work. However, communication of such suggestions should be kept distinct from statements on the application of the current rules.

- 3. Cooperation with national councils:** Cooperation with national councils should aim at facilitating a free, two-way flow of information between national councils and the Commission. In this respect, a close exchange on methodological standards and data could be to the mutual benefit of European and national councils. However, the EFB should avoid any initiatives which could be misunderstood as a European interference with autonomous national institutions since this would threaten local ownership and reputation.
- 4. Communication:** On public awareness, it is up to the EFB itself to come up with a comprehensive and proactive communication strategy. Such proactive communication was the intention for this new institution in the Five Presidents' Report which stated that the Board "should be able to issue opinions when it considers it necessary, including in particular in connection with the assessment of Stability Programmes and presentation of the annual Draft Budgetary Plans and the execution of national budgets" (Juncker et al. 2015, Annex 3). Therefore, any narrow interpretation of the Board's legal basis (if this prohibited real time public statements at sub-annual frequency and on the Board's own initiative) must be firmly rejected. The Board should, from the beginning, demonstrate that its communication strategy is autonomously decided. If Articles 2 ("on request") and Article 6 ("annual report") really raise questions about any legal restriction on such an independent communication strategy then the Commission Decision urgently needs to be clarified and amended. An EFB publicity strategy limited to an annual report on (outdated) considerations and recommendations would render the whole institutional innovation practically worthless. The Board should develop a calendar for its public statements which is meaningfully connected to crucial dates within the European Semester. In addition, it should come up with ad hoc press statements in close proximity to Commission Decisions. The real-time nature of its public statements is a necessary precondition for any impact on media debates. Moreover, the Board should establish a firm relationship with the European Parliament and use hearings as another occasion to make its messages public.
- 5. "Comply or explain" principle:** The Five Presidents' Report had stressed the "comply or explain" principle as an obligation for the Commission's reaction to Board statements: the Commission "should be able to deviate from the views of the European Fiscal Board provided that it has justifiable reasons and explains them" (Juncker et al. 2015, Annex 3). Hence, the Board should insist on

careful answers from the Commission, in particular in those cases where there is disagreement between the Board and the Commission.

6. Resources: Resources, in particular the working hours of the five board members, must be reviewed. It is highly implausible that the current number of working hours set aside in the member contracts is sufficient. The issue is of particular importance because it is the members who defend the Board's independence from the Commission, not the staff. There is also a risk that the Board might try to externalise its resource constraints by imposing extensive reporting requirements on national boards. This must be avoided since this could add to resource constraints which sometimes exist for national fiscal councils.

7. Deeper integration with the European fiscal framework: To limit political influence on the application of European fiscal rules as much as possible, the EFB can be given more significance in the following areas. Firstly, the EFB can be given the task of triggering escape clauses. Secondly, the EFB could provide (in cooperation with national fiscal councils) a "second opinion" on hard-to-measure (uncertain) inputs such as output gaps, structural budget balances, discretionary revenue measures or impacts of structural reforms. Thirdly, the EFB can also be included in the evaluation of fiscal adjustment programs financed by the ESM. Fourthly, the EFB can produce regular reports of compliance with the Directive on national fiscal frameworks or the Fiscal Compact. Functional medium-term budgetary frameworks, automatic correction mechanisms and the application of the comply-or-explain principle are especially important in this regard. The main findings would be included in the country specific recommendations (CSRs).

These additional mandates, however, stand in stark contrast with the limited availability of EFB's initial staff and other resources. Therefore, if desirable, these suggestions can be viewed in the context of an evolutionary tale for the current "interim" board.

8. Potential role with respect to EU budget: Finally, one longer-term reform question concerns the potential role of the EFB as a watchdog over budgetary decisions made by the EU itself. The budgetary system of the EU is in a constant flux. Although there is no general competency to deficit-finance the European budget, issues of contingent liabilities and off-budget activities have become increasingly relevant in the context of efforts to rescue the euro, the investment initiative or migration policies. Just as in the national budgetary context a truly independent council could also improve public information on fiscal risks at the European level. The respective role of the EFB should be discussed in the context of the beginning of a period of reflection for the next Multiannual Financial Framework.

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6 Research Notes

6.1 Do fiscal councils make fiscal rules more effective?

By Mustafa Yeter¹³

Introduction: Reforming fiscal institutions aimed at promoting sound fiscal policies ranked high on the political agenda in response to the economic crisis. To this end, the establishment of independent fiscal councils monitoring fiscal policy at the national level and ensuring its accordance with long-term fiscal targets was among the main proposals, especially in Europe. The motivation for proposing fiscal councils is an attempt to recreate the success of independent monetary boards in the fiscal sphere. By forming a non-partisan institution which acts as a fiscal watchdog monitoring government activity, proposing (alternative) policy recommendations, and stimulating the public debate by providing more transparency, fiscal councils are expected to represent a further tool against the debt bias of politicians (e.g., Calmfors and Wren-Lewis, 2011).

In this paper, I test empirically whether fiscal councils can contribute to more sustainable fiscal policy by strengthening fiscal rules and increasing their efficacy. This requires taking into account the potential endogeneity of fiscal councils. The latter might be driven by unobserved fiscal preferences or the unobserved competence of politicians (Beetsma and Debrun, 2016). Neglecting these potential sources of endogeneity would result in a significant bias which would invalidate obtained results (Heinemann, Moessinger and Yeter, forthcoming).

To this end, I will make two distinct contributions to the literature on fiscal councils in this paper. Firstly, I will assemble a panel data set on fiscal councils providing information over time with respect to changes in the mandate of national fiscal councils. Secondly, I will rely on propensity score matching, matching differences-in-differences, and the synthetic control method in order to obtain causal inference.

Data: Cross-sectional information on fiscal councils is provided by both the International Monetary Fund (IMF) as well as the European Commission (e.g., Debrun and Kinda, 2014). While using the information on the year of foundation may allow me to transform the data into a panel structure mechanically, this would assume that there were no changes in the mandate of fiscal councils over time. However, some councils such as the CPB Netherlands Bureau for Economic Policy Analysis or the Danish Economic Council date back to the 1940s or the 1960s respectively, so assuming no changes in the mandate would lead to a serious measurement error. Using the IMF data set as a baseline, I therefore extend the data and code changes over time with respect to the mandate to monitor national fiscal rules. To this end, I rely on OECD country notes, legal texts, and internet research on the official web

¹³ ZEW Mannheim and University of Goettingen, Contact address: P.O. Box 103443, 68034 Mannheim, Germany. E-mail: yeter@zew.de

pages of fiscal councils (OECD, 2012, 2015). Overall, my sample contains panel information on fiscal councils in 33 countries.

Information on the presence of fiscal rules and their de jure strength is obtained from the IMF (Schaechter et al., 2012). Fiscal data on the cyclically adjusted primary balance, gross debt relative to GDP and GDP per capita as well as long-run government bond yields is obtained from several IMF and OECD sources as well the European Commission. Political controls with respect to the possibility of plebiscites, the right of the executive government to dissolve the legislature, and the right of the legislature to question the executive government are obtained from the database Varieties of Democracy. My analysis further includes proxies for fractionalisation, information on the ideology of the executive government as well as the legal origin of a country (e.g., La Porta, Lopez-de-Silanes and Shleifer, 2008). The final unbalanced sample covers 46 countries including EU-28, OECD member states and exhibits varying time coverage within 1970–2015.

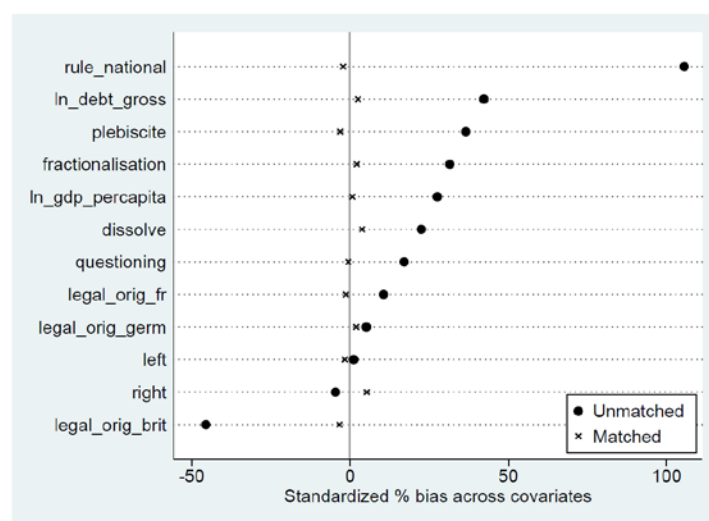
Methodology: As documented in Heinemann, Moessinger and Yeter (forthcoming), neglecting or only dealing insufficiently with the potential endogeneity of fiscal rules and fiscal councils invalidates the results of the empirical analysis. Ideally, one would like to observe fiscal outcomes in both states, namely with and without rules or councils in place. Since this is not feasible, it is necessary to account formally for the (self-) selection into treatment observed from the countries included in the sample.

In the first approach, I rely on propensity score matching using different matching algorithms. To match proper control units to the treated countries in my sample, I draw on a wide range of fiscal and political control variables which are likely to drive the presence and the individual mandate of fiscal councils. In an ideal world, the political controls would serve as a functional oversight for the executive government on their own. However, the degree of failure of these institutions in exerting an effective oversight is a likely driving factor for the presence of a fiscal council which then serves as a substitute.

The estimation of propensity scores must result in balance between treated and non-treated observations in the sample with respect to the above mentioned control variables to ensure the validity of the approach as such. Figure 6.1 documents that this balancing is properly achieved and further indicates a strong bias if the (self-) selection into treatment is not taken into account. As an extension, I implement a matching differences-in-differences approach which allows me to control for counterfactual trends by combining the matching methodology with a differences-in-differences framework.

Given the large heterogeneity in the design, mandate, and experience of individual fiscal councils, I rely on a second formal approach which allows me to obtain causal inference and testing for the effects of fiscal councils on a country-by-country basis. The synthetic control method combines case study and regression designs. In this case, control groups are obtained by estimating linear combinations of non-treated countries which match the pre-treatment development of the respective treated country as closely as possible and serve as a synthetic control group.

Figure 6.1 - Balancing property of the propensity score matching



Results: The supporting effect of fiscal councils monitoring fiscal rules is tested for both the cyclically adjusted primary balance which captures discretionary fiscal policy decisions and long-term government bond yield spreads which capture the response of fiscal markets. Table 6.1. provides the results using propensity score matching with stratification, nearest neighbour and kernel matching algorithms. While the top and middle part of the table documents the results for the cyclically adjusted primary balance, the bottom part provides the results for the bond yield spreads.

Table 6.1: Results using propensity score matching

| | Stratification | Nearest Neighbour | Kernel Epanechnikov | Kernel Gaussian |
|---|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
| <i>Average treatment on the treated</i> | | | | |
| Monitoring | 0.200 [0.484] {0.413} | 1.017 [0.940] {1.080} | 0.286 [0.476] {0.600} | 0.461 [0.418] {1.100} |
| Rule-index | 0.573 [0.480] {1.194} | 0.851 [0.629] {1.35} | 0.628 [0.467] {1.340} | 0.701 [0.399] {1.760} |
| Spreads | -0.509 [0.189] {-2.695} | -0.643 [0.220] {-2.920} | -0.525 [0.166] {-3.150} | -0.561 [0.151] {-3.700} |
| <i># of treated observations</i> | 70 | 70 | 70 | 70 |
| <i># of control observations</i> | 1,022 | 62 | 1,022 | 1,022 |

On average, I do not find evidence for an improvement of the cyclically adjusted primary balance if a fiscal rule is supported by a fiscal council whose mandate involves the monitoring of the former. The results are not altered if I account explicitly for the de jure strength of the fiscal rule in place. This pattern changes, however, when I test the impact of fiscal councils on the long-term government bond yield spread relative to Switzerland. In this case, fiscal councils contribute on average to a further reduction of risk premiums faced by countries.

Table 6.2: Results using radius matching

| | Radius matching | | | | | | |
|---|-------------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
| | 0.0001 | 0.0005 | 0.001 | 0.005 | 0.01 | 0.05 | 0.1 |
| <i>Average treatment on the treated</i> | | | | | | | |
| Monitoring | 0.351 [0.933] {0.377} | 0.106 [0.470] {0.226} | 0.226 [0.425] {0.531} | 0.230 [0.291] {0.790} | 0.219 [0.270] {0.813} | 0.506 [0.231] {2.190} | 0.602 [0.225] {2.681} |
| Spreads | -0.507 [0.479] {-1.060} | -0.500 [0.318] {-1.570} | -0.522 [0.313] {-1.670} | -0.464 [0.209] {-2.220} | -0.454 [0.184] {-2.460} | -0.521 [0.166] {-3.130} | -0.543 [0.151] {-3.580} |
| <i># of treated observations</i> | 24 | 50 | 54 | 66 | 66 | 70 | 70 |
| <i># of control observations</i> | 32 | 120 | 198 | 462 | 557 | 1,020 | 1,022 |

Table 6.2. provides the results using propensity score matching in combination with a radius matching algorithm. The columns of the table alter the maximum difference in propensity scores for observations to be considered as control units. Consequently, an increasing radius reduces the demands with respect to the similarity between treated and non-treated units in relative terms. The results in the case of radius matching confirm the previous pattern in which no or a non-robust impact is found on the cyclically adjusted primary balance but is found on the bond yield spreads.

The lack of a statistically significant impact of fiscal councils on the cyclically adjusted primary balance on average is further documented by the results using the synthetic control group method. Figure 6.2 provides the results for Germany and Sweden as a showcase. The dashed vertical line indicates the respective point in time of treatment and the light grey lines provide results for placebo tests. While the evidence for Sweden points towards a positive impact of fiscal councils, a similar result is not observed in the case of Germany. Running the analysis for further countries in my sample yields a majority of cases without a measurable impact on the cyclically adjusted primary balance. Overall, my analysis therefore does not document an additional impact of fiscal councils on fiscal fundamentals such as the primary balance. The analysis does, however, provide evidence for a reward in terms of reduced risk premiums from financial markets.

Figure 6.2 - Synthetic control group analysis

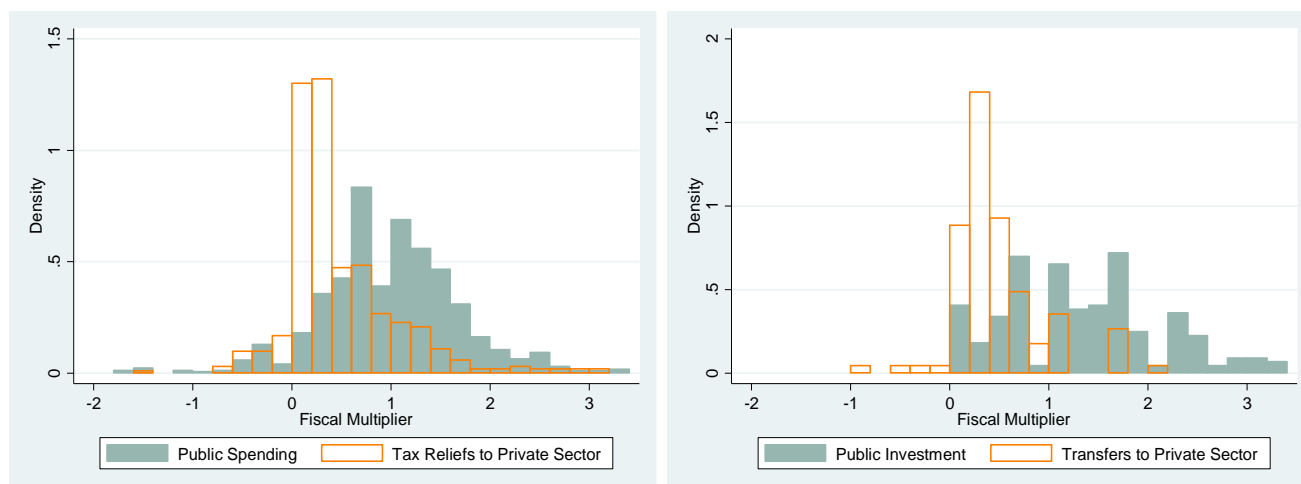
6.2 Are fiscal multiplier estimates biased?

By Zareh Asatryan

Introduction: Fiscal multiplier estimates are an important input for policy design: they measure the short-term impact of discretionary fiscal policy on output. Multipliers are typically defined as the ratio of a change in output at a particular horizon as a response to an exogenous change in fiscal policy (see, e.g., Batini et. al. 2014).

However, existing estimates range widely for objective reasons. For example, they may differ across policy instruments (e.g., spending or taxes), time-horizons, business cycles, monetary environments, geography, etc. A meta-analysis of 104 scholarly papers by Gechert (2015) reveals a wide distribution of multipliers which range from -0.19 to 2.27, respectively, at the bottom and top 5 percentiles of the distribution. Figure 6.3 plots the distribution of multipliers separately for general spending, tax reliefs, public investment, and transfers. The means (standard deviations) of these four variables are 0.98(0.69), 0.46(0.57), 1.34(0.79), and 0.47(0.46), respectively.

Figure 6.3 - Distribution of fiscal multipliers on spending and taxes (left), and investment and transfers (right)



Notes: The histograms exclude outliers outside the interval of [-1.7, 3.4] which is three times the standard deviation around the mean value of 0.87 of the total sample. The sample includes 2,283 observations of which 33 are dropped.

In addition to such objective reasons behind having diverse multipliers, there exist at least two further motives for why multipliers may be biased due to more subjective reasons. Firstly, being a simple parameter of interest, multipliers are popularly debated and are often politicised. This may lead the researcher to arrive at a “preferred” multiplier estimate by cherry picking the method, the identification strategy, the data and the context, among other variables of choice. Secondly, as put forward by Kirchgässner (2014), “there is quite a lot of consensus with respect to microeconomic questions, but

much less with respect to macroeconomic or macro policy questions.” Because macro debates often lack solution due to absence of clear causal inference there is more room for manipulation and ideology.

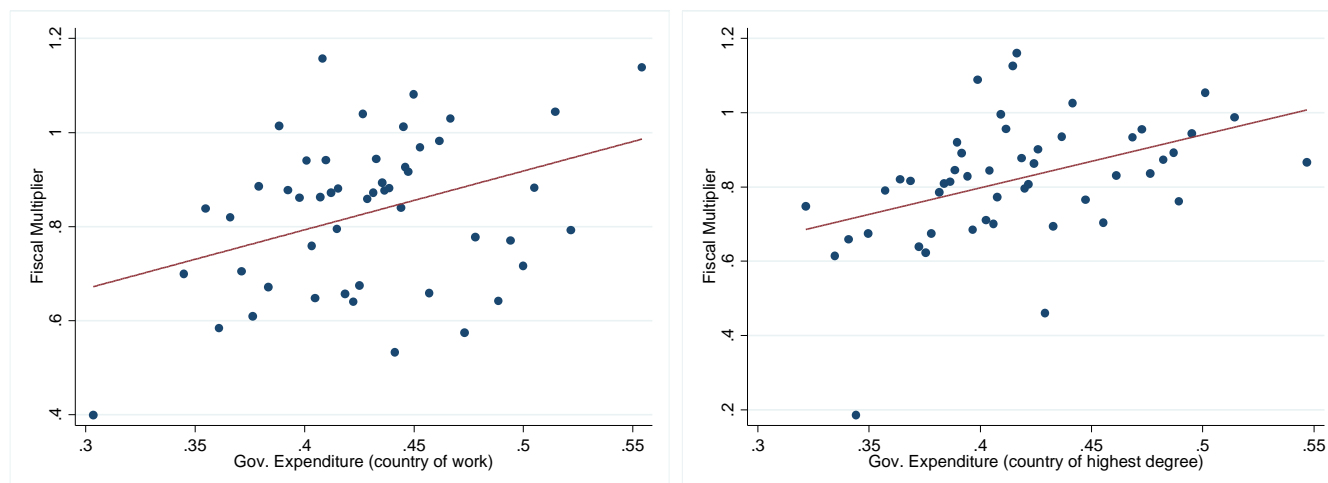
Data: In this note, we match data on 2,283 fiscal multipliers estimated by 173 authors in the period 1992-2012 to author-specific characteristics. The central question we ask is whether authors’ personal characteristics correlate with their estimated multipliers.

More specifically, we exploit information from the authors’ CVs and assign them to countries (and years) where the authors were either working when publishing the results, or received their highest degree of education. We then take the government spending-to-GDP ratio of each country-year observation¹⁴ to proxy for each author’s preferences towards the size of the government.

Results: Our baseline expectation is that the environment, i.e. the country of work or education, where an author works should have no correlation with his or her multiplier estimate.

Figure 6.4 plots the correlation between multiplier estimates (y-axis) and the government expenditure-to-GDP ratio at country of origin (x-axis). We find a positive and statistically significant correlation with a slope (standard error) of 1.251 (0.254) and 1.429 (0.265) for the left and right sub-figures, respectively.

Figure 6.4 - Fiscal multipliers and government expenditure at country of origin



Notes: Each dot shows the average fiscal multiplier (y-axis) for a given level of government expenditure as a ratio of GDP (x-axis), holding the controls constant. Country of origin is measured as the country of work or the country of education in the left and right figure, respectively. For both binned scatterplots we control for the underlying multiplier type, the employed model approach, and other relevant aspects (see table A2.2 below). This is achieved by residualizing the x and y variable on these controls before plotting them and obtaining the regression fit (partitioned regression). We then group the residualised x-variable into 50 bins with equal number of observations (2.22% of the sample) and

¹⁴ Sample of countries includes: Belgium, Canada, Denmark, Germany, Spain, France, Great Britain, Ireland, Italy, Netherlands, Portugal, Singapore, Sweden, and the USA. In this sample the government spending-to-GDP ratio varies between 0.22 (Singapore) and 0.65 (Ireland).

compute the mean of the x and y variable residuals within each bin. As before, we exclude outliers outside the interval $[-1.7, 3.4]$. The fitted line is an OLS regression based on the underlying data (not the specified bins) and controlling for the above factors.

Table 6.4 presents our regression results. The dependent variable is the fiscal multiplier estimate. In columns 1-3 and 4-6 the main dependent variable of interest is the government spending-to-GDP ratio of country of work and education, respectively. In all regressions we control for important study properties, such as the multiplier-type, time-horizon, number of authors, and publication-status. Since a researcher may affect the results by “manipulating” the important properties of the study such as its method (e.g., RBC, DSGE, VAR, etc.), we estimate models first without controlling for the method to quantify the total potential bias (columns 1 and 4), and then by including such controls. In columns 3 and 6 we additionally control for country fixed effects (not reported). We cluster the standard errors at the level of papers.

Our preliminary results of Figure 6.4 and Table 6.4 are consistent with the hypothesis that authors’ preferences regarding the size of the government (as measured by the level of government expenditure at country of origin) correlate with the size of the estimated multipliers. The size of the effect is fairly large: A 10 percentage point increase in spending-to-GDP ratio increases the fiscal multiplier by 0.11 to 0.21 points on average (or by 13 to 25% of the mean).

Table 6.4 - Effect of fiscal preferences on estimated fiscal multipliers

| Variables | | (1) | (2) | (3) | (4) | (5) | (6) |
|--|----------------------------------|------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Expenditure/GDP (workplace) | | 1.951*** (0.718) | 1.251* (0.644) | 2.161* (1.135) | | | |
| Expenditure/GDP (education) | | | | | 2.037*** (0.601) | 1.429** (0.547) | 1.132** (0.498) |
| Model Type (baseline: VAR) | RBC | | -0.514*** (0.187) | -0.478*** (0.146) | | -0.534*** (0.202) | -0.463*** (0.143) |
| | DSGE_NK | | -0.0761 (0.0807) | -0.0821 (0.0856) | | -0.0765 (0.0807) | -0.0541 (0.0877) |
| | MACRO | | 0.181** (0.0843) | 0.264*** (0.0694) | | 0.133 (0.0872) | 0.241*** (0.0721) |
| | Single Equation | | -0.165 (0.168) | -0.210 (0.169) | | -0.154 (0.172) | -0.166 (0.171) |
| | Estimation Model | | | | | | |
| Multiplier Type (baseline: Governm. Consumption) | SPEND | 0.0422 (0.0799) | 0.0642 (0.0792) | 0.0797 (0.0801) | 0.0142 (0.0884) | 0.0464 (0.0847) | 0.0642 (0.0829) |
| | INVEST | 0.465*** (0.166) | 0.505*** (0.153) | 0.441*** (0.147) | 0.459** (0.192) | 0.509*** (0.174) | 0.463*** (0.159) |
| | MILIT | 0.178 (0.240) | 0.219 (0.245) | 0.116 (0.224) | 0.160 (0.253) | 0.203 (0.253) | 0.144 (0.232) |
| | TAX | -0.396*** (0.117) | -0.390*** (0.120) | -0.358*** (0.131) | -0.395*** (0.124) | -0.385*** (0.127) | -0.354** (0.139) |
| | TRANS | -0.438*** (0.107) | -0.408*** (0.109) | -0.453*** (0.107) | -0.403*** (0.115) | -0.357*** (0.122) | -0.403*** (0.112) |
| | EMPLOY | 0.0852 (0.146) | 0.128 (0.142) | 0.232* (0.124) | 0.205 (0.160) | 0.206 (0.155) | 0.251* (0.132) |
| | DEF | -0.399*** (0.126) | -0.311** (0.152) | -0.321** (0.160) | -0.422*** (0.139) | -0.338** (0.163) | -0.331** (0.167) |
| Control Variables (baseline: cumulative multiplier) | PEAK | 0.00598 (0.113) | 0.0474 (0.123) | 0.104 (0.118) | -0.0369 (0.121) | 0.0137 (0.128) | 0.0897 (0.126) |
| | HORIZON | -0.0971 (0.117) | -0.104 (0.122) | -0.00994 (0.112) | -0.200* (0.108) | -0.191* (0.114) | -0.0686 (0.106) |
| | HORIZON ² | 0.0465 (0.0343) | 0.0490 (0.0346) | 0.0223 (0.0301) | 0.0738** (0.0322) | 0.0720** (0.0326) | 0.0394 (0.0280) |
| | PEAK*HOR | 0.159 (0.173) | 0.0469 (0.191) | -0.0695 (0.166) | 0.247 (0.176) | 0.135 (0.194) | -0.0432 (0.161) |
| | PEAK*HOR ² | 0.00237 (0.0604) | 0.0256 (0.0638) | 0.0651 (0.0552) | -0.0229 (0.0608) | -0.00129 (0.0648) | 0.0603 (0.0522) |
| | - | - | - | - | - | - | - |
| | M/GDP (in %) (country sample) | 0.0129*** (0.00325) | -0.0142*** (0.00315) | -0.0163*** (0.00313) | -0.0111*** (0.00352) | -0.0133*** (0.00326) | -0.0171*** (0.00333) |
| Dummy = 1 if journal article | | 0.0560 (0.0752) | 0.0460 (0.0723) | 0.0637 (0.0766) | 0.115 (0.0840) | 0.0927 (0.0833) | 0.0750 (0.0854) |
| Dummy = 1 if single author | | 0.0155 (0.117) | -0.00177 (0.118) | 0.0322 (0.121) | 0.0409 (0.127) | 0.000364 (0.134) | 0.000674 (0.139) |
| Constant | | 0.218 (0.353) | 0.599* (0.319) | -0.0142 (0.581) | 0.204 (0.312) | 0.553** (0.274) | 0.568* (0.291) |
| Observations | | 2,250 | 2,250 | 2,250 | 2,014 | 2,014 | 2,014 |
| R-squared | | 0.255 | 0.285 | 0.342 | 0.253 | 0.285 | 0.344 |
| Country fixed effects | | | | x | | | x |

Notes: The level of observation is author-multiplier. Standard errors are clustered by paper.

6.3 Exploiting synergies between fiscal rules and fiscal councils in the EU

By Lúdvít Ódor

Introduction: A proper fiscal framework should ensure long-term sustainability while avoiding pro-cyclical fiscal behaviour. The framework in the eurozone failed on both fronts. In good times, just before the crisis hit, it did not promote the creation of sufficient fiscal space; in bad times it was too restrictive to stabilise the economy. This note argues that a fundamental redefinition of accountability between the central and national authorities – based on the subsidiarity principle - is necessary to make the common currency more resilient. Europe needs a *decentralised* and *depoliticised* fiscal framework, where synergies between smart fiscal rules and independent fiscal institutions are exploited, both at the national and European level.

Maze or pyramid? Several issues have to be taken into consideration when reforming the fiscal framework in Europe. Firstly, it is necessary to better align theory and the actual design of fiscal rules and institutions. The fundamental conflict between using one-size-fits-all approaches and at the same time taking into account country specificities has often led to reliance on escape clauses, special regimes and “other factors”. As a result, Europe ended up with a complex web of sometimes contradicting rules and procedures (Ódor, 2014). Paradoxically, the system is relying on so many rules, that the final verdict is in fact in many cases a discretionary decision by the European Commission/Council.

Secondly, the division of labour between the community and national level is blurred. There is no clear separation of accountability and responsibility. The European framework combines a non-credible no bail-out principle, sovereignty of Member States in budgetary issues, the SGP and rescue funds such as the ESM or EFSF. It is necessary to define when and under what conditions an intervention from the centre is warranted. It is also important to limit political influence in the application of rules and procedures as much as possible.

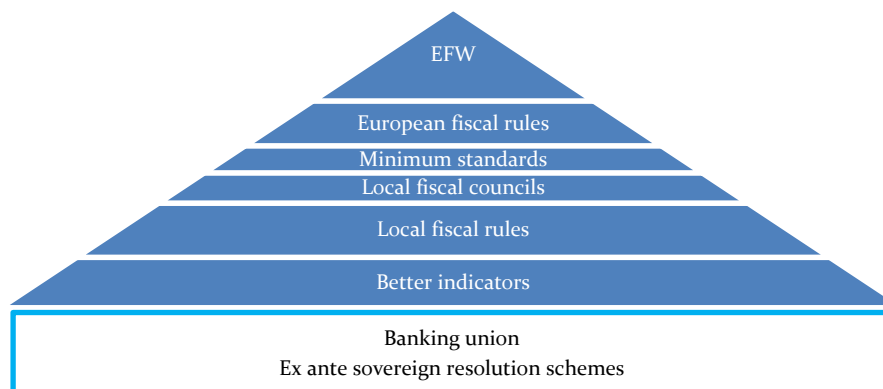
Thirdly, current fiscal indicators allow fiscal gimmickry, and real time evaluation of structural budget balances is more art than science. More appropriate methodological tools are available in the literature, but their application is often hampered by the current institutional set-up.

The solution to these three fundamental problems we propose in Ódor and P. Kiss (2017)¹⁵ is similar to the arrangement advocated by Wren-Lewis (2003). The first line of defence against irresponsible fiscal policy behaviour should be at the local level, using home-grown fiscal rules and independent fiscal institutions. The community level in our proposal is represented not only by the European Commission, but also by an independent fiscal watchdog for the eurozone. These institutions should in our view focus primarily on avoiding free-riding and pro-cyclicality at level of the whole area and supervising countries breaching European limits.

¹⁵ The first version of the paper appeared well before the decision of the Commission to set up the EFB.

It is important to note that it is not possible to separate the issue of fiscal frameworks from the question of the overall set-up of a currency union. Therefore, at the bottom of Figure 6.5 we list two important pre-conditions to be met: a fully functional banking union and a stronger no bail-out principle. Even if the no bail out principle is unlikely to achieve full credibility, as is the case in the US (at least in the medium term), the more losses are absorbed by shareholders and creditors the easier the design of fiscal rules at the community level.

Figure 6.5 - Proposal for a new European fiscal framework



Separation of accountabilities: The problem of deficit bias in currency unions arises both at the local level and the level of the whole area (free-riding). The obvious approach would be to build a hierarchical system of responsibilities (as presented in Figure 6.5). When there is no sign of free-riding behaviour with potential contagion effects, the national level should be responsible for fighting against the local deficit bias. In that case, a country-specific, tailor-made solution should be designed (local indicators, rules and institutions).

Area level rules and institutions should primarily focus on problems concerning *common interest*. High on this list is possible contagion, free-riding behaviour or, for example, counter-cyclical aggregate fiscal policy. If the eurozone is successful in putting in place clear rules for burden sharing, a banking union, and debt restructuring with a strong backstop mechanism, the current trend of legislating more and more complex fiscal rules can be reversed.

The presence of EFW can make rules simpler: The most important argument in favour of a Euro-area Fiscal Watchdog (EFW) is that currently there is too much political pressure on the European Commission to interpret fiscal rules in a flexible manner. This has also been recognised in the Five Presidents' Report (Juncker et al., 2015).

In the proposal above, authorities at the European level would have three responsibilities: monitoring compliance with minimum standards defined for local fiscal frameworks, checking compliance with European fiscal rules and supervising countries over pre-agreed limits.

As far as minimum standards are concerned, the EFW would carry out a yearly evaluation exercise. When deviations are observed, these should be reflected in country-specific recommendations via the European Semester. In the case of serious non-compliance, there would be a possibility to ask the European Court of Justice to rule on the matter (as in the case of the Fiscal Compact). One very important task to fulfil would be the activation of escape clauses. Apart from that, the EFW should be in a position to issue direct recommendations to national authorities breaching European rules. Here the “comply or explain” principle would apply. In the most serious cases, the EFW would have the tools to recommend veto power over national budget plans.

Setting up an EFW: Based on international experience, a small council (up to 3-5 members) with a medium-sized secretariat seems to be the preferable alternative. The selection of council members is also very important. One should strive for an optimal balance between academics and policy makers. Hands-on experience with budgets seems to be necessary as well. After selecting the management, the council should be free to hire and fire staff members. The number of staff would depend on the mandate (approximately 30-50 analysts).

In order to avoid duplicities and blurred responsibilities, two important sets of relationships should be clarified: vis-à-vis the European Commission and local fiscal councils. Since the EFW would function in this set-up as an independent analytical body only, major decision-making processes should remain in the hands of the European Commission. However, there would be no role for the EC with regards those Member States operating without gross policy errors. When pre-agreed limits are identified by the EFW, the EC should step in and issue recommendations. If these are not followed in the draft budget, ex-ante veto power would be exercised (based on the recommendation from the EFW). The EFW can be also part of the “troika” to judge sustainability of debt after measures are implemented.

There are important arguments for why cooperation between the EFW and local fiscal councils would be beneficial for all parties involved. On the one hand, the EFW might use the output of a local IFI when judging individual country circumstances and measures. This way it is possible to abandon one-size-fits-all methodologies and to focus on best possible estimates/methodologies instead. In our view it is much better to use discretion in methodology than in the interpretation of fiscal rules (as is the case now). There are at least three important areas where local IFIs can have a significant comparative advantage: calculation of structural budget balances, costing discretionary measures and identifying ex-ante risks in draft budgets (especially on the expenditure side, including creative accounting techniques).

Local fiscal councils might also benefit from the presence of a eurozone fiscal watchdog. By evaluating minimum standards, the EFW would be a guardian of their independence. Moreover, by collecting international best practices and research output, cooperation with the EFW might also increase the quality of output from local IFIs. However, it should be noted that it is of utmost importance that the independence of all councils involved are respected. Local fiscal councils should not be viewed as

“branches” of the EFW, but rather home-grown, local institutions responsible for monitoring local fiscal rules.

EFB vs. EFW: The European Commission decided to establish an independent advisory European Fiscal Board in October 2015. While the institutional set-up and mandate of the EFB has significant overlaps with our proposal for the EFW, important differences prevail.

Our proposal is consistent with a decentralised fiscal framework. On the other hand, the EFB was set up to operate within the current centralised framework following the current practices of the Commission by sharing the same legal background. Part time members of the board can definitely play an important advisory role, but real-time evaluation of European fiscal trends is unlikely with the limited resources. Institutionally the EFB is not independent. It was set up by the EC and is also financed by the Commission. Moreover, all five members of the board were nominated by the EC and its secretariat is composed of Commission employees.