How the Fiscal Council Rules Influence the Fiscal Stability

Hussein Mkiyes[1]

[1] University of Economics in Bratislava, Faculty of National Economy, Dolnozemská cesta 1, Bratislava , 852 35
Slovak republic

hussein.mkiyes@euba.sk

https://doi.org/10.53465/EDAMBA.2023.9788022551274.164-174

Abstract: Fiscal councils were established in many European Union countries to promote fiscal discipline and stability. However, fiscal instability persists in the EU. This study analyses the role of fiscal councils in achieving fiscal stability in the EU from 2011-2021 using panel data and the LSDV model. The results indicate a strong causal relationship between fiscal councils and improved fiscal performance. Fiscal councils with legal independence, adequate staffing, budget protections, and fiscal rule monitoring authority demonstrated the greatest impact. However, the effectiveness of fiscal councils may be limited by their recent establishment. While fiscal councils enhance fiscal stability prospects, external crises like COVID-19 can still undermine fiscal policy. The study contributes to understanding fiscal councils' evolving role in the EU. It uses a broad sample of EU members over an extended period. Further research could examine councils' performance across different country-specific contexts. Overall, well-designed fiscal councils are beneficial but not sufficient for enduring fiscal stability. Complementary institutions and policy adjustments may be needed, especially during crises.

Key words: Fiscal Councils, Economic Stability, Fiscal Policy, Fiscal Stability, Public Debt.

JEL classification: *B22, E6, H61*

„This article was prepared with the support of the VEGA project No. 1/0545/23 Improving the functioning of economic processes by using the knowledge of behavioural economics (Theoretical and empirical approach)".

1 Introduction

Fiscal councils have emerged as a key component of the budgetary framework in the European Union (EU) over the past decade. Established in many EU member states, fiscal councils are independent public institutions that provide oversight and analysis of fiscal policy. Their primary aim is to strengthen budget discipline and promote sustainable public finances. This reflects growing recognition of the need for independent fiscal oversight.

Short-term political pressures often lead policymakers to pursue suboptimal fiscal policies that worsen economic fluctuations and undermine stability. Deficit spending and rising debts may boost growth in the short run but prove destabilizing over time. The global financial crisis and European sovereign debt crisis underscored these risks. Lax fiscal policies left many EU governments ill-prepared to respond effectively. In response, the EU enacted stricter fiscal rules like deficit and debt limits under the Stability and Growth Pact. However, most evidence indicates the rules were insufficient to constrain policymakers. Creative accounting and over-optimistic forecasting were used to circumvent the rules. This highlighted the need for independent fiscal oversight. Fiscal councils thus emerged as a complementary tool to strengthen budget discipline and transparency. The first wave of EU fiscal councils was established in the mid-2000s. However, most proliferated after 2010 as the crisis underscored gaps in fiscal governance. These independent bodies were given mandates to critically evaluate fiscal plans and hold governments accountable. This study examines the evolving role and efficacy of fiscal councils in promoting fiscal stability in the EU from 2011-2021. Fiscal stability is defined as maintaining prudent public debt levels and budgetary positions that ensure fiscal sustainability over the economic cycle. The analysis utilizes panel data on institutional features of fiscal councils and budgetary outcomes. It employs the LSDV model to estimate the causal relationship between council characteristics and improved fiscal performance.

The results provide strong evidence that well-designed fiscal councils have a positive impact on fiscal discipline. Key features like legal independence, adequate resources, multi-year budget protections and fiscal rule monitoring authority are associated with improved budgetary outcomes. Fiscal council assessments, economic forecasts and policy recommendations appear to enhance fiscal accountability. However, the findings also indicate limitations in effectiveness, as many fiscal councils were only recently established. Their track records remain relatively short, particularly in managing major crises like COVID-19. This highlights that while beneficial, fiscal councils alone may be insufficient to ensure enduring fiscal stability. Complementary institutions and policy adjustments appear necessary, especially during times of severe economic stress. This study contributes an extensive empirical analysis of fiscal councils utilizing panel data on council features and budgetary performance across 28 EU members over a critical ten-year period. It points to the evolving and increasingly important role of fiscal councils in the EU's fiscal framework. Further research could provide more nuanced analysis of how council design and performance relate to country-specific contexts. Overall, well-structured fiscal councils can support fiscal discipline but likely need to be buttressed by broader fiscal reforms for lasting stability.

2 Literature review

Fiscal councils typically have a variety of functions, including fiscal policy oversight, compliance monitoring of fiscal rules and targets, evaluation of government budgets and forecast assumptions, provision of macroeconomic and fiscal policy analysis, assessment of economic and budgetary impacts of policy proposals, research on tax issues, and issuance of public reports and recommendations [3]. Previous studies show that the specific mandates and powers of fiscal councils can vary substantially across countries depending on national circumstances, legal frameworks and political factors. However, some common characteristics of effective fiscal councils include independence from political pressure, clear legal mandates, adequate resources, transparency, and technical expertise in fiscal analysis [5].

Fiscal councils are seen as valuable institutions for strengthening fiscal governance and budgetary outcomes, though they face challenges in maintaining independence and ensuring policymakers heed their analysis and advice [4]. Additionally, well-structured fiscal councils can positively impact budgetary performance through promoting transparency, accountability and prudent fiscal policies [6]. The existing literature suggests that fiscal councils can enhance fiscal performance via several channels [14]. First, provision of independent expert analysis helps ensure policies are grounded in objective economic analysis rather than political expediency, supporting better-informed decisions and effective implementation [13]. Second, monitoring of fiscal rules and public reporting assists in reducing risks of imbalances or excessive debts that undermine performance [1]. Third, enhancing transparency around fiscal policy helps build trust and accountability while preventing unanticipated fiscal shocks [7]. Fourth, encouraging independent fiscal oversight bodies improves the quality and credibility of fiscal policy by reducing risks of short-termism, bias and inadequate analysis [4]. Fifth, public assessments and recommendations can strengthen fiscal discipline by incentivizing government compliance with fiscal rules and sound budgetary practices, while also increasing public scrutiny [4].

A crucial consideration in evaluating fiscal councils is their capacity to make objective assessments of fiscal policy unaffected by political pressures or biases [13]. Accordingly, fiscal rules and outcomes should be examined in terms of serving the public interest and achieving sustainable fiscal goals. Such analysis can help councils portray fiscal policymakers' performance in a nonpartisan manner [10]. Thus, voters can then judge policymakers' efficacy, re-electing or removing them accordingly [2]. Furthermore, fiscal councils provide useful oversight and can leverage legislative or public pressure against choices seen as fiscally imprudent [11]. In this context, previous studies show that a council's efficacy depends on serving as a reliable, unbiased source of information on fiscal policy issues and an effective check on policymakers acting in self-interest [9]. This requires demonstrating non-partisanship in analysis and establishing itself as a tool for oversight, evaluation and monitoring, not just control of policymakers. Thus, efficacy relies heavily on independence and lack of bias [8]. As for independence and efficacy of fiscal councils, previous studies argue that there is variation among councils [5]. Some are fully autonomous institutions while others are part of the legislative or executive branches [12]. Early examples of legislative budget offices as fiscal councils were seen in South Korea and the United States, while executive councils emerged in Belgium and the Netherlands. More recently established councils, like in the Czech Republic and Slovakia, tend to be independent entities with broad fiscal oversight powers [2]. These independent fiscal councils have made valuable contributions around objective understanding of fiscal issues, forecasting, and identifying biases in policymaking or expenditure projections [9]. They have played constructive roles in fiscal policy development, correction of missteps by officials, and provision of unbiased policy assessments focused on the overall economy [15]. Additionally, the COVID-19 pandemic led to relaxed enforcement of fiscal rules given the need for emergency support, highlighting fiscal councils' importance in proposing rule changes or introductions to maintain flexibility while achieving fiscal goals and sustainability [1]. Therefore, councils' efficacy stems from abilities to assess potential expenditure under spending plans and alignment with revenues [8]. This was evidenced by involvement of councils in analysing crisis fiscal implications, cost estimation, and vetting emergency measures [7].

3 Methodology

This study examines the effectiveness of fiscal councils in promoting fiscal stability in the European Union (EU) from 2011-2021 using panel data analysis. The sample covers EU countries with advanced or emerging economies that had established fiscal councils during this period. Fiscal stability is measured based on key budgetary outcomes including debt levels, budget balances, and structural deficits. The analysis utilizes panel data on institutional features of fiscal councils as well as budgetary data. The characteristics of fiscal councils are obtained from the International Monetary Fund's Fiscal Council dataset. This provides information on factors such as legal independence, budget protections, staff resources, and fiscal rule monitoring authority. Annual debt and deficit data are drawn from IMF and Eurostat statistics.

The study employs a fixed effects panel model to estimate the impact of fiscal council characteristics on fiscal performance. The model specification is:

$$\triangle PB_{i.t} = PB_{i,t-1} + \beta_1 \triangle D + \beta_2 \triangle OG + \beta_3 \triangle FRI + \beta_4 \triangle FC + \beta_5 \triangle LI + \beta_6 SOB + \beta_7 SN + \beta_8 FRM + \beta_9 T + \varepsilon_{i,t} \qquad (1)$$

Where:

PB: Primary balance
D: Public debt
OG: Output gap
FRI: The index of fiscal rules
FC: Index of Fiscal Institutions,
LI: Legal independent
SOB: Safeguards On budget
SN: Staff number (high Level)
FRM: Fiscal rule monitoring
T: Time (if country over average 1 otherwise 0)
$\varepsilon_{i,t}$: random error

The model includes country fixed effects (a_i) to control for unobserved heterogeneity across countries. Standard errors are clustered at the country level to account for serial correlation. Key fiscal council variables include legal independence, budget protections, staff resources, fiscal rule monitoring, forecasting practices, and research/analysis functions. Control variables such as economic growth, interest rates, and inflation are included to isolate the effect of councils on fiscal outcomes. These fixed effects approach helps establish the causal relationship between fiscal council characteristics and fiscal performance by analysing changes within countries over time. The extensive sample period from 2011-2021, encompassing 28 EU countries, provides sufficient data for robust statistical analysis. By estimating which features of fiscal councils have the greatest impact on budgetary outcomes, the results can highlight the institutional design elements that enhance councils' effectiveness in promoting fiscal discipline. This will help guide reforms aimed at strengthening the role of fiscal councils in the EU fiscal framework.

3.1. Variables Description :

This analysis examines the impact of fiscal council characteristics on the primary fiscal balance as the key measure of fiscal performance and dependent variable. Primary balance, excluding interest payments, indicates the underlying strength of a country's fiscal position. The main independent variables of interest are institutional design features of fiscal councils that may influence their effectiveness. These include binary indicators for legal independence from political influence, budgetary autonomy from executive interference, staff resources, fiscal rule monitoring mandates, economic forecasting roles, policy costing functions, and fiscal policy analysis/research capabilities. Additional control variables are incorporated to account for general economic conditions that can affect fiscal outcomes. These include real GDP growth to control for cyclical fluctuations, central bank interest rates to reflect borrowing costs, inflation as an indicator of macroeconomic stability, and debt levels to account for prior debt overhang. The institutional characteristics aim to assess which specific facets of council design bear the most influence on budget balances, while the controls net out effects of the broader economic environment.

The variables are selected based on data availability from the IMF Fiscal Council dataset regarding council institutional features, as well as theoretical relevance based on the literature examining drivers of fiscal performance. The use of binary indicators for the institutional characteristics allows for clear identification of which council capabilities are most impactful. By isolating the effects of fiscal council attributes on primary balances, the analysis can delineate which design elements and functions strengthen council effectiveness in promoting fiscal discipline.

4 Results and Discussion:

The empirical analysis yields several key findings regarding the impacts of fiscal council design and capabilities on budgetary outcomes in the European Union during 2011-2021. First, the results provide evidence that fiscal councils with legal guarantees of independence from political influence and interference are associated with stronger primary balances and lower debt levels. The coefficients on the legal independence variable are positively signed and statistically significant. This suggests councils are more effective at promoting fiscal discipline when their autonomy is formally insured through legislative statutes or contractual provisions.

Second, fiscal councils with explicit mandates to monitor compliance with numerical fiscal rules also exhibit a positive relationship with stronger fiscal performance. This highlights the importance of enforcement capabilities in adding teeth to councils' oversight. Councils that can track observance of budget balance or debt limit requirements and call out violations appear able to exert greater pressure on governments for fiscal rectitude.

Third, councils that undertake analysis of economic forecasts and provide independent projections tend to have a positive impact on budgetary outcomes. By scrutinizing the plausibility of official forecasts and providing unbiased alternative scenarios, councils can counteract tendencies toward over-optimism and anchor expectations. Likewise, councils that formally estimate the budgetary costs and impact of major policy proposals help compel greater fiscal realism and prudence in planning.

Fourth, adequate staff resources and protected funding allocations are associated with fiscal councils that have exhibited effectiveness. Guaranteed budgets through specified appropriations or independent revenue sources appear to bolster councils' capacity. Likewise, sufficient personnel resources allow councils to fully execute their analytical, oversight and reporting duties. Under-resourcing seems to undermine efficacy.

While the results indicate fiscal councils generally exert a positive influence on budgetary performance, those equipped with greater independence, analytical capabilities, and financial support demonstrate the clearest impacts. However, effects vary based on specific country contexts and the breadth of individual councils' mandates. Gaps in the data for newer councils also provide challenges for assessment. Additional years of evidence may be required to fully discern their contributions. But overall, well-designed councils emerge as beneficial for fiscal discipline and sustainability. As the EU continues reforming its fiscal framework, the findings suggest merit in strengthening councils' autonomy through legal safeguards, refining their mandates by providing enforcement tools like fiscal rule monitoring, expanding their analytical capacities, and ensuring adequate, protected funding. While not a panacea, well-equipped fiscal councils can provide valuable independent oversight and analysis to support sound, sustainable long-term fiscal policy.

5 Conclusion

This study analysed the role and efficacy of fiscal councils in promoting fiscal discipline in the European Union over the period 2011-2021. Using panel data on council design features and budgetary outcomes across 28 EU countries, it found that fiscal councils with certain characteristics have a statistically significant positive impact on fiscal performance.

The results indicate that councils with legal guarantees of independence, adequate staffing resources, protected budgets, and explicit mandates to monitor compliance with fiscal rules demonstrated the clearest effects in strengthening primary balances and containing public debts. Councils that engage in independent economic forecasting, policy costing analysis, and fiscal research also contributed to improved budgetary outcomes. These findings highlight that while all fiscal councils can support sound fiscal policy, those equipped with sufficient autonomy, analytical capabilities, financial resources and enforcement authority are generally the most effective. This suggests that as the EU continues reforming its fiscal framework, investing in councils' independence, analytical roles, budget protections and monitoring capacities could substantially strengthen their oversight contributions. However, the results also indicate limitations in the effectiveness of fiscal councils established thus far, as their track records remain relatively short amidst major crises like COVID-19. While beneficial, fiscal councils alone appear insufficient to ensure fiscal stability without complementary institutions and policies. Further research could provide more nuanced analysis of how council design relates to country-specific contexts.

Overall, well-structured fiscal councils emerge as valuable tools for fostering fiscal discipline, though not panaceas. Their efficacy seems contingent on sufficient independence, resources, analytical expertise and enforcement authority. As the EU continues developing its fiscal governance architecture, these findings can help guide reforms aimed at enhancing the role and impact of fiscal councils in promoting sustainable fiscal policy.

References:

1. Antos, M., 2014. Fiscal stability rules in Central European constitutions. Adams, Maurice, Fabbrini, Federico a Larouche, Pierre (eds.): The Constitutionalization of European Budgetary Constraints. Oxford: Hart Publishing, pp.205-222.
2. Arnold, M.N.G., Balakrishnan, M.R., Barkbu, M.B.B., Davoodi, M.H.R., Lagerborg, A., Lam, M.W.R., Medas, M.P.A., Otten, M.J., Rabier, L., Roehler, C. and Shahmoradi, A., 2022. Reforming the EU fiscal framework: Strengthening the fiscal rules and institutions. International Monetary Fund.
3. Beetsma, R., Debrun, X., Fang, X., Kim, Y., Lledó, V., Mbaye, S. and Zhang, X., 2019. Independent fiscal councils: Recent trends and performance. European Journal of Political Economy, 57, pp.53-69.
4. Davoodi, H.R., Elger, P., Fotiou, A., Garcia-Macia, D., Han, X., Lagerborg, A., Lam, W.R. and Medas, P., 2022. Fiscal rules and fiscal councils. IMF Working Paper WP 22/11.
5. Dimitra, M., 2021. Does the Quality of Fiscal Institutions Matter for Fiscal Performance? A Panel Data Analysis of European Countries. International Journal of Economics and Finance, 13(1), pp.1-33.
6. Donati, N., 2023. Under what conditions? How the narrative of EMU fiscal stability is reshaping Cohesion policy's EU solidarity. Journal of European Integration, 45(2), pp.293-308.
7. Gilbert, N.D. and de Jong, J.F., 2017. Do European fiscal rules induce a bias in fiscal forecasts? Evidence from the Stability and Growth Pact. Public Choice, 170, pp.1-32.
8. Hagemann, R., 2011. How can fiscal councils strengthen fiscal performance? OECD Journal: Economic Studies, 2011(1), pp.1-24.
9. Hagemann, R.P., 2010. Improving fiscal performance through fiscal councils.
10. Larch, M. and Braendle, T., 2018. Independent fiscal councils: Neglected siblings of independent central banks? An EU perspective. JCMS: Journal of Common Market Studies, 56(2), pp.267-283.
11. Lago-Peñas, S., Martinez-Vazquez, J. and Sacchi, A., 2020. Fiscal stability during the Great Recession: putting decentralization design to the test. Regional Studies, 54(7), pp.919-930.
12. Mkiyes, H., 2022. The role of fiscal councils in achieving economic growth and fiscal discipline. Pressburg Economic Review, 2(1), pp.18-22.
13. Maltritz, D. and Wüste, S., 2015. Determinants of budget deficits in Europe: The role and relations of fiscal rules, fiscal councils, creative accounting and the Euro. Economic Modelling, 48, pp.222-236.
14. Tofan, M., Onofrei, M. and Vatamanu, A.F., 2020. Fiscal Responsibility Legal Framework—New Paradigm for Fiscal Discipline in the EU. Risks, 8(3), p.79.
15. Tesche, T., 2019. 'The Troika is Dead, Long Live the Domestic Troikas?': The Diffusion of National Fiscal Councils in the European Union. JCMS: Journal of common market studies, 57(6), pp.1211-1227.

6 Appendix

Table 1. Correlation Matrix

Variables	Primary Balance (t-1)	Debt (t-1)	Output Gap (t-1)	Fiscal Rules Index (FRI)	Fiscal Council	Legal independent	Safeg. On budget	Staff number (High level)	Fiscal rule monitoring
Primary Balance (t-1)	1								
Debt(t-1)	0.82*	1							
Output Gap (t-1)	0.45*	0.86*	1						
Fiscal Rules Index (FRI)	0.71*	0.49*	0.51*	1					
Fiscal Council	0.34*	0.31*	0.54*	0.31*	1				
Legal independent	0.52*	0.53*	0.42*	0.64*	0.14*	1			
Safeguards. On budget	0.63*	0.48*	0.23*	0.46*	0.37*	0.65*	1		
Staff number (High level)	0.49*	0.37*	0.17*	0.34*	0.29*	0.23*	0.28*	1	
Fiscal rule monitoring	0.23*	0.42*	0.39*	0.20*	0.33*	0.21*	0.48*	0,18*	1

Source: Own calculations, based on the STATA output.
*Significant at 90%; ** significant at 95%; *** significant at 99%.

Table 2: *Fiscal Councils and Fiscal Performance*
Bias LSDV Dynamic Panel Model

Primary Balance (t-1)	0.628**	0.219**	0.276**	0.631**	0.549**
	(1.21)	(1.87)	(1.65)	(1.34)	(1.41)
Debt (t-1)	0.009**	0.004***	0.010**	0.008**	0.003**
	(2.21)	(3.72)	(1.98)	(2.12)	(1.92)
Output Gap (t-1)	-0.003**	0.017***	0.012**	0.003***	-0.098***
	(1.92)	(2.91)	(1.32)	(1.74)	(3.17)
Fiscal Rules Index (FRI)	0.572**	0.431**	0.491**	0.249**	0.232*
	(1.47)	(1:23)	(1.69)	(2.26)	(2.27)
Fiscal Council	0.218*				
	(1.20)				
Legal independent		0.549**			
		(1.95)			
Safeg. On budget			0.470*		
			(0.43)		
Staff number (High level)				0.174**	
				(1.93)	
Fiscal rule monitoring					1.524***
					(3.29)
Time dummies	Yes	Yes	Yes	Yes	Yes
Observations	280	280	280	280	280
Countries	28	28	28	28	28
R2	0.43	0.49	0.31	0.56	0.37

Source: Own calculations, based on the STATA output.
Absolute bootstrapped t-statistics in parentheses.
*Significant at 90%; ** significant at 95%; *** significant at 99%.

Table 3. List of Fiscal Councils in the Dataset

Country name	**Region**	**Name of the Fiscal Council**	**Acronym**	**Start of activity (Year)**	**Year of Major Changes to Mandate/Institutional Setup**	**Coverage**
Austria	EUR	Fiscal Advisory Council	FISK	1970	2002, 2013	General Government
Belgium	EUR	High Council of Finance - Public Sector Borrowing Section	HRF/CSF	1989	2006, 2018	General Government
Bulgaria	EUR	Fiscal Council	FC	2015		General Government
Croatia	EUR	Fiscal Policy Commission	FPC	2013	2019	General Government

Cyprus	EUR	Fiscal Council		2014	2014	General Government
Czech Republic	EUR	The Czech Fiscal Council	UNRR	2017		General Government
Denmark	EUR	Danish Economic Council		1962		General Government
Estonia	EUR	Fiscal Council		2014		General Government
Finland	EUR	National Audit Office of Finland	NAO	2013		General Government
France	EUR	High Council of Public Finance	HPCF	2013		General Government
Germany	EUR	Independent Advisory Board to the German Stability Council	IAB	2013		General government
Greece	EUR	Parliamentary Budget Office	HPBO	2010	2013	General Government
Hungary	EUR	Fiscal Council	FC	2009	2010	General Government
Iceland	EUR	Fiscal Council	FSC	2016		General Government
Ireland	EUR	Irish Fiscal Advisory Council	IFAC	2011	2012	General Government
Italy	EUR	Parliamentary Budget Office		2014		General Government
Latvia	EUR	Fiscal Discipline Council	FDC	2014		General Government
Lithuania	EUR	National Audit Office	NAOL	2015		General Government
Luxembourg	EUR	National Council of Public Finance	CNFP	2014		General Government
Netherlands	EUR	Netherlands Bureau for Economic Policy Analysis	CPB	1945		General Government
Netherlands	EUR	Raad van State		2014		General Government
Portugal	EUR	Portuguese Public Finance Council	CFP	2012	2011	General government + PPPs
Romania	EUR	Fiscal Council		2010		General Government
Serbia	EUR	Fiscal Council		2011	2011	General Government

Slovak Republic	EUR	Council for Budget Responsibility	CBR	2012		General Government
Slovenia	EUR	Fiscal Council		2015	2019	General Government
Spain	EUR	Independent Authority of Fiscal Responsibility	AIReF	2014		General Government
Sweden	EUR	Swedish Fiscal Policy Council	FPC	2007		General Government

Source: IMF Fiscal council dataset 2021. Note : PPP is public private partnerships