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Another Quiet Revolution?

Future role of independent fiscal institutions in Europe

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Abstract

There seems to be a fair degree of consensus that synergies between fiscal rules and independent fiscal institutions can be more effective in fighting the deficit bias or to follow more closely optimal policies. More and more fiscal councils are being created each year, especially in the European Union, where important changes to the basic fiscal architecture shook up the whole institutional set-up. Several amendments to the Stability and Growth Pact together with the adoption of the Fiscal Compact made the existence of functionally independent bodies a legal requirement. Although the parallels between the delegation of monetary policy to independent central banks and creation of fiscal councils are far from perfect, we may well be witnessing another "quiet revolution", the term coined by Alan Blinder in his book[3] about important changes in central banking in last decades. In this paper we argue that in order to complete the revolution, further changes to the European fiscal framework are necessary to eliminate the sometimes deep inconsistencies that might occur between various fiscal rules, monitoring procedures and communication of basic policy messages. We propose a new institutional framework, where national and supranational responsibilities are separated and the first line of defense against the deficit bias is at the national level. In this model, the community level would be responsible for checking compliance with minimum standards defined for local fiscal frameworks and for EU-wide coordination of policies instead of yearly fine-tuning of national budgets.

Keywords: fiscal rules, independent fiscal institutions

JEL classification: H1, H6

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1 Useful comments from Michal Horváth, George Kopits, Philip Lane, Geert Langenus, Gábor P. Kiss, Kevin Page and especially Simon Wren-Lewis and Charles Wyplosz are gratefully acknowledged.
2 Council for Budget Responsibility, odor@rrz.sk
3 The Quiet Revolution (2004), Yale University Press

Content

1 Motivation

"CBR … it should be like a hedgehog in the pants for every government."

Peter Kažimír (Minister of Finance, Slovak Republic)

Twenty years ago there were only a couple of institutions we can call fiscal councils by today standards. These first generation councils were created mostly on an ad-hoc basis addressing specific needs in several countries ("home-grown" institutions). The Central Planning Bureau (CPB) in the Netherlands started its operation after the Second World War with an objective to „supply the government with scientific knowledge and insights needed for active economic policy." The Congressional Budget Office (CBO) in the US was created to serve the Congress by providing mainly non-partisan legislative cost estimates. In Germany, Denmark, Austria and Belgium groups of "wise men" (with almost no staff) operated to discuss general economic policy issues related to debt or the fiscal situation in general. The Swedish Fiscal Policy Council was created in 2007 to review and assess the extent to which the fiscal and economic policy objectives proposed by the Government and decided by the Riksdag (the Swedish Parliament) are being achieved. Despite the fact that these bodies lack de jure independence, many of them have gained high credibility and the notion of de facto independence over the years.

The Great Recession and the subsequent escalation of fiscal problems brought back the question of eliminating the deficit bias and "fiscal alcoholism" more generally. The failure of the SGP in Europe and intensive market pressures in some countries motivated academics, economists but also international organizations to propose changes to the existing fiscal architecture. A new consensus emerged from these discussions: synergies between fiscal rules and independent monitoring institutions might be more effective in fighting the deficit bias than rules or councils alone. This consensus was then embedded into the new EU legislation, **making the second generation of fiscal councils more powerful, but on the other hand less rooted in local traditions**. We consider this development as the starting point of a new "quiet revolution" in economic policymaking. However, it is far from clear that it will be equally successful as in the case of central banking. Especially if it does not deliver the expected outcomes and is not supported by the general public. This paper discusses the strengths and weaknesses of the current institutional arrangement in Europe and makes several recommendations to eliminate fundamental inconsistencies and make the "revolution" work.

The rest of the discussion paper is organized as follows. The second section discusses parallels between monetary and fiscal policy, while the third different manifestations of the deficit bias. The fourth assesses the question of fiscal rules. The fifth briefly summarizes the main arguments put forward to create independent fiscal councils. The sixth part describes the differences and similarities between councils in different countries. The analysis of the EU setup is presented in the seventh section. Recommendations can be found in the eight, while the ninth contains a proposal for one possible "final" solution for the euro area.

2 Parallels between monetary and fiscal policy

Changes to the conduct of monetary policy (MP) were enormous in the last few decades. Despite recent problems after hitting the zero lower bound (ZLB), Blinder rightly calls this development as a "quiet revolution". Independent central banks, inflation targets, transparent communication of objectives and policy and monetary research all contributed to a much better understanding and execution of monetary policy. On the other hand, the more important macro policy tool from a social welfare point of view – fiscal policy (FP) – is still conducted on an ad-hoc basis and in a very opaque environment in many countries. Leeper (2010) is talking about "monetary science and fiscal alchemy".

The important question is: are the differences between the two policies due to the different nature of fiscal policy (comparing apples to oranges) or the gaps are resulting from lack of reforms in fiscal policymaking? The short answer is both. In our view there are two major inherent differences between MP and FP. First, fiscal policy has many instruments with possible *large* distributional impacts (standard MP has also distributional "side-effects" via the inflation channel, but usually these are limited in size, especially over the business cycle). Second, FP has a lot of supply-side effects. These two aspects make the separation of technocratic work and political process much harder than in case of MP[4]. The traditional "taxation without representation" has to be clearly respected, however there can be still ample scope for IFIs to clarify impacts of policies or for example to better coordinate the macroeconomic effects of MP and FP when the economy is close to the ZLB. In other words, we argue in this paper that the above-mentioned two major differences do not justify the large gaps between the conduct of MP and FP. On the other hand it is important to bear in mind those when designing better fiscal frameworks.

The quiet revolution in central banking has occurred because of de-politicization of some aspects of monetary policy. The Great Inflation of the seventies was the main trigger, when the public realized the cost of high inflation very clearly. Now we are in a period of "Great Debt" and similarly the public sees the costs of permanently high debt. There might be more appetite to adopt changes. The question is: where can we draw a borderline between technocratic work and political decisions? In monetary policy a consensus has been achieved that independent central banks can fairly well target inflation on a medium-term horizon by setting short-term interest rates. Moreover, simple rules can help to fight time-inconsistency problems (Kydland and Prescott, 1977) while at the same time mimic optimal policy from a theoretical point of view. The next figure illustrates a simple comparison of the conduct of monetary and fiscal policy.

4 However it should be noted that many uncoventional monetary policy measures also have significant distributional aspects. Especially those which target special asset markets. See Brunnermeier and Sannikov (2012).

Figure 1 – Monetary vs fiscal policy

	Monetary policy	Fiscal Policy
Understanding the economy	New micro-founded models	Models from the seventies dominate in practice
Institutional set-up	Independent central banks	Political decision making
Objectives	Inflation targets	No clear consensus; some notion of sustainability
Operational rules	Short-term interest rates as an instrument and simple rules (optimal policy)	Tax smoothing in theory vs ad-hoc fiscal rules in practice
Dynamic behavior and expectations	Firmly anchored inflation expectations, importance of time-inconsistency	Importance of fiscal expectations recognized mostly in crisis times
Communication	Open communication, high transparency	Fiscal gimmickry is the rule not the exception
Theory vs Practice	Convergence	Important differences prevail

Source: author

Maybe the characterization of the status quo on Figure 1 is a bit unfair to fiscal policy, because the institutional framework is changing very rapidly and there are also important unresolved questions in monetary policy. On the other hand it would be a mistake to put fiscal policy on the same "scientific" level as monetary policy.

Before we analyze what FP can learn from MP in terms of institutional issues it should be clearly stated what are the key differences in the process of delegation tasks to independent bodies. Wren-Lewis (2013) provides an excellent overview. In his view there is a much broader consensus about the ultimate objective of MP, while in case of FP the discussion is more about intermediate targets. Central banks have the discretion to choose the path of output and inflation in the medium run by setting the short-term interest rate. In this sense it is a delegation of control, while in case of independent fiscal institutions (IFIs) it is more about the delegation of advice. Governments can almost always override this advice[5].

Bearing in mind those limitations, the most important step towards a better FP is to state the appropriate objective. Given the complexity of fiscal policy, this exercise is not straightforward. Here we focus on the "macro" aspects of fiscal policy leaving aside the cost-benefit analysis of individual tax or expenditure measures. The single most important lesson from *theory* since Barro (1979) is the tax-smoothing argument. It is not optimal to offset shocks to government debt rapidly – gradual adjustments are much better from a social welfare point of view. However it is not clear what should be the optimal debt path for a given country when we incorporate more realistic assumptions (i.e. risk premia). From a *practical* point of view we know that countries often have chronic deficits and rapidly increasing debt levels even in normal times.

5 An interesting counter-example is Hungary, where the fiscal council has a veto right over the budget.

This is in many cases a result of a so called "deficit bias" (Calmfors and Wren-Lewis, 2011). Deficit bias is directly connected to the concept of fiscal space. One of the most important lessons from the Great Recession is that without sufficient room for maneuver, fiscal policy loses much of its stabilization potential and also heavily complicates the work of monetary policy. As Obstfeld (2013) notes: "absent adequate fiscal space, financial instability will be worse and may lead to price instability or sovereign default, which themselves will further impair the functioning of financial markets, at a great cost to the broader economy." Without eliminating the deficit bias it would be very hard to go back to more prudent levels of debt or to follow optimal policies.

This is the reason that from a practical point of view we see the elimination of the **deficit bias** (as efficiently as possible) as the most important policy objective of fiscal policy (of course not the only one; for example coordination of fiscal and monetary policy is also crucial especially in crisis times). This goal implicitly assumes anchored fiscal expectations, predictability and counter-cyclicality of policies and sustainability of some fiscal stock variable, i.e. gross debt, net debt or inter-temporal net worth ("taxpayers' equity"). Deficit bias is interpreted here in a very broad sense; including all potential factors allowing the government to create permanent deficits (non-transparency, contingent liabilities, fiscal illusion[6] etc.). As Portes and Wren-Lewis (2014) show the severity of the deficit bias is an important variable when designing fiscal rules. Without such a bias it is much easier to follow optimal policy (tax-smoothing).

What are the best instruments to fight the deficit bias? In a general sense it is some **mix of fiscal rules and independent fiscal institutions**. The detailed design very much depend on the source of the bias. The next section deals with this question.

To sum up, both in monetary and fiscal policy the goal is to be flexible in the short run and rigid in the long run. The long run target is inflation for MP and can be debt for FP (set by the government or by a constitutional rule). The main instrument for MP is the short-term interest rate and can be structural balance for FP (set by an IFI for example). Main redistributive aspects of policies are left to politicians.

3 Potential sources of deficit bias

First, we have to look at the potential sources of deficit bias to understand the illness before we recommend a cure. Drazen (2004), Cukierman and Meltzer (1986) and Calmfors and Wren-Lewis (2011) report several potential reasons for permanent increases in deficit and debt. Here we mention six of them: (i) informational asymmetry; (ii) impatience; (iii) myopia; (iv) common-pool theory; (v) time-inconsistency and (vi) electoral competition.

[6] See Puviani (1897).

The most important reasons for deficit bias might be country-specific[7] or even time-varying and therefore one-size-fits-all solutions can be easily suboptimal in monetary unions. Ódor (2011) looked at the case of Central Europe and argues that informational asymmetry, myopia and common-pool problems are the most important reasons behind persistently high deficits in this region. On the other hand it is important to stress that while forms and exact mandates of fiscal councils can and should differ, some "minimum standards" should be respected (independence, professional requirements, etc.). Apart from the possible roles of fiscal councils, Ódor and P. Kiss (2012) discuss also different fiscal rules for the Visegrad 4 countries. They propose a following structure: long-term debt rule as a limit (not operational target), medium-term deficit rule as a target and expenditure limits as an instrument (derived from a deficit target). It is important to note that expenditure limits have to reflect discretionary revenue measures in order to maintain political neutrality.

As far as the deficit bias is concerned, the easiest case to address is the informational problem. However it should be noted that legal requirements to supply more information is just part of the story. Journalists, think-tanks, financial market players or the general public are usually not fiscal experts, so there might be a role for fiscal councils to "translate" the conclusions into ordinary language. It is often hard for voters but also financial markets to figure out the true state of public finances and to distinguish bad luck from bad policy.

Another possible explanations are myopia, impatience and electoral competition. The problem is complex, since it works not just at the level of government, but also at individual level. Hyperbolic discount functions, differences between discount rates of governments and electorate or re-election probabilities can all play an important role. It would be too optimistic to think that changes to the fiscal architecture could eliminate this problem. On the other hand, regular fiscal reports with long-term focus, non-partisan cost estimates or medium-term expenditure ceilings might certainly mitigate the problem. Fiscal councils should be some kind of "lobbyist for future generations."

Common pool theory refers to the situation when decision makers under the pressure of various interest groups are unable to internalize the overall costs of higher deficit and debt. It is more severe in case of fragmented coalition governments, at the end of election periods and in good times. It is therefore important to strengthen the role of finance ministers: to avoid the situation when all ministers are against one. Pre-set expenditure ceilings or overall fiscal risks communicated by an independent fiscal body might serve this purpose.

If we look at subsequent revisions to fiscal objectives in Europe in stability and convergence programs the following lesson emerges. The best period to balance the budgets is always three years from the actual year. While in theory it is optimal to absorb unexpected shocks gradually,

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7 For example different degree of government´s credibility, forms of governance and political set-ups all require country-specific solutions.

it is in many aspects similar to the "quitting smoking tomorrow" syndrome, when tomorrow never comes. Even if politicians are serious about their intentions *ex-ante*, with the passage of time more and more excuses are emerging and the temptation to break previous promises are growing. As Horváth and Ódor (2009) argue, an optimal mix of fiscal rules and fiscal institutions can serve as a commitment technology to ease this type of deficit bias.

Wyplosz argues that the single most important reason for the deficit bias is the common pool problem and if one can solve it, the rest will follow automatically. On the other hand, solving the other 5 problems will not prevent the bias from surfacing. In addition, solving all six factors will deliver unnecessarily complex arrangements.

As we can see the design of an appropriate fiscal framework depends very much on the severity of deficit bias and its most important source. Ideally voters or financial markets should be able to punish profligate governments. But as we showed earlier informational asymmetry makes it hard for voters to evaluate trends in fiscal policy correctly. Moreover, as the literature shows, financial markets usually react too late, but then too abruptly. It is however important to emphasize that an optimal fiscal framework might help these two channels to work more properly (for example by eliminating creative accounting or by imposing strong no bail-out rules).

In the next two sections we look more closely at the question of appropriate fiscal rules and reasons put forward to create fiscal councils.

4 What kind of rules?

Portes and Wren-Lewis (2014) discuss several issues in the design of fiscal policy rules. Here we focus on the case of a monetary union, where the problem of deficit bias can manifest itself both at local level and at the level of the whole currency area. As Ódor (2014) argues it is impossible to design effective fiscal frameworks without proper clarification of responsibilities between the local and central level. One extreme is to rely on pure market discipline (US), the other is to have direct control from the center (Germany). Ódor concludes that currently it is better to build a functional de-centralized system of fiscal discipline in the euro area. In this case it is inevitable to have a strong no bail-out clause through mechanisms of bank resolution schemes or for example principles for "bail-ins". Once these mechanisms are functional and credible, there can be more tailor-made solutions at the national level.

Fiscal rules at the national level should be country-specific, firmly embedded in local traditions and institutional foundations. One possible solution is to follow the 3-step procedure advocated by Ódor and P. Kiss (2011) for the Visegrad countries. The main anchor should be a country specific debt limit (or path). The main operational target would be a yearly deficit figure calculated ex-ante by the fiscal authority or the fiscal council taking into account the optimal speed of adjustment (based on the actual economic environment, cyclically adjustments, one-offs, etc.). The main operational instrument would be in a form of medium-term expenditure ceilings (net of discretionary revenue measures) with full coverage of the public sector. There are at least 3 important advantages of aggregate expenditure ceilings over cyclically-adjusted budget balances when used as a main operational fiscal rule: easy ex-post verification, superiority in curing the common pool problem (competing expenditure programs) and better support for automatic stabilizers. Of course, these ceilings are determined based on ex-ante paths for structural balances.

One should not forget also rules for transparency and rules for subnational government units. However these are beyond the scope of this paper.

Both the different source of the deficit bias and the country-specific nature of optimal debt paths make the introduction of uniform operational fiscal rules at the central level inferior. Therefore fiscal rules at the central level should not be very complex and detailed, but rather should ensure that fiscal variables are kept within reasonable limits to avoid spillovers and free-riding in a monetary union. If there is a political will to build a stronger fiscal union, the focus of European rules should be on the European budget and on area-wide monetary-fiscal coordination and not on national budgets. On the other hand, "minimum standards" seems to be necessary to put in place to ensure sounder fiscal policy at the national level. We come back to this issue in section 9.

5 Fiscal councils: why do we need them?

It should be noted at the beginning that not all countries need fiscal councils. If the deficit bias is absent or is not serious, independent fiscal institutions can add only little value added[8]. So in this section we assume that there is a significant deficit bias in a country in question. Here we review the main arguments in favor of creating fiscal councils (they are not necessarily mutually exclusive).

1. Complements to fiscal rules. Kopits and Symansky (1998) presented a set of eight criteria for optimal fiscal rules. However there are important trade-offs between many of them, so it is impossible to score high in all aspects. The most prominent example is flexibility vs. enforceability. Portes and Wren-Lewis (2014) talk also about trade-offs between optimality and effectiveness. One can argue that independent fiscal institutions can ease these trade-offs. For example, more complex rules can be put in place (harder to circumvent) if there is a trusted authority in order to check the compliance with them. Or fiscal councils can help

[8] Even if there is no deficit bias and the government is behaving in a responsible manner, fiscal councils can be helpful. They can explain to the public that it is indeed good policy rather than good luck, thereby increasing the sustainability of those policies after the next election.

to justify extraordinary circumstances when it is clearly suboptimal to follow the fiscal rule in place. In other words there is a significant room for complementarity between fiscal rules and fiscal councils.

2. Efficient commitment technologies. Let us make an analogy here. Economic professors from the Yale University designed a commitment contract website based on game theoretic arguments (stickk.com). They claim that commitment devices can increase the chances to achieve personal objectives (losing weight, quit smoking, etc.) by as much as 30%. If politicians are serious about fiscal goals ex-ante, similar commitment technologies might also help. The four main ingredients in micro-level contracts are: goals, stake, referee and support. In fiscal policy goals and stakes can be designed via fiscal rules, IFIs can play the role of a referee and the general public might provide the support.
3. Informational asymmetry – independent think tanks and international organizations can fairly well understand the revenue side of public finances. However, the detailed picture about the expenditure side and creative accounting operations represent the monopoly power of finance ministries in many countries. As it was mentioned earlier, fiscal councils can serve as the missing link to achieve full transparency of fiscal accounts. Non-partisan interpretation of fiscal trends can make the democratic punishment of a profligate government easier, financial market reaction smoother and parliamentary decisions more competent (evidence-based policy).
4. Delegation of technocratic aspects of fiscal policy – macroeconomic forecasts, tax revenue projections or for example forecasts of interest expenditures should not be subject to political debate. One can go a step further and argue that deficit paths can also be in principle delegated to technocratic bodies. Political battles should focus on proposing new legislation and allocating resources. While it is not possible to separate macroeconomic effects and resource allocation completely, fiscal councils can do a lot of technocratic work without normative decisions. The inter-temporal budget constraint or the values of fiscal multipliers have no inherent ideology in principle.
5. Representing future generations – when fiscal policy decisions are made, usually no one is representing the needs of future generations. Fiscal councils can help to avoid exploitation of unborn generations.
6. Fiscal research – the “quiet revolution” in monetary policy not only made central banks more independent but also allocated more resources to monetary research (not only applied). No similar trend was visible in case of fiscal policy. Maybe the reason is that ministries of finance had no incentives to increase the transparency of fiscal policy action. Fiscal councils can be a right place to focus more on applied research in the area of fiscal policy (i.e. optimal debt level). They can also support or finance more academic research.
7. Fiscal literacy – voters in many countries, but especially in converging economies do not understand the basic principles of fiscal policy. Fiscal councils can have more targeted information campaign toward the general public. Central banks have cartoons, games or

special prizes for the younger generations in order to increase the understanding of monetary policy.

8. Fiscal monitoring in a monetary union – the common pool problem is "squared" in a monetary union. Monitoring from the center might be less effective to contain free-riding behavior than a more decentralized approach via national fiscal councils.

To sum up, fiscal councils might play a useful role in 3 broad areas:

- interpretation and communication of fiscal policy,
- monitoring compliance with fiscal rules,
- delivery of technocratic work, including possible setting of deficit paths.

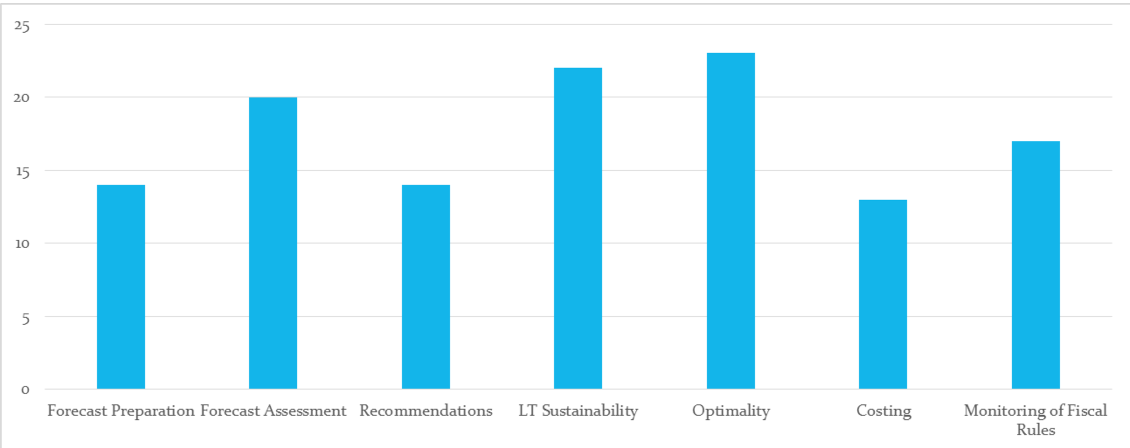
In the next section we look at current state of play in case of second generation fiscal councils.

6 Where do we stand now?

In the previous section we highlighted the main arguments put forward to create a fiscal council in theory. In this part we look at the current practice: what are the differences and similarities between existing fiscal councils.

The International Monetary Fund (IMF) maintains a Fiscal Council Dataset[9] currently displaying 27 institutions in 25 countries from which 18 are in Europe. The number of independent fiscal institutions in Europe is increasing rapidly mainly due to the legal requirements in the new SGP and the Fiscal Compact. The next figure illustrates the major focus of fiscal councils.

Figure 2 – Ex-ante analysis in fiscal councils



Source: IMF

9 Available at http://www.imf.org/external/np/fad/council/

It can be summarized in four broad areas:

- Macroeconomic forecasting,
- Ex-ante and ex-post evaluation of compliance with fiscal rules,
- Long-term sustainability analysis,
- Costing of legislative proposals.

In the euro area the recently adopted "six-pack", "two-pack" and the Fiscal Compact provide explicit legislative backing for fiscal councils. One can identify three roles in the European legislation:

1. Monitoring compliance with national medium-term rules ("six-pack")
2. Producing or endorsing macroeconomic forecasts ("two-pack")
3. Monitoring compliance with the balanced budget requirement in structural terms (Fiscal Compact).

From the list of potential arguments for creating fiscal councils (section 3) the weakness of fiscal rules and delegating technocratic aspects of fiscal policy were the most important in case of Europe. The natural question is. Is this set up optimal or we can do more?

7 Set up in the EU

In this section we briefly look at the current mix of fiscal rules and fiscal councils in the European Union. Ódor (2014) analyses the European fiscal architecture more deeply, here we focus only on the potential role fiscal councils might play in the future.

Currently we have complex rules both at the European and national levels. Moreover there is a European fiscal watchdog (the European Commission) and many national fiscal councils. The former has a value added in monitoring area-wide aspects of fiscal policy, the latter is superior as far as country-specific situation is concerned. One would therefore expect a set-up as on figure 3, where the overlaps are minimal and room for potential inconsistencies are limited.

Figure 3 – Separation of responsibilities

	European FC	National FC
European rules to avoid gross errors	X	
Local fiscal rules		X

Source: author

The current situation is however far from that presented on figure 1. One can mention at least 4 groups of problems.

First, European fiscal rules try to supplement national fiscal rules to fine tune the budgets of individual countries. Moreover there are too many European rules with possible inconsistencies. Voters usually trust more to local institutions.

Second, the line between national and European rules is sometimes blurred. The preventive arm of the SGP and the Fiscal Compact are essentially the same. The former is monitored by the EC, while the latter by a local IFI. It might easily happen that the two can reach different conclusions based on the same rule (for example due to different methodologies to calculate structural budget balances).

Third, comparative advantages of local FCs are not recognized, for example in case of identifying one-off measures or costing discretionary revenue measures.

Fourth, there is still a lot of political influence on the EC, which is a problem if one really wants a truly independent watchdog at the EU level.

It should be clear that we are not proposing "Chinese walls" between the community and national levels. On the contrary. Free flow of information, reports and analyses should be strengthened between the European Commission and local fiscal institutions to have proper checks and balances. What we state here is that duplication of responsibilities and accountability should be avoided and at the same time comparative advantages should be recognized.

8 Completing the "revolution"

The Great Recession and the subsequent rise in public debts resulted in new ways countries are trying to fight the deficit bias. An important innovation in fiscal frameworks is to seek for synergies between fiscal rules and fiscal institutions. The euro area – where the debt crisis is especially severe – embedded the requirement to set up fiscal councils into supra-national legislation. Monitoring fiscal rules and producing (or endorsing) macroeconomic forecasts are the main tasks attached to these newly created bodies. Based on the analysis in the previous sections and on Ódor (2014) and with an objective to i) maximize the utility from fiscal councils and ii) make the European set up more functional we have the following recommendations/suggestions[10].

1. National fiscal councils should focus on country-specific sources of deficit bias. Tailor made solutions tend to work better than "one-size-fits-none" approaches.
2. Fiscal councils should engage more in providing applied fiscal research and increasing fiscal literacy.

[10] These recommendations are designed to respect that in EU only gradual changes are politically feasible. A more radical solution is described in the next section.

3. Increase the scope of technocratic work delivered by fiscal councils (possible including setting deficit targets) at the national level.
4. Separate clearly national and European fiscal rules and respective monitoring responsibilities. It is can be very confusing to hear two different policy messages based on the same rule (SGP vs Fiscal Compact).
5. Use the local knowledge where appropriate. For example in case of one-off effects, output gaps or costing of discretionary revenue measures.
6. No fine-tuning of national budgets is necessary at the EU level. A hierarchical system is possible, where the first line of defense is represented by national fiscal rules monitored by national fiscal councils.
7. Give more independence to the EC or create a different EU fiscal watchdog.
8. Introduce professional requirements for IFI council members to avoid politically motivated nominations. Consider partial funding of local IFIs from the EU budget to ensure adequate capacities for the tasks defined in EU legislation. However, full independence (functional and financial) outside EU matters should be retained.

There are recommendations which require changes to the institutional set-up[11]. In some cases there are different technical solutions how to achieve the desired outcome. This question is especially relevant when potential greater involvement of independent fiscal institutions in European procedures is considered. IFIs are a heterogeneous group with widely different origin, mandate and resources. Currently the European fiscal framework assumes that each euro area member country should have an IFI. Moreover it prescribes three important tasks to carry out by these institutions: macroeconomic forecasts, a role in activation of correction mechanisms and escape clauses. To avoid question marks over the independence of local fiscal councils one has to carefully balance the costs and benefits when granting more power to IFIs in the future. In our view it can be done in four ways (initially the informal set-up is the most likely scenario):

- informal – the EC will use the analytical results of IFIs when available (for example when identifying one-off measures, discretionary revenues measures or evaluating effective action via the bottom-up methodology),
- semi-formal – the European legislation can require more tasks carried-out by IFIs without taking into account the capacity constraint of local councils (like in the case of macroeconomic forecasts); as in the "informal" case, the EC will not be obliged to use the output of IFIs;
- formal – the EU budget would finance additional tasks required to avoid capacity constraints; moreover there would be strict professional requirements laid down in EU legislation for the selection of council members[12]; in this set-up the EC would use the analysis of IFIs in SGP procedures;

[11] This sections follows very closely Ódor (2014).
[12] In extreme cases the EC would have the power to nominate one council member.

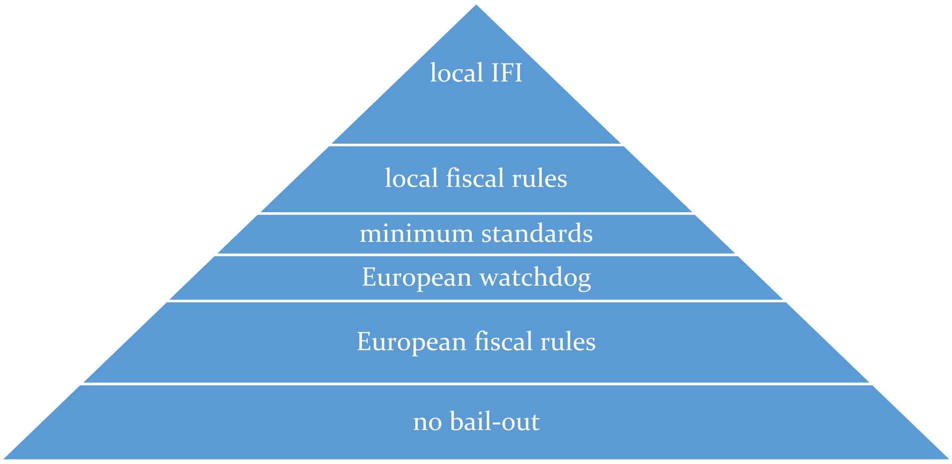
- de-centralized – the first line of defense against the deficit-bias would be at the national level: local IFIs would monitor compliance with local rules (preferably constitutional). The role of the EC in this set-up would be to step-in only in case of "gross policy errors".

The next section describes this last option in a greater detail.

9 The "final" model

In this section we propose one possible set-up for the European fiscal architecture. It is based on the de-centralized set-up discussed in the previous section and illustrates what can be a "final" solution if all recommendations are gradually implemented. The basic structure is highlighted on the next figure.

Figure 4 – Proposal for a European fiscal framework



Source: author

Let us look at each layer in turn.

No bail-out – as Ódor (2014) argues it is important to restore the credibility of the no bail-out clause as much as possible. Private sector involvement, partial restructuring or bail-ins seems to be essential to limit the risk of contagion between banks and the sovereign and also among sovereigns. Private investors should remain responsible for their investment decisions. The good news is that recent discussions about the banking union and future role of resolution funds go in this direction.

European fiscal rules - they should *not* try to fine-tune local budgets every year. Instead they should be simple and effective only if domestic frameworks are not able to function without "gross policy errors" (the original idea behind the SGP). For example long-term debt limits (possible country-specific) can serve this purpose relatively well. Another possibility is to have fiscal rules for the EU budget – if there is a political will to have a stronger fiscal union.

European watchdog - it should i) check the compliance with EU-wide fiscal rules (if existent), ii) assess whether minimum standards regarding rules and institutions are respected at the national level and iii) make recommendations if rules or standards are violated. In this set-up the European Commission acts as a "quality controller" and defender of local independent fiscal institutions.

Minimum standards – these can be formulated both for fiscal rules and fiscal institutions. In case of local IFIs it might be helpful to assure: independence, mandate, professional skills and quality of outputs or for example sufficient funding. In case of local fiscal rules, their legal power, coverage and counter-cyclicality might be assessed.

The last two layers – **local fiscal rules and local IFIs** – should be country specific, tailored to national circumstances (source of the deficit bias, optimal country-specific debt path).

In order to implement this framework one should clearly design not only the "layers" but also the linkages between them. While duplicities should be avoided, appropriate checks and balances are needed to utilize all the possible synergies. Moreover, as we have stated earlier free flow of information and results of technocratic work between the layers is necessary to have clear policy messages.

10 Conclusions

Gradual debt reduction in order to regain adequate fiscal space will be one of the main priorities of economic policy making in the next decades. Since there are important linkages between fiscal policy, monetary policy and financial stability (especially in crisis times), we argue in this paper that further de-politicization of fiscal policy will be necessary to eliminate the deficit bias. Similarly to monetary policy, it can be achieved via greater involvement of independent fiscal institutions, simple rules, transparent communication and fiscal research.

The situation in currency unions is more complicated, where there is a fundamental conflict between the need to adopt country-specific solutions on the one hand and the assurance of equal treatment across the member states on the other hand. We argue that in order to fight more effectively against the deficit bias in the euro area, further changes to the institutional set-up are necessary. Our proposal is to rely more on local rules and institutions to ensure fiscal prudence at the national level (optimality). In our view European procedures should focus more on gross errors of national fiscal policy to contain spillovers (limits). Moreover, the center can be also responsible for counter-cyclical policy at the aggregate level if there is a need to strengthen the fiscal union. It is however very important for the European level to act as a quality controller (checking compliance with minimum standards regarding local rules and institutions) and defender of national fiscal councils.

Despite recent problems after hitting the zero lower-bound, the transformation of monetary policy has been enormous after the Great Inflation of the seventies. Currently we see first signs of a similar revolution in fiscal policy. In our view breaking the path-dependency of the SGP and rethinking of the role independent fiscal institutions will be crucial to make the revolution work.

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