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# The Divergence between the EU and non-EU Fiscal Councils

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**Abstract:** *The European sovereign crisis that followed the 2008 crisis showed that rules-based fiscal policy is insufficient in itself in order to avoid fiscal alcoholism and excessive sovereign debt. Nevertheless, these policies have become more and more widespread in order to limit indebtedness. This article deals with one of the most important elements of rules-based systems: the fiscal council. The key question imposed was: is it mostly a European phenomenon, or rather a global standard? Is there a divergence between the EU and non-EU fiscal councils, or not? As a method, we employed descriptive statistics, then a hierarchical cluster analysis, based on the data of the IMF Fiscal Council Dataset. In conclusion, an EU and a non-EU cluster were formed, thus our working hypothesis was mostly underpinned. Our results have thus contributed to the literature and advanced the case that the increased number of fiscal councils can be attributed to European regulations or internal political issues rather than strengthening of fiscal prudence.*

**Keywords:** *rules-based fiscal policy, fiscal council, independent fiscal institutions, fiscal prudence*

**JEL codes:** *E02, E62, F36, H61, H68*

## 1 Introduction: establishment of Independent Fiscal Institutions

The European sovereign crisis that followed the 2008 crisis shed light on the fact that rules-based fiscal policy, which contains an explicit rule on the current deficit and the debt limit (adopted by the Stability and Growth Pact at the European Union level), is insufficient in itself (Calmfors and Wren-Lewis, 2011). It became broadly clear that fiscal rules alone are insufficient, as they cannot ensure fiscal discipline and its sustainability. For this reason, experts started to look for new methods to enforce budgetary discipline. Extensive attention was paid to the establishment and reinforcement of independent fiscal institutions (IFI).

In a European context, a specific proposal was raised in the early 2000s. Already at that time, Wyplosz (2002) predicted that rules-based budgets would never solve the fundamental economic policy problem and the consequent inclination to generate deficit. He proposed that every Member State should be required to set up a fiscal policy committee independent of the government, under the control of people with the appropriate professional background, and with a mandate to maintain the sovereign debt over the medium term. Larch and Braendle (2018) also considered it logical to take fiscal macro-economic stability policy out of the hands of elected national governments. The concept was that independent fiscal institutions would determine the target deficit and the maximum allowed sovereign debt for the particular year. Elected politicians would be left with elbow room to determine the structure of fiscal revenues and expenditures, while observing the target deficit for the year. Short-term fiscal policy distortions could thus be eliminated. An additional argument regarding the euro area is that a better coordinated

fiscal stabilization policy would facilitate further economic and monetary integration, and could also increase the efficiency of the euro area's centralized monetary policy.

The initial, simple EU-level fiscal rules included in the Stability and Growth Pact have gradually been completed. Additions include, for example, the two amendments to the Stability and Growth Pact, and the "Treaty on Stability, Coordination and Governance" (TSCG), in force since 2013, which contains new and more detailed provisions on the national limitation of fiscal policy discretion and on increasing EU-level fiscal co-ordination. In 2011, all Member States of the EU was officially requested to set up IFIs.

The European Fiscal Board (EFB), which was established in 2015, is an independent body of the European Commission. It was set up for a fundamentally advisory function, and it assists the Commission in performing its multi-lateral fiscal supervisory functions for the euro area. The EFB's duty is to provide an independent evaluation of the fiscal processes all over Europe, and more specifically in the entire euro area. In this sense, this institution can already be considered to be a preliminary institution of fiscal union. The European Commission makes considerable efforts to promote fiscal union and Acharya and Steffen (2017) and others, believe that the three unions are interrelated, as there can be no single government securities market without a fiscal union.

The IMF papers are consistent with the EU's intentions: Berger et al. (2018) think that without at least some degree of fiscal union, the EU will face existential risks and, for this reason, at least some kind of simplified fiscal union will be needed following the earliest possible completion of the banking union and capital market union. However, there are sceptics as well: according to Herzog (2018), even if the EU Commission thinks that without a supranational fiscal capacity the EMU will fail, it is not really feasible because of the resistance of the member states. Therefore, it would be better to "stick to and enhance the rule-based architecture of Maastricht" (Herzog, 2018).

That said, a fiscal policy function independent of governments is not yet a political reality. For this reason, the fiscal councils that have been established so far have the following competences: forecasting, analysis, evaluation and consultation. A few countries have had independent institutions with fiscal control functions for a long time, actually for several decades. These include the Central Planning Bureau of the Netherlands, the Economic Council of Denmark and the High Council of Finance in Belgium. All of them are intended to supervise the discretionary fiscal policies of the incumbent governments (watchdog function).

It must be highlighted that the US-model (a Budget Office working closely with the legislature) was adopted by some countries. Such cases include Canada and Mexico (which neighbor the US), Australia and South Africa (with a common cultural and legal heritage) and, finally, South Korea. The later adopted its system gradually after the Asian sovereign crisis of 1998.

IFIs have a highly heterogeneous practice. In some countries, IFIs have mandates exceeding the central government and covering all the other government sectors: decentralized agencies, local governments and state-owned companies. Consequently, IFIs have very different sizes: examples range from IFIs composed of a few persons (exclusively economists) to supervisory bodies with staffs of several hundreds. The latter are already fundamentally engaged in ex-post supervision and can be classified among audit offices/courts of auditors. IFIs are, fundamentally, fiscal institutions that perform ex-ante assessment, while ex-post evaluation is essentially conducted by courts of auditors (Kopits, 2016). The OECD summed up IFI good practices in one of their recommendations (OECD, 2014). Simultaneously, the IMF also developed its recommendations (IMF, 2013).

The majority of the authors engaged in this topic (Debrun and Kumar, 2007; IMF, 2013; Kopits, 2016 and Beetsma and Debrun, 2016) describe fiscal council operation and structure as highly heterogeneous. Below it is shown that, in fact, there are relatively homogeneous groups according to the individual considerations.

The fundamental question of our study is whether fiscal councils can be considered as a basically European model or whether what we are witnessing is the evolution of a global standard.

## **2 Methodology and Data**

This analysis is based on the IMF's Fiscal Council Dataset (Debrun et al., 2017). This database contains data for 39 FCs in 37 countries as at the end of 2016. In addition to general information (the official name of the fiscal council, the date of its establishment or profound reform), the database includes the main features of the individual FCs' competences (specific duties and the means of influencing fiscal policy) and key institutional characteristics (independence, accountability requirements and human resources).

Our methodology seeks to find relatively homogenous groups in accordance with certain considerations. Our test hypothesis is that, in a breakdown by EU and non-EU, fiscal councils have different characteristics. As a first step, we will use descriptive statistical methods. In the second step, cluster analysis will be applied, the details of this analysis are based on the descriptive statistics, thus will be provided later.

It is a general problem to manage in countries (Belgium and the Netherlands) where there are 2 operative fiscal councils, and thus the competences and responsibilities are divided between the 2 organizations. As these are usually handled in consolidated way, this analysis includes 37 councils, and it is noted whenever the sample includes 39 councils.

## **3 Descriptive statistics: Results and Discussion**

The structure adopted by Debrun et al. (2017) is followed for the data processing.

### **General information**

The following indicators were analyzed for each fiscal council: region (EU vs. non-EU); the year of foundation; the year of major changes to its mandate; if it is a parliamentary organization or a separate institution; which level of government is covered by its mandate.

There was a major increase in the number of fiscal councils all over the world in response to the crisis. The major part of this increase can be linked to the EU's mandatory regulation. In the case of IFIs outside the EU, it is mainly the larger developed countries with federal structures (Australia, Canada and the USA) that have adopted these institutions and provided them with legal and operational independence. In addition to a federal structure, the establishment of IFIs may in many cases be clearly related to episodes of fiscal crisis. In the case of developing countries, IMF and OECD recommendations may have a significant role in the establishment of IFIs. The non-federal South Korea is a special case, as the National Assembly Budget Office was set up in 1994, and then it was re-organized in 2000, in response to the 1998 crisis, in the form of a Legislative Counselling Office and a Budget Policy Office, and made completely independent in 2003 under the name of the National Assembly Budget Office. In 1998-1999, as a result of a crisis, the federal state of Mexico also established its own institution under the name of the Center for Public Finance Studies. Naturally, the latter two are advisory bodies to parliaments, established to improve the fiscal authenticity of the given countries after the crises, and otherwise follow the organizational pattern of the U.S. Congressional Budget Office (Curristine et al., 2013). The Australian (2012) and South African (2014) Parliamentary Budget Offices were launched with similar motives and follow a similar example.

In Chile, the fiscal council established in 2013 was reformed in 2018 to increase its independence. However, the fiscal discipline policy was started in Chile in 2001 by the Fiscal Responsibility Law, which required that the structural balance must have a 1% surplus. Major changes were made to the mandate in 11 of the 39 councils (7 of them in the EU). The overwhelming majority of the changes (8) were made after, and as a response to, the crisis.

An important question is how this role appears institutionally: as a parliamentary fiscal advisory body independent of the government or as a body separate from parliament. As the IMF database does not include the latter breakdown, we have completed the database. Clearly, the typical institutional form in the EU is to have separate councils, while the practice outside the EU is mixed. Note that in the EU the national audit offices are assigned this role (in Lithuania and in Finland).

**Table 1** Institutional form

	EU	Non-EU
<b>Parliamentary organization</b>	2	8
<b>Organization separate from Parliament</b>	24	5

Source: the authors, Note: In this case a sample of 39 councils were divided

Another important difference between the EU and non-EU groups is in the competences of the fiscal councils. Fiscal councils outside the EU usually (with the exception of 4) have mandates that only cover the central budget. In the EU they have a wider scope everywhere: they supervise the complete field of public finances.

### Key elements of the mandate

Every IFI conducts positive and descriptive analyses. More than half of the IFIs are empowered to carry out normative analyses (i.e. recommend action to achieve the specific fiscal objectives). In non-EU countries, only 31 percent of them have a normative competence, while in EU Member States, this ratio is 67 per cent.

The most important activity IFIs perform is the predictive evaluation of the various aspects of fiscal developments. In an EU/non-EU breakdown, a significant difference is seen between the two groups.

**Table 2** Key mandate elements

	Forecasting	Forecast Assessment	Recommendations	Long-term sustainability <sup>1</sup>	Consistency with objectives <sup>2</sup>	Costing of measures <sup>3</sup>	Monitoring fiscal rules
<b>EU</b>	38%	88%	71%	75%	96%	33%	100%
<b>Non-EU</b>	62%	69%	77%	38%	54%	62%	31%

Source: IMF Fiscal Council Dataset, Notes: 1) "Long-term sustainability" is defined as the long-term forecast of government balance and debt level. 2) "Consistency with objectives (beyond fiscal rules)" is defined as the assessment of government budgetary and fiscal performance in relation to fiscal objectives and strategic priorities. 3) "Costing of measures" is defined as the quantification of either short-term or long-term effects, or both, of measures and reforms.

In the EU, every institution checks compliance with the various fiscal rules from a forward-looking perspective, including the evaluation of forecasts and longer-term sustainability. In non-EU countries, these aspects are considerably less significant, as the emphasis is basically on forecasts and on the assessment of the short- and/or long-term impacts of public finance actions. With the exception of 6 institutions (2 IFIs in the EU, and 4 in developing, non-EU countries), the majority conduct ex-post analyses.

### Responsibilities and means

The following main instruments are used to influence the budget:

**Table 3** Fiscal councils' direct impact on the budget process (in %)

	<b>Forecasts used in the budget</b>	<b>Binding forecasts</b>	<b>Comply or explain</b>	<b>Formal consultation or hearings</b>	<b>Can stall the budget process</b>
<b>EU</b>	13%	8%	33%	63%	4%
<b>Non- EU</b>	8%	0%	0%	23%	0%

Source: IMF Fiscal Council Dataset

Overall, it is clear that fiscal councils' direct impact on the budget process is currently less significant; they are basically considered as advisory bodies. However, in the EU Member States, they have a set of relatively more powerful instruments.

The other basic method they use is pressure through public opinion, and the provision of objective information to the public about budgeting procedures. All but one of the fiscal councils make public reports. Six of the 37 fiscal councils did not have data available on the evaluation of media impact. According to the IMF's evaluation, 26 of 30 councils have a high media impact. In the EU Member States where data was available, 95 per cent of the IFIs had a significant media impact, and this ratio was 64 per cent in non-EU councils.

### **Independence**

Independence can be considered from a legal and from an operational perspective. Legal independence is when the council's independence from political intervention is ensured by law or contract. However, de facto operational independence from politics may be implemented even in the absence of legal independence, due to the council's independent expertise. Note that in our opinion, in an undemocratic country (Iran) the term "independence" does not make any sense.

88 per cent of the EU IFIs can be considered legally and 81 per cent operationally independent. In non-EU countries, the corresponding ratios were 69 and 54 per cent, respectively. If the latter is further subdivided into developed and developing non-EU countries, we get two markedly different groups. Merely 33 per cent of IFIs in developing non-EU countries show operational independence, and if Iran is removed from this group, the ratio is only 22 per cent.

### **Resources**

The IMF database characterizes the human resources related to IFI management by several groups of variables. One such group of variables relates to the composition and content of the IFI: the headcount, the number of years mandated, whether mandates are renewable or not, the members' backgrounds etc. This group has not been included in this analysis, as it is not considered a relevant indicator for our hypothesis. The other group of characteristics – which we consider relevant – concerns the selection and dismissal of IFI leaders.

Less than half (46%) of the IFIs can appoint their leaders independently of the government. In terms of dismissal, IFI leaders are slightly more protected from the government. The third group of variables shows the size of IFIs based on the number of non-executive employees. The majority of IFIs are small in size: those employing more than 15 persons are already considered large (there are 13 of them). For this reason, in the cluster analysis the sample is divided into two: small and medium-sized/large institutions (with an employee headcount exceeding 15).

## **4 Cluster analysis: Results and Discussion**

This research uses the method of hierarchical cluster analysis, i.e. the classification of countries in different groups called clusters. The Euclidean square-distance indicator is selected to determine the distance between countries. Ward's method is used for

classification, as it reduces dispersion in groups and increases their homogeneity. The dissimilarity between two clusters is computed as the increase in the "error sum of squares" (ESS) after fusing two clusters into a single cluster. Ward's method chooses the successive clustering steps to minimize the increase in ESS at each step. For the calculation, we used Orange datamining software.

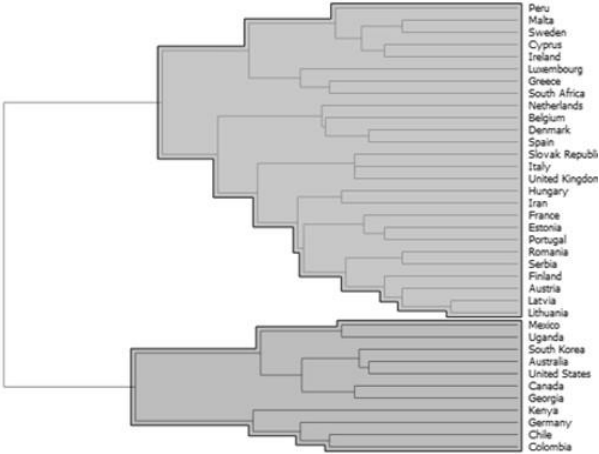
The explanatory variables are those detailed under the title "Descriptive statistics". Two constant variables (the year of establishment and the year of a major change) are omitted from the analysis for technical reasons (as during the cluster analysis they cannot be effectively used together with discrete variables) and, on the other hand, we wanted to form homogeneous groups of IFIs according to their operational characteristics at the end of 2016.

Each of the other variables is transformed into a discrete numerical value (which may be 0 or 1). The absence of data is marked by a separate variable (0 or 1). For example, the following 3 variables are defined for the selection of Governing / High-level Management Members: "Selected only by Government", "Selected not only by Government", and "Selected by n.a.". If any data is missing, the last variable may be 1 and the others may be 0. Based on the above, we have 34 variables for each country.

The results are depicted in a dendrogram. We also applied a multi-dimensional scaling (MDS) technique in our database. The primary result of the MDS analysis is a two-dimensional visualization of countries, expressed as distances between points displaying the similarity of objects.

The below two figures (Figure 1 and Figure 2) clearly show the two main clusters: in practice, an EU vs. non-EU breakdown. The cluster analysis includes South Africa, Iran and Peru in the EU group. Germany is transferred to the non-EU group. If the regional variable is removed a similar result is given, which underpins the robustness of our result. As we can also observe, the countries which adopted the US-model were in the same clusters, with the exception of South Africa.

**Figure 1** 1<sup>st</sup> Dendrogram



Source: the authors' cluster analysis

**Figure 2** MDS Two-dimensional Results

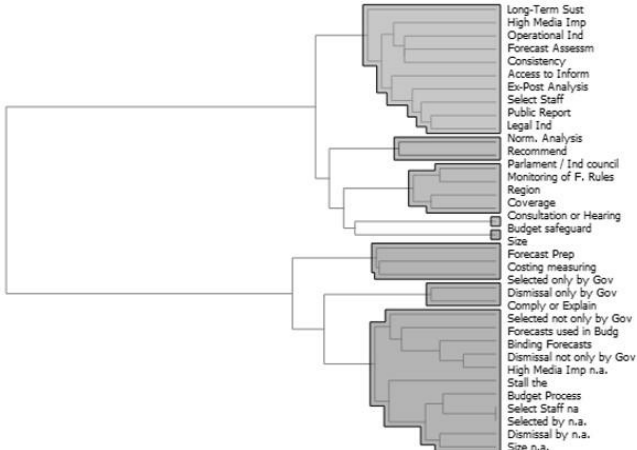


Source: the authors' cluster analysis



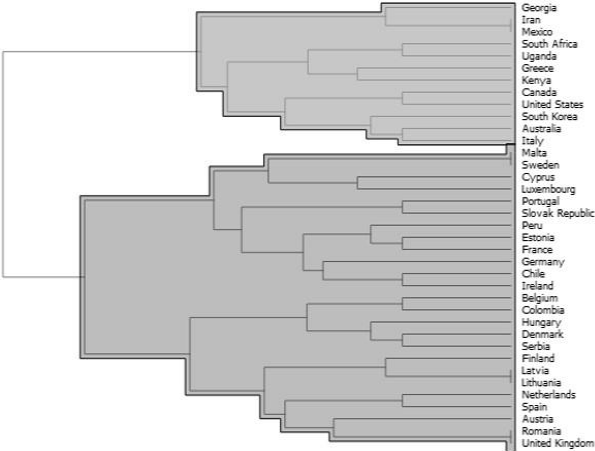
Below (Figure 3) is a cluster analysis of factors in order to use the factor characteristic of a cluster rather than a large number of factors. Factors are classified into the following 8 clusters. One factor was selected of each of the eight clusters (long-term sustainability; normative analysis; parliament or independent body; consultation or hearing; budget safeguard; forecast preparation; dismissal only by government; selected not only by government). Having selected these 8 factors, the cluster analysis was run again (see the results at Figure 4).

**Figure 3 Dendrogram of Factors**



Source: the authors' cluster analysis

**Figure 4 2<sup>nd</sup> Dendrogram**



Source: the authors' cluster analysis

The EU vs. non-EU groups clearly separated in this case as well. Note that in this case the results are already sensitive to which of the 8 indicators are selected from among the above variable clusters, as the number of variables has been reduced considerably. Depending on this, the countries at the border of the two clusters may drift from one cluster to the other.

Overall, our cluster analysis and its sensitivity test has reinforced the experiences detailed in the descriptive part, namely that the characteristics of fiscal councils differ in an EU vs. non-EU breakdown. Another important phenomenon of the second dendrogram is that the US-model-adopting country-group has become clearly visible in the non-EU cluster.

**5 Conclusions**

In order to improve the regulation and methodology of fiscal surveillance, much has been done at the national and international level, but the ex-post control of public finances, the

rule-based budget and fiscal controlling cannot fully prevent fiscal imbalances. Therefore, independent fiscal institutions (IFIs) have been established in many countries.

The literature emphasizes the heterogeneity of fiscal councils. In contrast, our cluster analysis confirms the hypothesis that there is a divergence between the EU and non-EU Fiscal Councils.

The separation between the two groups can be captured by the following features. Regarding the institutional form, EU IFIs are typically a body separate from the parliament, while outside the EU there are considerably more IFIs that may be linked to the parliament. In terms of the key mandate elements, in the EU every institution checks compliance with the various fiscal rules from a forward-looking perspective, while in non-EU countries IFIs have considerably less weight. In the latter, the stress falls primarily on forecasts and on the assessment of the short- and/or long-term impacts of major public finance actions. In an analysis of the influence on fiscal processes, it can be established that currently fiscal councils' direct impact on the budget process is less significant; they are basically considered as advisory bodies. Nevertheless, in the EU Member States, they have a set of relatively more powerful instruments in this area.

Practically everywhere (95%) in the EU, IFIs have an indirect impact, through the media, while not all non-EU IFIs have it (64%). Most IFIs have both legal and operational independence in the EU, while this ratio is also lower among non-EU IFIs. In non-EU developing countries, it is particularly low.

In our opinion, one of the main causes of divergence between IFIs in the EU and in non-EU countries is that, in the EU, the strengthening of IFIs is supported by an increase in fiscal cohesion and the longer-term objective of the fiscal union. This process is accelerated by the common European regulation and other integration policies (common crisis management mechanism, banking and capital market union). In contrast, outside the EU the establishment of IFIs is triggered by federal organization, on the one hand, and the need to respond to the reduction of fiscal authenticity caused by crises, on the other hand.

The IMF and the OECD have also contributed to the latter. An additional factor is the adoption of similar patterns (USA) operative outside the EU. For this reason, in normal circumstances central government politicians in non-EU countries may not be expected to voluntarily give up discretionary fiscal policy or, even if they adopt a rules-based fiscal policy, to "voluntarily" establish genuinely independent supervisory institutions. Based on the above, IFIs can very much be considered a European solution rather than the evolution of a new global standard.

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