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ARE INDEPENDENT FISCAL INSTITUTIONS REALLY INDEPENDENT?

Slawomir Franek

University of Szczecin, Poland. Email: sfranek@wneiz.pl

Abstract

In the last decade the number of independent fiscal institutions (known also as fiscal councils) has tripled. They play an important oversight role over fiscal policy-making in democratic societies, especially as they seek to restore public finance stability in the wake of the recent financial crisis. Although common functions of such institutions include a role in analysis of fiscal policy, forecasting, monitoring compliance with fiscal rules or costing of spending proposals, their roles, resources and structures vary considerably across countries. The aim of the article is to determine the degree of independence of such institutions based on the analysis of the independence index of independent fiscal institutions. The analysis of this index values may be useful to determine the relations between the degree of independence of fiscal councils and fiscal performance of particular countries. The data used to calculate the index values will be derived from European Commission and IMF, which collect sets of information about characteristics of activity of fiscal councils.

Keywords: Public Finance, Fiscal Governance, Public Budgeting

1. Introduction

Fiscal stress experienced in recent years by the economies of many countries may signify the inadequate adaptation of institutional solutions in the public finance sector to the changing political and economic conditions of the contemporary world. It can be observed especially on the example of integrating Europe. Leaving fiscal policy to individual euro area member states caused the results of irresponsibility of some countries to spread over the whole area of the European Union. Hence, solutions which are to reinforce budgetary credibility of particular member states have appeared. A solution used in some countries is the establishment of independent fiscal institutions (IFI), also referred to as fiscal councils (FC), which in their most extreme form could resemble the activities of independent central banks, taking at least a share of the responsibility for fiscal policy making independent from the government influence. The aim of the article is to determine the degree of independence of such institutions based on the analysis of the independence index of independent fiscal institutions. The basis for calculating the index value is the dataset contained in Fiscal Institutions Database compiled by the European Commission and IMF Fiscal Council Dataset and analyzed by Debrun and Kinda (2014).

2. The Role of Independent Fiscal Institutions - Literature Overview

Due to the budgetary problems of recent years in many countries certain actions have been undertaken to strengthen fiscal discipline. A particular role was played by the activities whose aim was to reinforce the institutional aspects of the budgetary process, in particular: applying

fiscal rules, extending the budget forecast timescale and establishing new fiscal institutions. It concerns especially European Union countries which are over-optimistic in the preparation of budgetary macroeconomic forecasts. Jonung and Larch (2006) demonstrate that EU countries systematically overestimate the economic growth forecasts. Beetsma *et al.* (2009) observe that the implementation of the budget balance in countries governed by the rules of the Stability and Growth Pact is on average worse than it results from official forecasts. Debrun and Kinda (2014) show on the sample of 26 advanced and emerging European countries over the period 1998-2010 that countries with fiscal councils have less biased and more accurate budgetary forecasts.

Frankel and Schreger (2013) show that euro area countries are particularly prone to prepare over-optimistic forecasts when the deficit level exceeds the ceiling of 3% GDP. In order to prevent such practices independent fiscal institutions are established. Their existence may help to curtail political influence on the technical aspects of fiscal policy-making or its monitoring.

In principle, fiscal councils have to prepare independent macro-economic forecasts or provide assumptions on key parameters on which budgetary forecasts are based. The aim is to curtail the temptation to prepare revenue projections in a too optimistic way, which would allow politicians to create fiscal space to plan the level of expenditure higher than indicated. Moreover, the task of fiscal councils is to evaluate the long-term impact which tax and expenditure initiatives undertaken by politicians exert on fiscal situation. Thus, these institutions promote transparency of the implemented fiscal policy, prevent creative accounting and counteract the policy of public fund excessive spending, thanks to which they can quiet down financial market reactions and cause parliament decisions to be undertaken competently in accordance with the evidence-based policy.

It has to be underlined that the functioning of the independent fiscal institutions is laid down in the European Union legislation. In the Council Directive 2011/85/UE of 8 November 2011 on requirements for budgetary frameworks of the Member States it was indicated that the monitoring of fiscal rules "should be based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States" (p.43). What was also highlighted is the legitimacy of making use of macroeconomic and budget projections provided by independent bodies. Moreover, in Regulation (EU) No.473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area it was indicated that "unbiased and realistic macroeconomic forecasts can be provided by independent bodies or bodies endowed with functional autonomy vis-à-vis the budgetary authorities of a Member State and which are underpinned by national legal provisions ensuring a high degree of functional autonomy and accountability" (p.12).

Hagemann (2011) accentuates that Fiscal Council is "an independent publicly funded entity staffed by nonelected professionals mandated to provide nonpartisan oversight of fiscal performance and/or advice and guidance from either a positive or normative perspective on key aspects of fiscal policy" (p.76). Fiscal councils are independent public institutions aimed at strengthening commitments to sustainable public finances through various functions, including public assessments of fiscal plans and performance, and the evaluation or provision of macroeconomic and budgetary forecasts.

Debrun *et al.* (2013) point out that a fiscal council is "a permanent agency with a statutory or executive mandate to assess publicly and independently from partisan influence government's fiscal policies, plans and performance against macroeconomic objectives related to the long-term sustainability of public finances, short-medium-term macroeconomic stability, and other official objectives" (p.8). Independent fiscal institutions are defined also as "non partisan public bodies, other than the central bank, government or parliament that prepare macroeconomic forecasts for the budget, monitor fiscal performance and/or advise the government on fiscal policy matters" (European Commission, 2014, p.142). Although these institutions are primarily financed by public funds, functionally they are independent vis-à-vis

fiscal authorities. Courts of Auditors are included in this definition if their activities go beyond the accounting control and cover any of the tasks mentioned above.

Therefore, independent fiscal institutions should analyze the consequences of budgetary decisions and reveal the logic of political decisions.

The current trend to establish independent fiscal institutions has two main sources of inspiration. Firstly, the ideas to create such institutions were originally put forward academia representatives. Among the examples we can numerate the works of von Hagen and Arden, Wren-Lewis, Ball, Blinder, Calmfors, Wyplosz (Jonung and Larch, 2006). In some of these proposals, their authors suggested delegating to these institutions a share of fiscal policy making decisions (the so called hard option). In the hard option it is assumed that the council determines annually the budget balance or the expected level of public debt. It is assumed that it constitutes an objective which has to be met by the government during the budgetary process. The country in which solutions of this kind were implemented is not known. It probably results from the fact that fiscal policy making has definitely more political dimension than conducting monetary policy. In practice, independent fiscal institutions have been ascribed a slightly different role than independent central banks. While central banks are formally responsible for the formulation of conditions for the monetary sphere, independent fiscal institutions were assigned the role of public finance monitoring. Secondly, the concept of independent fiscal institutions derives from the previously existing institutions, whose competences enabled them to act as independent watchdogs of budgetary decisions. Examples of such institutions include High Council of Finance (*Conseil Supérieur des Finances*) in Belgium established as early as in 1936, Bureau for Economic Policy Analysis (*Centraal Planbureau*) in the Netherlands operating since 1947, Economic Council (*De Økonomiske Råd*) in Denmark established in 1962, or Congressional Budget Office founded in the USA in 1975. In practice, the functioning of such institutions consists in playing an advisory or monitoring role without the power to make fiscal decisions.

The tasks realized by independent fiscal institutions can be described as follows. Firstly, the Dutch, Danish and British examples indicate that these institutions can be a source of objective macroeconomic forecasts, which may be used in the budgeting process. Secondly, such institutions may also provide information about approximate costs of various government initiatives, as for example in the USA and Canada. Thirdly, their role may consist evaluating ex ante the implemented fiscal policy with regard to the possibility of reaching mid-term fiscal objectives. These are the tasks imposed on the Hungarian Fiscal Council (*Költségvetési Tanács*). Fourthly, independent fiscal institutions evaluate ex post fiscal objectives, which is illustrated by the Swedish example. Fifthly, their activity may concentrate on a long-term analysis of budget balance, which is exemplified by the activity of Austrian Fiscal Advisory Council (*Fiskalrat*). And finally, some of these institutions engage in developing recommendations for the implemented fiscal policy, as for example in Austria, Denmark and Sweden.

Tasks designated to such institutions are quite highly dependent on the environment in which they function. For example, the Swedish Fiscal Policy Council (*Finanspolitisk rådet*) specializes in the overall assessment of fiscal policy, with less emphasis on formal aspects and more emphasis on drawing on scientific research. At the same time, it does not prepare macroeconomic forecasts or detailed budgetary projections. It results from the natural allocation of responsibilities to other government agencies operating in a similar area. Thus, this is the Swedish National Institute of Economic Research (*Konjunkturinstitutet*) which is responsible for the preparation of independent macroeconomic forecasts and the analysis of the consequences of tax solutions as well as the labour market situation, whereas the National Financial Management Authority (*Ekonomistyrningsverket*) concentrates its activities on the preparation of budgetary projections and the assessment of budget implementation (Calmfors, 2010).

Table 1 presents the variety of tasks carried out by some independent fiscal institutions.

Table 1. Tasks Carried Out by Some Independent Fiscal Institutions

	Monitoring of fiscal stance	Forecast preparation	Forecast assessment	Long-term sustainability assessment	Policy costing
Austrian Fiscal Advisory Council	✓	✓	✓	✓	✓
German Council of Economic Experts		✓		✓	
Danish Economic Council	✓	✓	✓	✓	
Netherlands Bureau for Economic Policy Analysis	✓	✓		✓	✓
High Council of Public Finance (France)	✓		✓		
Swedish Fiscal Policy Council				✓	
Council for Budget Responsibility (Slovakia)	✓			✓	✓
Fiscal Council (Hungary)	✓	✓	✓		
Office for Budget Responsibility (UK)	✓	✓	✓	✓	✓
Congressional Budget Office (US)		✓	✓	✓	✓
National Assembly Budget Office (South Africa)		✓	✓		✓
Center for Public Finance Studies (Mexico)		✓	✓		✓

Source: Fiscal Council Dataset, IMF and Database on fiscal governance, European Commission.

3. Arguments for the Independence of Fiscal Councils

Fiscal councils can exert direct influence on the improvement of public finances by indicating long-term consequences and revealing situations in which political decisions are only to a limited degree made for the benefit of public interest and favor more certain interest groups (Rogoff and Bertelsmann, 2010). Supporting budget transparency in this way, they strengthen the responsibility of fiscal authorities. It may be also achieved by monitoring extra-budgetary expenditure and all forms of creative budget accounting. Being the guardian of fiscal discipline, the council, assessing the implemented fiscal policy, reviews politicians' decisions from the perspective of their natural tendency to exert influence on economy in short horizon and shows public opinion the long-term consequences of the adopted solutions. A particularly significant function of the council is its influence on strengthening fiscal rules operating in a given country. It may be stated that independent fiscal institutions fulfill a complimentary role to fiscal rules at least due to two reasons. Firstly, the analytical activity of the council may constitute a sort of restriction for the government searching for creative solutions, the aim of which is to fulfill obligations defined in a fiscal rule in the case of loosening the budget. Secondly, the pressure of the council may be a factor reinforcing the credibility of the government in a situation when there exist deviations from initial objectives. This pressure may force the government to present the actual reasons for failure to fulfill the undertaken obligations.

Empirical evidence of fiscal council influence on fiscal performance is limited. Hagemann (2011) compared fiscal indicators of the selected countries (Belgium, Chile, Hungary, and United Kingdom) before and after the formation of fiscal councils. Some of the analyses demonstrate that fiscal councils contribute to the improvement of fiscal performance (Lebrun, 2006 and Coene, 2010). Debrun and Kumar (2007) analyzing European Union countries stated that fiscal councils may contribute to better fiscal outcomes, especially when combined with the application of fiscal rules.

Because of the fact that the process of reforms which have been implemented in reaction to the last crisis assumes a range of solutions (e.g. the Stability and Growth Pact was reinforced in the EU), at the present stage it cannot be concluded that the positive effects in fiscal sphere can be credited exclusively to the established fiscal councils. If it was the case, the fiscal situation of the USA, given that the American Congressional Budget Office has been functioning since the 70s of the previous century, would be better than in many other countries in which fiscal councils have not been formed so far (e.g. Czech Republic or Bulgaria). Moreover, it is visible that the situation of Romania with regard to public debt is at present worse than in previous years, when a fiscal council did not exist in this country (it was appointed in the second half of 2010). The Romanian public debt in 2013 constituted 37.9% of GDP, whereas in 2009 it was 23.2% of GDP, and in 2008 it amounted to 13.2%. Also in Sweden, despite the functioning of a fiscal council, public debt has not decreased significantly – in 2007 when the council was established it amounted to 38.2% of GDP, while in 2013 it had almost identical value of 36.8% of GDP. Furthermore, in years prior to the establishment of the council, the debt decreased from 70.3% of GDP in 1996 to approximately 50% of GDP in 2002. It seems, therefore, that the problem is more complex. Debrun and Kinda (2014) confirm this observation stating that the very existence of fiscal council does not ensure fiscal balance. Yet, they observe that certain characteristics of fiscal councils have a significant impact on fiscal discipline. These characteristics are: independence, preparation or assessment of forecasts, monitoring of fiscal rules and media impact. In particular, countries with independent fiscal councils, either with legal guarantees through legislations or with operational guarantees through adequate human resources, have on average better fiscal outcomes. Hence, it is reasonable to indicate these features of fiscal councils which prove their independence.

4. Fiscal Institution Independence Index - Empirical Results

Independence of fiscal councils is discussed in Principles for Independent Fiscal Institutions prepared by OECD, in which independence and non-partisanship of fiscal council are equated with the appointment of the council governing board on the basis of achievements and competences in the sphere of public finance and budgetary process, without referring to political affiliation and with separation of the term of office from the election cycle. It is also indicated that the mandate of IFIs should be clearly defined in higher-level legislation. Moreover, attention is drawn to the financial autonomy of fiscal councils so that the resources allocated to IFIs commensurate with their mandate in order for them to fulfill it in a credible manner. These institutions should also have a guaranteed access to all relevant information in a timely manner, including methodology and assumptions underlying the budget and other fiscal proposals.

In the process of creation of independent fiscal institutions, it is necessary to determine their position in the budgetary process structure from the point of view of at least three criteria: the degree of independence, impact possibilities and composition. In reference to fiscal council independence, it is appropriate to apply the same rules as in the case of central banks, on which there is a consensus into such areas of autonomy as functional, institutional, personal and financial independence. The independence of fiscal institutions should be perceived through the prism of their independence from the government, political leaders in power, opposition parties and ongoing political fights (Kornai, 2010).

The attention should be drawn to several aspects of this issue. Firstly, it means that council members should be appointed for a particular term of office in such a way as to enable the council to function independently from the election calendar. Secondly, it is essential to decide on the method in which the council members are appointed. Canadian, American or

Hungarian examples demonstrate that decisions in this regard fall under the competence of the parliament. In the case of Danish, Swedish and British solutions, council members are appointed by the government. Thirdly, it is necessary to specify the relations council members and the government. It is especially important to work out standards for contact between council representatives and government members. It concerns, for instance, the issue of to what extent the possibility that the council will take a stance on the government budgetary proposals during a closed door meeting before they are made public may influence the independence of the budget evaluation carried out later. Cases have been reported in which regular meetings of the Netherlands' Central Planning Office with ministers are used to exert pressure on the Office to alter these fragments of these analyses which do not meet government's expectations (Calmfors, 2010).

In a longer perspective, the capabilities of a fiscal council to exert influence on political and economic environment are determined by the quality and impartiality of its analyses. It is the basis to build reputation strong enough to create public opinion pressure on government actions, which in such a situation cannot ignore opinions and recommendation presented by the council. In short term, the opinions of the council may be treated by the government as the basis for discussion over fiscal constraints. It means that especially in the situation of public finance crisis council recommendations may be used by the government as a form of support in making decisions which are difficult to accept by public opinion.

The composition of a fiscal council may vary. Examples of such institutions demonstrate that they are composed of four types of members: scholars, specialists in public finance originating from public administration structures, analysts from the financial sector, and former politicians. At the same time, it has to be stressed that members of academia constitute a dominant group.

Thus, the independence of fiscal councils entails legal guarantees of political independence (institutional independence), protection of their budget from government (financial independence), personal independence of their members and influence on the budgeting process (functional independence).

Taking into account the above-indicated aspects of the functioning of fiscal institutions we can construct an index describing the degree of their independence. On the basis of the European Commission database, twelve features significant for the evaluation of their independence degree were selected (in the brackets the method of evaluation of each parameter was specified). These features include:

1. Interactions with the government during the budgetary process (the government has to consult FC during the budgetary process – 1; generally consulted by government during the process; no obligation – 0.5; other – 0).
2. Interaction with the parliament during the budgetary process (the national parliament has to audition FC during the budgetary process – 1; generally auditioned by national parliament during the process; no obligation – 0.5; other – 0).
3. Issuing normative statements (involving judgement) on fiscal policy (yes – 1, no – 0).
4. Reaction of the government to the council's forecasts (there is a legal or constitutional obligation to use the forecasts – 1; there is a political agreement within the executive or between executive and legislative powers that the forecasts are generally used – 0.67; the government is free to use its own forecasts, but deviations from the projections of the fiscal institution have to be justified publicly – 0.33; the government is free to use its own forecasts, without any obligation to provide justification – 0).
5. Absence of politicians or civil servants among governing/high-level management members (the absence of politicians and civil servants – 1; the absence of politicians – 0.5; presence of politicians – 0).
6. The method of appointing the governing/high-level management members (the absence of the government and parliament in the appointment process – 1; the absence of the government – 0.5; government involvement – 0).
7. Members' political neutrality (members cannot hold political posts – 1; there is possibility to hold political posts by members – 0).
8. The length of the term of office (tenure longer than 5 years – 1; other – 0).

9. Institutional status (outside government and parliament structures - 1; attached to national government – 0.5; attached to government – 0).
10. Financing sources (funding by sources other than directly by government – 1; funding directly by government – 0).
11. Legal status: specified in the constitution, 0.5 – specified in an act, 0 – other.
12. Access to inside information (full – 1; privileged 0.5; no privileged – 0).

Table 2 presents the values of the fiscal institution independence index for the examined European Union member states, calculated as an arithmetic mean of points obtained for the particular criteria (numbered from 1 to 12). Constructing the index for these countries in which there exist several institutions considered to be independent fiscal institutions (Austria, Belgium, Germany, Greece, Spain, France, Hungary, Portugal, Sweden, UK), the author selected only one institution for the purpose of the analysis. A particular institution was chosen if it is considered to be a fiscal council also by the International Monetary Fund.

Table 2. Independence Index of Independent Fiscal Institutions

Country	Name of the institutions	Operational independence					Personal independence				Legal&organisational independence				Independence Index
		Number of independence criterion													
		1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.		
AT	Austrian Fiscal Advisory Council	0.5.	0	1	0	0.5	0	1	0	1	1	0.5	0.5	0.50	
BE	High Council of Finance	0.5	0.5	1	0	0.5	0	1	0	0	0	0.5	0	0.33	
DE	German Council of Economic Experts	0	0	1	0.33	1	1	1	0	1	0	0.5	0	0.49	
DK	Danish Economic Council	0.5	0	1	0	1	1	1	0	0	1	0.5	0	0.50	
EE	National Audit Office of Estonia	0	0	1	0	0.5	0.5	1	0	1	0	1	0	0.42	
EL	Centre for Planning and Economic Research	0	0	0	0	1	0	1	0	0	0	0.5	0	0.21	
ES	Independent Authority for Fiscal Responsibility	1	1	1	0.33	0	0	1	1	1	1	1	1	0.78	
FI	National Audit Office	0	1	1	0	0.5	0.5	0	0	0.5	0	0.5	1	0.42	
FR	High Council of Public Finance	1	1	1	0.33	0	0.5	1	0	1	0	0.5	1	0.61	
HR	Commission on Fiscal Policy	0.5	0	1	0	1	0	1	0	1	0	0	0.5	0.42	
HU	Fiscal Council	1	1	0	0	1	1	0	1	0.5	0	0.5	1	0.58	

IE	Irish Fiscal Advisory Council	0	0	1	1	1	0	1	0	1	0	0.5	0.5	0.50
IT	Parliamentary Budget Office	1	1	1	0	0.5	1	1	1	0.5	0	1	1	0.75
LT	National Audit Office of Lithuania	0	0	0	0	1	0.5	1	0	1	0	1	0	0.38
LU	Court of Auditors	0	1	0	0	0	0.5	1	1	0.5	0	1	1	0.50
LV	Fiscal Discipline Council	1	0.5	1	0	1	0	1	1	1	1	1	0.5	0.75
MT	National Audit Office	1	0.5	0	0.67	0.5	0.5	1	0	1	1	1	0	0.60
NL	Netherlands Bureau for Economic Policy Analysis	0.5	0.5	0	0.67	0.5	0	1	1	0	0	1	0.5	0.47
PL	Supreme Audit Office	0	0	1	0	1	0.5	1	0	1	0	1	1	0.54
PT	Public Finance Council	0	0	1	0	1	0	1	1	1	0	0.5	1	0.54
RO	Fiscal Council	0	0	0	0	1	0.5	1	1	1	0	0.5	1	0.50
SE	Swedish Fiscal Policy Council	0	0.5	1	0	1	0	1	0	0	0	0.5	0.5	0.38
SI	Institute of Macroeconomic Analysis and Development	1	0.5	0	1	0.5	0	1	0	0	1	0.5	0.5	0.50
SK	Council for Budget Responsibility (Slovakia)	1	0	0	0	1	1	1	1	0	1	1	0.5	0.63
UK	Office for Budget Responsibility	0	0	0	0.67	1	0	1	0	0	0	0.5	1	0.35

Source: Database on fiscal governance, European Commission.

As follows from the data presented in the Table 2, the countries introduced these solutions to their budgetary systems which relatively recently have the highest values of the independence index for independent fiscal institutions. Spain and Latvia appointed their councils in 2013 and Italy and Slovakia in 2012. Additionally, it has to be observed that out of 45 independent fiscal institutions listed by the European Commission, only 28 functioned before 2008. It may be also noticed that out of the three distinguished independence factors, the highest value has the factor of personal independence. In the eight examined countries (Germany, Denmark, Hungary, Italy, Latvia, Portugal, Romania, Slovakia) at least three out of four criteria of this area of independence are fulfilled, although the Hungarian fiscal council is the only one whose members belong to political parties. Out of the three differentiated independence areas, the criterion of operational independence has the lowest average values for the examined countries, which means that fiscal councils have limited possibilities to formally influence changes in government policy and which also proves their consulting and monitoring role. In particular, it regards the criterion number 4, for which the average value amounts only to 0.2 (Figure 1). It means that forecasts prepared by fiscal councils have little influence on budgetary parameters used by governments. Only in the case of the forecasts by the Slovenian Institute of Macroeconomic Analysis and Development and Irish Fiscal Advisory Council the governments are legally obliged to use these forecasts in the budgetary process.

Thus, independent fiscal institutions do not play a leading role in the budgetary process, but act as supporting institutions. They have little influence on fiscal policy, and in principle it

comes down to functioning as a reviewer of government by exerting pressure on the implementation of transparent fiscal policy.

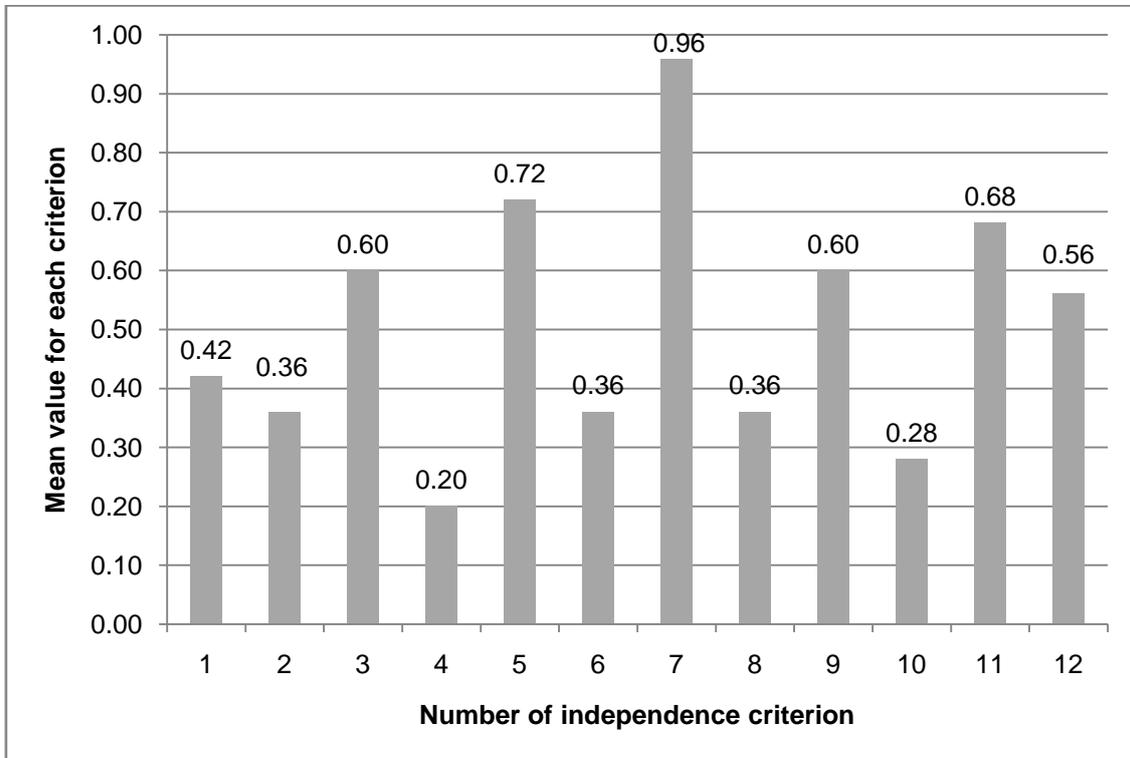


Figure 1. Average Value of the Independence Degree in the Examined Countries for Each Independence Criterion

The analysis of the particular independence criteria for these institutions indicated that they have lots of space to increase the degree of their independence with regard to government. The average value of independence index for the institutions examined amounts to 0.51, while for operational independence it is only 0.4. It means that even if the activities of such institutions are strongly depoliticized, the effects of their activities in the scope of fiscal policy making and the influence on decisions made by fiscal authorities are simultaneously strongly limited. Therefore, it seems to be more appropriate to refer to these institutions as fiscal councils (or even fiscal watchdogs) rather than independent fiscal institutions, because the effects of their independent functioning are rather illusory.

5. Conclusion

Experiences of European countries indicate that independent fiscal institutions are an element of a broader view at public sector transformations, with a significant role of fiscal rules and other solutions promoting activities to reinforce fiscal credibility of economies in the long-term perspective. However, their role differs significantly from this of independent central banks. They rather constitute an analytical and advisory support for fiscal power, promoting budget transparency and exerting pressure on governments with regard to fiscal discipline. Thus, it seems more appropriate to refer to such institutions as fiscal councils (or even fiscal watchdogs) rather than independent fiscal institutions, because the effects of their independent functioning are rather illusory.

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