European Journal of Political Economy 32 (2013) 285–299

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Fiscal forecast errors: Governments versus independent agencies?

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ARTICLE INFO

Article history:
Received 18 May 2012
Received in revised form 13 August 2013
Accepted 3 September 2013
Available online 17 September 2013

JEL classification:
H6
E62
C53

Keywords:
Forecast errors
Fiscal policies
Fiscal forecasting
Political economy

ABSTRACT

We present evidence pointing to the fact that international agencies' fiscal forecasts were affected to some extent by the same type of problems that the literature widely acknowledges for governmental ones. Informational shortages may lead independent agencies' staff to internalize "political biases" in governmental forecasts when trying to grasp genuine "private information". Our study is based on a real-time database of EC, OECD and national governments' public deficit forecasts for 15 European countries over the period 1999–2007 and four vintages of projections per forecasted year. Against this background, independent national fiscal institutions might be a natural option, to the extent that they may have better access to inside national information than international organizations. Our results also provide some support to policy positions that claim a closer monitoring of official budgetary projections, in particular as regards transparency requisites, accountability and the threat of sanctions.

1. Introduction

Should the role of preparing budgetary projections be delegated to an independent agency? A debate around this issue has been recently spurred in Europe by many voices, given the high public deficit and debt levels currently held by many European Union (EU) governments. In fact, planned government deficits turned out to exceed recurrently budgetary plans by a significant magnitude in recent years. For example, as late as October 2008 the public deficits estimated for 2008 by many European governments missed by some 2 percentage points of GDP the afterwards released figures for 2008. A similar situation occurred in 2009–2012, leading many countries to register record high government deficits. Explanatory factors for these misalignments include large GDP shocks or fiscal stimulus packages adopted on the run, but beyond this, also lack of both transparency and a realistic account of facts.[1] As short-run budgetary targets were missed by far, medium run plans were revised quickly and resulted in a fast decline of the credibility of Europe's fiscal framework, namely the Stability and Growth Pact (SGP). As a consequence, right now, many European countries are embarked in widespread medium-term fiscal consolidation packages, that require adherence to strict budgetary targets for long periods of time. In parallel, there is an ongoing policy debate on the need to strengthen economic governance in the EU that has already resulted in a number of institutional reforms.[2]

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[1] For an evaluation of the effects of the financial crisis on the fiscal positions of OECD countries, see Tagkalakis (2013).

[2] On the importance of the design of fiscal rules and forms of governance in EU countries see Hallerberg et al. (2007). For the discussion on EU's fiscal framework weaknesses and needs for reform see, for example, Larch et al. (2010) or Muscatelli et al. (2012). For the most recent approved and ongoing reforms and/or agreements, see EC's webpage dedicated to EU economic governance ("http://ec.europa.eu/economy_finance/economic_governance/index_en.htm").

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http://dx.doi.org/10.1016/j.ejpoleco.2013.09.002

The deterioration of governments' budget balances and the lack of accuracy of fiscal projections are neither issues confined to the current juncture nor only to EU countries. Indeed, a large strand of the literature has analyzed in the recent past the potential bias the political and institutional process might have on government revenue and spending forecasts, as well as the nature and properties of forecast errors within national states.[3] For the case of EU governments, this literature tends to find evidence in favor of the existence of systematic political and institutional biases in revenue forecasting, while the evidence for the US is mixed, depending on the institutional coverage of the analysis (Federal government or States).[4]

One particular aspect under evaluation in the policy fora linked to the previous discussion is the proposal to introduce independent forecasts in the fiscal domain prepared by independent agencies (Debrun et al., 2009; Leeper, 2009; Wyplosz, 2008; Jonung and Larch, 2006; European Commission, 2006). These independent agencies could be for example national councils or intergovernmental agencies. As regards the latter option, in the case of EU countries, some authors have advocated that the European Commission (EC) should have some role as the "independent agency" preparing budgetary and/or macroeconomic projections, given that fiscal forecasts by national authorities are scrutinized by the EC according to EU's fiscal rules framework (the SGP).[5]

Against this framework, in order to be in a position to judge the appropriateness of such proposals, the relevant question is whether the track record of international agencies' forecasts is better than the one of national governments. In this particular respect the literature is almost silent. There are almost no studies that compare the accuracy and the determinants of governments' fiscal forecasts with those of international organizations for a given country. The fact that some international organizations like the EC, the OECD or the IMF publish fiscal forecasts and have been doing so for long periods of time provides a natural laboratory to analyze their track record against that of national governments. From a theoretical point of view, once accounting for errors in macroeconomic forecasts, independent agencies' fiscal forecasts should not be expected to display the biases typically found in governments' fiscal projections. Nevertheless, one may also claim that information matters when preparing budgetary projections, and as a consequence outside forecasts (from international organizations) could turn out to be less accurate than inside forecasts (from staff of the relevant organizations, like for example the Ministry of Finance or the Treasury), as found by Grizzle and Klay (1994) for the US states.

In our paper we provide homogeneous and comprehensive empirical evidence pointing to the fact that international agencies' budgetary forecasts for EU countries do display correlation with electoral cycles. These results are derived using a common methodology – based on the same econometric method and the same empirical specification – to look at alternative datasets, over the same sample period. We build up a large real-time dataset covering fiscal forecasts: (i) that are prepared by national governments (GOV), the EC and the OECD; (ii) for 15 European countries; (iii) for two forecast origins per year (Spring and Autumn of each year); and (iv) for two forecast horizons from each forecast origin (Spring current year, Autumn current year, Spring one year-ahead and Autumn one year-ahead). By focusing on the sample 1999–2007, we analyze a period with a common monetary policy regime (Eurosystem) and a common fiscal policy regime (SGP). In addition, we eliminate three potential sources of distortion: (i) the changes in statistical standards that did occur in the preceding period (ESA79-ESA95 changeover); (ii) the EMU convergence process; and (iii) the great recession that started in 2008.

We try to illustrate the empirical analysis in the framework of a model in which the international agency tries to minimize the distance to the forecast of the government. We exploit the idea that government's information set includes private information (e.g. better access to the relevant data, information on policy measures, etc.) not available to international agencies. When preparing fiscal projections, international agencies' staff try to grasp as much private information as possible from government's forecasts, while at the same time face a "signal extraction problem" when trying to disentangle "political biases" from genuine "private information".

The rest of the paper is organized as follows. In Section 2 we present some political economy arguments to frame the subsequent empirical analysis, pose the hypotheses to be tested, and discuss the related literature. In Section 3, we describe the data and variables used in the study. In Section 4 we discuss the empirical methodology and the main results. In Section 5 we present some conclusions and policy lessons. Finally, we include an Appendix in which we develop, in the framework of the approach of the main body of the paper, a theoretical illustration on the potential role of sanctions in forcing better fiscal forecasts.

2. Some political economy considerations

2.1. Political economy arguments and literature review

Why could fiscal forecasts prepared by governmental agencies differ from those of international organizations?

First, fiscal forecasts can display differences because governments usually have access to more information than outside forecasters. For example, governments have advanced information on short-term tax developments, the design and impact of planned tax measures or information on the implementation of spending plans.

[3] See for example Brück and Stephan (2006), Jonung and Larch (2006), Boylan (2008), Leal et al. (2008), Beetsma et al. (2009), von Hagen (2010), Pina and Venes (2011), Frankel (2011), Jong-a-Pin et al. (2012), or Frankel and Schreger (2013a, 2013b).

[4] As Auerbach (1999) argues, if the costs of forecast errors were symmetric (i.e. if positive errors were as bad as negative errors), the forecasts should present no systematic bias (i.e. on average the forecast error should not differ significantly from zero). There are, however, reasons to presume that the loss function of governments may not be symmetric. Thus a kind of bias in fiscal forecasts could be optimal. For instance, a government would tend to favor a deficit when the loss of an underestimation is greater (for example, a conservative, stability oriented government, see Bretschneider et al., 1989). Public authorities may have an interest in presenting a pessimistic forecast to build in a safety margin that would allow them to meet budgetary targets, also in case of revenue or expenditure slippages. The literature in question finds mixed evidence for political economy-based explanations of this sort. See Leal et al. (2008) for a broad survey of the issues discussed here.

[5] See for example Buti and van den Noord (2004).