



Does fiscal responsibility matter? Evidence from public and private forecasters in Italy



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ABSTRACT

Nowadays, fiscal forecasts are a centerpiece of macroeconomic policy decisions, particularly in highly indebted European Union countries such as Italy. The Stability and Convergence Programs and the new Fiscal Compact seem to have improved fiscal responsibility, but have they facilitated a greater accuracy of fiscal forecasters? We have compiled a new data set of fiscal forecasts for Italy, covering the last two decades 1992–2014, and checked whether the improvement in fiscal responsibility has reduced forecast errors. Neither the improvement in fiscal responsibility nor the political reforms reduced the optimistic bias in the fiscal projections of public and private forecasters.

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1. Introduction

Since the signing of the Treaty on Stability, Coordination and Governance (TSCG) in 2012, with the aim of strengthening fiscal discipline and introducing stricter surveillance within the euro area, forecasts of the fiscal budget for European countries have been being used as the basis for fiscal planning during the European semester. Thus, it is crucial to understand the different sources of fiscal forecast errors and to try to improve the forecast accuracy in order to achieve better planning. Moreover, as over-optimistic forecasts make it more difficult to fulfil the budget deficit objectives, improving the forecast accuracy is a key policy issue in highly indebted countries like those of southern Europe.

In recent times, various econometric studies have analysed the determinants of fiscal forecast errors, especially fiscal rules and fiscal responsibility; political and economic variables; and the nature of the forecaster.

Fiscal rules are constraints on fiscal policy by means of numerical limits on budgetary aggregates that aim to contain pressures to overspend, and to ensure fiscal responsibility and debt sustainability. The Stability and Growth Pact (SGP) established in 1997 in the European Union was based on these types of numerical fiscal rules. However, fiscal responsibility refers to a broader set of measures that have the objective of achieving long-run fiscal sustainability. These include the setting up of independent fiscal institutions (such as the Fiscal Council), transparency standards, and surveillance and enforcement mechanisms, among others.

An improvement in fiscal responsibility may affect forecast errors through various different mechanisms. Frankel (2011) and Frankel and Schreger (2013, 2016) found evidence that numerical fiscal rules, such as those included in the Stability and Growth Pact, tend to increase the biasedness of the official forecasts of growth and budget deficits, as they provide an additional incentive for governments' tendency to satisfy fiscal targets by wishful thinking. On the other hand, other types of rules at the national level, such as the creation of an independent fiscal institution that provides independent forecasts, may reduce the bias in forecasts.

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Political variables influence the fiscal errors in several ways, with the effect of the electoral cycle on fiscal performance being significant during upturns when the electoral cycle is considered jointly with the output gap (Merola & Pérez, 2013). Various authors conclude that deviations from the budget balance forecasts are explained in part by electoral cycles (Bruch & Stephan, 2006; Giuliadori & Beetsma, 2008; von Hagen, 2010) but also by the degree of fragmentation and other political variables (Frankel & Schreger, 2013; Pina & Venes, 2011).

The economic cycle also influences forecasts directly and indirectly. It is more difficult to obtain good fiscal forecasts in periods that are close to turning points, due to both the uncertain response of automatic stabilisers and the lower precision of GDP forecasts. In particular, if GDP forecasts tend to be optimistic (or pessimistic), fiscal forecasts, especially revenues, will move in the same direction (Buettner & Kauder, 2015). The literature has concluded that higher GDP forecast errors imply higher fiscal forecast errors (Merola & Pérez, 2013). Other researchers have noted that the government tends to provide output growth forecasts that are more rosy than realistic when growth is not rich, in an attempt to push up the budget balance forecasts (Bruch & Stephan, 2006; Pina & Venes, 2011; Beetsma, Bluhm, Giuliadori, & Wierds, 2013).

The nature of the forecaster might also influence the quality and accuracy of the forecasts.¹ In particular, there is a vast body of literature on the importance of private agencies when producing fiscal forecasts. Many studies have demonstrated that independent budget forecasting could be a useful contrast to the overly optimistic forecasts provided by national and international agencies (see (Debrun, Hauner, & Kumar, 2009; Jonung & Larch, 2006; Merola & Pérez, 2013), among others). The main finding is that official forecasts are usually more over-optimistic than private forecasts (Abreu, 2011; Frankel & Schreger, 2016). Jalles, Karibzhanov, and Loungani (2015) also provide evidence of the quality of private sector forecasts of the budget balance, considering a sample of 29 advanced and emerging countries between 1993 and 2009. They conclude that it could be useful to include private sector forecasts in the policy process, given their lower 'optimism bias' relative to government forecasts, but they also show that private sector forecasts have several limitations too, and could be improved.

Our contribution to the literature follows all of these lines. In particular, we investigate whether fiscal forecast errors are rational and accurate for public (national and international) and private forecasters, and whether fiscal responsibility pushed the different agencies to modify their fiscal forecasts after the introduction of the SGPs and the

new fiscal compact in Italy. With this aim, a new data set of fiscal forecasts for Italy has been compiled, and standard forecasting competition methods are applied.

The Italian case is particularly relevant because of its increasingly high debt levels. Italian debt has been over 100% of GDP for most of the past two decades. It was over 106% of GDP during the years 1994–1996, then decreased over the period 1998–2000, before increasing again to 127% of GDP in 2008, against the EU average of 68%. It is projected to peak at 132.7% in 2015, before gradually declining to 123.8% in 2019.² Although the public deficit was reduced to 2.6% of GDP in 2015, the increase in public debt is driven by the large gap between the high implicit rates paid on debt (4.2% on average) and the nearly zero average annual nominal GDP growth (–1.3% real GDP growth and +1.4% deflator), i.e. the snowball effect.³

Italy experienced a double-dip Great Recession, due to the sovereign-debt crisis of mid-2011, when Italy's economy was hit severely by the increased risk aversion in financial markets. In fact, Italy's public finances were actually in relatively good shape at the onset of the 2008 crisis.⁴ However, the government had little room for implementing countercyclical policies because of the high levels of public debt. Moreover, not only did the GDP fall more in Italy than in most other European countries but also its recovery was much lighter. Until 2011, the Italian government's reaction consisted only of introducing light budget laws, mostly with the aim of maintaining the stabilization of public finances and reducing the contagion effect of the financial crisis. The 2008 "anticrisis decrees" increased tax audits and VAT on television services, and introduced a tax amnesty that aimed to return capital stocks from abroad. It was only in 2011 that serious fiscal consolidation started, and these measures were then reinforced and expanded by the technocratic government of Mario Monti, which was appointed in late 2011. Most of the policy changes involved tax increases (the reintroduction of real estate taxation on the main residence, increases in the VAT standard rate from 20% to 22%) and budget cuts (cuts in social benefits and public sector pay, reform of the pension system). These measures amounted to 3.1% of GDP in 2012 and 4.7% in 2013 (see Figari & Fiorio, 2015, for an in-depth analysis of fiscal consolidation policies in Italy).

On the institutional side, the 2012 constitutional reform amended articles 81, 97, 117 and 119 of the Constitution to insert the principle of the "balanced budget". The reform also established that the harmonisation of public accounts would be an exclusive competence of the State, whereas previously it had been shared between the state and the regions. The new constitutional law left the establishment of the maximum deviation from the parameter of equilibrium in the budgets for a reinforced law. This reinforced law, passed in December 2012, set up a fiscal independent authority that is linked to the Parliament, called the

¹ In addition, a recent strand of the literature on fiscal forecasting shows that the forecast quality is affected crucially by the information set used. In particular, it has been proven that analysts' use of quarterly and monthly fiscal data, together with higher frequency macroeconomic indicators, provides significant additional information for the prediction of annual budgetary outcomes. It has been shown that the use of this information helps to improve the fiscal forecasts made by the international organizations that play a key role in monitoring compliance with fiscal rules in the European case. Along these lines, see Ghysels and Ozkan (2015), Pedregal and Pérez (2010) and Pérez (2007).

² European Commission, Council recommendation on the 2016 national reform programme of Italy, Brussels, 18-5-2016.

³ European Commission, Country report: Italy 2016.

⁴ The public deficit dropped to 1.3% of GDP in 2007, after three years above the 3% threshold imposed by the Stability and Growth Pact, while the EC recommended that Italy be removed from the Excessive Deficit Procedure starting in 2005.

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