



ESRI Research Bulletin

Fiscal Forecast Errors: Governments Versus Independent Agencies?

Rossana Merola (ESRI) and Javier J. Pérez (Bank of Spain)

The *Research Bulletin* provides short summaries of work published by ESRI staff and overviews of thematic areas covered by ESRI programmes of research. Bulletin articles are designed to be easily accessible to a wide readership. A reference or references to the full publication is included at the end of each Bulletin article.

An archive of bulletin articles will be found at www.esri.ie/bulletin

Fiscal Forecast Errors: Governments Versus Independent Agencies?¹

* **Rossana Merola (ESRI) and Javier J. Pérez (Bank of Spain)**

Should the role of preparing budgetary projections be delegated to an independent agency? A debate around this issue has arisen in Europe, given the deterioration of governments' budget balances in many European countries and the lack of accuracy in fiscal projections. Of particular concern is that planned government deficits turned out to consistently exceed budgetary plans by a significant magnitude in recent years. Explanatory factors for these misalignments include unexpected or unplanned large GDP shocks or fiscal stimulus packages. However beyond this, a lack of both transparency and a realistic account of facts may be at fault.

One particular aspect under evaluation in the policy fora is the proposal to introduce forecasts prepared by independent agencies into the fiscal domain. Such independent agencies could be, for example, national councils or intergovernmental agencies. The fact that some international organisations such as the European Commission, the OECD and the IMF publish fiscal forecasts provides a natural benchmark for analysing their track record against that of national governments.

From a theoretical point of view, it is not clear that fiscal forecasts prepared by international agencies should necessarily perform better than those prepared by governments. On the one hand, one may expect that international organisations prepare truly independent forecasts that are not subject to political biases. On the other hand, governments usually have access to private information (e.g. information on planned policy measures, etc.) which is only available to international agencies after a reasonable lag. When preparing fiscal projections, international organisations' forecasters try to grasp as much private information as possible from the government's forecasts. However, they face a signal extraction problem when trying to disentangle political biases from genuine private information.

¹ Merola, R. and J.J. Pérez (2013), "Fiscal Forecast Errors: Governments Versus Independent Agencies?", *European Journal of Political Economy*, Vol. 32, December 2013, pp.285–299. <http://dx.doi.org/10.1016/j.ejpoleco.2013.09.002>

* rossana.merola@esri.ie; javierperez@bde.es

This paper tests whether fiscal projections prepared by international agencies are more reliable and free of political economy distortions.

We build up a large real-time dataset covering both fiscal forecasts compiled by national governments in the framework of the Stability and Convergence Programmes and the Excessive Deficit Procedure (EDP), as well as fiscal forecasts prepared by the European Commission and the OECD and reported respectively in the issues of the European Economy and the OECD Economic Outlook. The dataset covers fiscal forecasts over the sample 1999-2007 for the 15 European countries prior to the 2004 EU enlargement. We consider two forecast origins per year (spring and autumn of each year) and two forecast horizons (current year and one year ahead).

Our main result suggests that, in the past, both governmental and international agencies' fiscal forecasts contain a political bias and are affected by the electoral cycle. Informational shortages may lead international agencies' staff to internalise political biases when trying to grasp genuine private information. However, we find that the OECD and the European Commission are more independent than governments, especially during economic upturns when elections strongly influence governments' budget balance forecast errors.

Moreover, we find that government projections are less reactive to the economic cycle and hence more judgemental than European Commission and OECD fiscal forecasts, especially during economic downturns. This is consistent with the common approach to conduct discretionary policies more actively in times of distress, typically by implementing expansionary measures at the beginning of a downturn and implementing fiscal adjustment measures when public debt builds up beyond certain sustainable limits.

The analysis and results of this paper have important implications for the current policy debate. Institutional changes should aim at improving the accountability and the transparency of fiscal data reported by governments in order to minimise ex-ante the political bias. A first solution could be increasing the ex-ante pressure on misbehaving governments. For instance, the threat of sanctions (i.e. a penalty on poor government's track record of fiscal forecasts) might be influential for the purpose of minimising the private information bias in governments' forecasts. Another potential solution is the creation of independent national forecast agencies.