



The political economy of EDP fiscal forecasts: An empirical assessment

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ABSTRACT

We analyse the budget balance forecasts prepared by 15 European countries in their Excessive Deficit Procedure reportings, studying the statistical properties of forecast errors and their politico-institutional determinants. Forecast errors are responsive to growth surprises, fiscal institutions and opportunistic motivations: upcoming elections induce over-optimism, most apparent when the opposition wins, whereas commitment or mixed forms of fiscal governance and numerical expenditure rules (unlike deficit and debt rules) are associated to greater prudence. The main findings hold when using forecasts from national draft budgets. Taking subsamples reveals that opportunistic and institutional effects are only significant under the Stability and Growth Pact.

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1. Introduction

This paper studies the track record of the general government budget balance forecasts by 15 European Union (EU) countries drawing on a previously unexploited data source: the notifications reported twice a year in the context of the Excessive Deficit Procedure (EDP). We document the statistical properties of forecast errors and analyse their economic, political and institutional determinants through panel data modelling. As a robustness exercise, we also examine the forecasts contained in the national draft budgets.

The use of forecasts is a pervasive feature of fiscal policy. When drafting their budgets, governments need a macroeconomic scenario upon which to base revenue projections. On the expenditure side, it is also the case that budgetary appropriations often have the nature of a forecast—which is particularly clear as regards social transfers and entitlement spending in general, but also holds for other items. In the EU, the institutional framework for fiscal policy has been a powerful catalyst for the dissemination and scrutiny of macroeconomic and budgetary projections: countries report current year forecasts in EDP notifications, and medium-term plans in their Stability and Convergence Programmes (SCPs).

Besides their influence on private agents' expectations and behaviour, fiscal forecasts play a prominent role in the assessment of compliance with both the preventive and corrective arms of the Stability and Growth Pact (SGP). Therefore, it is of interest to analyse forecasting accuracy, and to address the factors which may help explain forecast errors. A number of studies – such as Strauch et al. (2004); Brück and Stephan (2006); Annett (2006) or Jonung and Larch (2006) – document the existence of forecast

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biases in fiscal policy formulation, which vary across countries and time and are influenced by political considerations (e.g. forthcoming elections) or budgetary institutions (e.g. forms of fiscal governance).

Forecasts of fiscal variables are prepared by national governments, international organisations and – in some countries – independent institutions, giving rise to several different datasets. [Artis and Marcellino \(2001\)](#) analyse forecasts by the IMF, the OECD and the European Commission; [Brück and Stephan \(2006\)](#) focus on the latter organisation; [Strauch et al. \(2004\)](#); [Moulin and Wierts \(2006\)](#); [Annett \(2006\)](#); [Hallerberg et al. \(2009\)](#) and [Beetsma et al. \(2009\)](#) resort to national SCPs. In this study, we draw on different sources of forecasts—EDP notifications, and also national draft budgets.

Relative to national budgets or SCPs, EDP data offer the important advantage of a larger sample; in particular, it becomes possible to analyse whether forecasting behaviour changed with the coming into force of the SGP. A number of recent papers have used this dataset: [Gordo and Martins \(2007\)](#) study the magnitude of data revisions, i.e. statistical reliability; [Koen and van den Noord \(2006\)](#) and [Buti et al. \(2007\)](#) address issues of accounting transparency. Whilst these studies work only with fiscal outturns, we are, to the best of our knowledge, the first to analyse forecasts from the EDP notifications. It also turns out that the strategic nature of EDP forecasts has a strong resemblance to that of figures in national budgets.

Apart from drawing on new datasets, this paper contains another innovative contribution. We consider a larger set of possible determinants of fiscal forecast errors, putting together a number of economic and politico-institutional factors that previous analyses had considered separately, as well as testing the significance of some previously unused variables.

We find that, besides reflecting GDP growth surprises, budget balance forecast errors are also responsive to the institutional framework of fiscal policy and to opportunistic political motivations. The commitment and mixed forms of fiscal governance ([Hallerberg, 2004](#)) are associated to more prudent forecasts, and so is the reliance on stronger expenditure rules. By contrast, upcoming elections tend to induce budget balance forecasts that turn out over-optimistic, especially when the subsequent outcomes are reported under a government dominated by the former opposition. Interestingly, these institutional and political effects were virtually absent before the coming into force of the SGP.

The remainder of this paper is structured as follows. The next section describes the datasets of fiscal forecasts and discusses the strategic nature of those projections. [Section 3](#) assesses the statistical properties of forecast errors, through summary statistics and formal tests of unbiasedness and autocorrelation. [Section 4](#) presents an extended set of potential determinants of forecast errors, and reports panel data evidence of their actual impact on fiscal projections. The final section concludes.

2. Data

2.1. Sources and samples

According to Council Regulation (EC) No. 3605/93 and in the context of the EDP, EU countries must report twice a year to the European Commission a set of public finance data including both forecasts and outcomes. These data transmissions, often referred to as EDP reportings or notifications, started in March 1994 and have since taken place at regular dates, by 1 March and 1 September until 2005, and by 1 April and 1 October from 2006 onwards.

EDP notifications include forecasts of the general government nominal budget balance, gross debt, interest expenditure and gross fixed capital formation (GFCF), as well as of GDP at current market prices, for the current year (i.e., year t) and estimates or finalised values of the same variables for years $t-1$, $t-2$, $t-3$ and $t-4$. Budget balance figures are also to be provided for the general government sub-sectors (central, state and local governments, and social security funds). Finally, countries also report detailed information on differences between public accounts and national accounts data and on stock-flow adjustments.

To our knowledge, this dataset has never been used before to study fiscal forecasting. Nevertheless, it presents an important advantage over SCPs, hitherto the most widely used source of fiscal projections by national governments: EDP notifications provide a wider coverage, in particular as regards the 1990s, since SCPs only started to be submitted on a regular basis in late 1998. Further, EDP notifications have a higher standardisation of reporting dates, thus potentially improving comparability both over time and across countries.

One should nonetheless acknowledge that our dataset, as indeed any set of fiscal forecasts prepared by national governments, cannot achieve perfect comparability and homogeneity, for both political reasons (discussed in [Section 2.2](#)) and technical reasons. The latter include some important methodological changes which have taken place since 1994: most prominently, whilst all the notifications until 1999 were prepared in accordance with ESA 79 accounting rules, from March 2000 onwards countries started to report their data according to ESA 95. Further, the fact that in the United Kingdom the fiscal year does not coincide with the calendar year implies a slightly different timing of data transmissions relative to the annual budget cycle.¹ By means of sensitivity analysis we will go some way to ensure that our empirical findings are not distorted by these data peculiarities. In this paper we use data for the ratio of the general government budget balance to GDP, from 1994 to 2007. Our sample includes the 15 countries belonging to the EU before the 2004 enlargement. Since issues of creative accounting are beyond the scope of our study, we do not explore the reported information on debt or on stock-flow adjustments (see [Buti et al., 2007](#)). Nor do we make use of data on sub-sectors' balances, since the possibility of intra-annual transfers between them would make it difficult to conduct a meaningful

¹ The UK fiscal year goes from 1 April to 31 March. Forecasts in EDP notifications refer to fiscal or financial years—e.g. by 1 April 2007 the UK reported projected figures for the 2007/2008 financial year. Therefore the April reporting deadline coincides with the beginning (or end) of fiscal years, whereas for other countries there is a 3-month gap. Still as regards reporting dates, we have retained corrections to the original data submitted on a few occasions by national governments shortly after the notification deadlines.

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