



The political economy of EDP fiscal forecasts: an empirical assessment

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Background: EU fiscal framework requires Member States to outline budgetary plans i.e. path to be followed towards medium-term budgetary framework.

Underlying presumption: Forecast errors not 'white noise'. Projections driven by economic, political and institutional factors.

Data: EDP reporting of EU fiscal surveillance framework. Variables: budget balance, investment expenditure and interest expenditure

Key questions addressed: How accurate are 'forecasts' in year t for year t ? What are the determinants of gap between reporting and outcomes?

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Are EDP notifications in year t for year t really forecasts?

Inertia: March/April notification for year t generally confirms targets/plans of annual budget presented at the end of $t-1$. Information set at beginning of year t not very different from the one at the moment of approval of budget.

EU surveillance: attention chiefly on notification for year $t-1$ and consistency with ESA95 rules. EDP notifications rarely serve as reference for Commission services' spring forecasts.

Strategic behaviour: No government forecasts excessive deficit in notifications (SGP foresees 'expedite procedure' for projected deficits above 3% of GDP).

Type of uncertainty: apart from revenues, uncertainty largely relates to implementation of budget plan. By experience gap between plans and outcomes is chiefly due to expenditure overruns.

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Statistical properties of EDP 'forecasts':

Budget balance: Optimism of UK notifications in clear contrast with findings of work examining SCP or national forecasts (Strauch et al., 2004, Jonung and Larch, 2006)

Interest expenditures: Systematic optimism seen as failure to anticipate magnitude of the fall in interest rates. Alternative explanation is windowdressing. For a given target of the budget balance, overestimation of interest expenditure embellishes primary balance.



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Determinants of 'forecast errors'

Economic controls – Output gap not significant; ex post measure not indicative for assessment in real time.

Ongoing or imminent EDPs – Significance of dummy underlines that notifications are more like plans than forecasts.

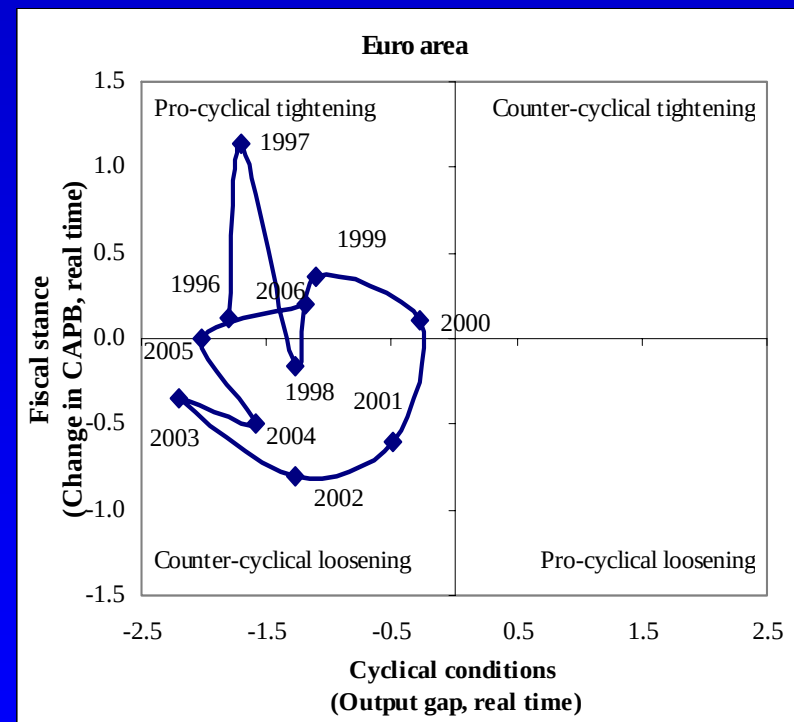
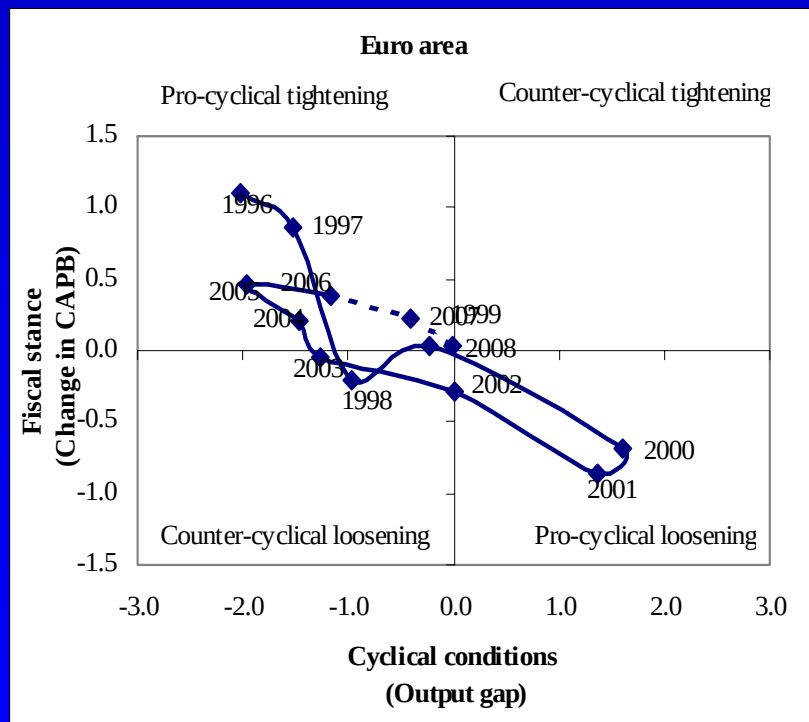
Expenditure rules – Instrumental to stick to targets (Public Finances in EMU 2007); result confirms that 'forecast errors' measure implementation risk.

Committment/delegation – committment produces more prudent forecasts. Reflection of higher costs of renegotiating plans. Herfendahl index as alternative indicator.



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Ex-post vs. ex-ante assessment of cyclical conditions



Source: OECD