OVER-OPTIMISTIC FISCAL FORECASTS IN THE EURO AREA – and how to discourage them

The rules of the euro area can encourage its members to overstate their economic statistics, according to research by **Niels Gilbert** and **Jasper de Jong**, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015. But their study also finds that the upwards bias in GDP reporting is smaller in euro area countries that have an independent fiscal council.

Forecasts published by the European Commission are at the heart of fiscal governance in the European Union. But in making its forecasts, the Commission depends to a large extent on information from the member states. This raises questions about how biased the national forecasts may be, particularly when fiscal rules are binding – that is, for expected deficits above the critical value of 3% of GDP as enshrined in the Stability and Growth Pact.

The new study finds that the Commission's forecasts for euro area members are, on average, 1.4% of GDP more optimistic when their governments expect the rules of the Pact to apply. The authors conclude:

> 'Given that independent fiscal forecasts at the national level appear to reduce the biases in the Commission's forecasts, a pragmatic, 'no-regret' solution is to monitor and safeguard the independence of fiscal councils that are currently being set up throughout Europe.'

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All else equal, the European Commission's budget balance forecasts for members of the euro area are biased upwards when the rules of the Stability and Growth Pact threaten to bind. The presence of independent fiscal councils at the national level appears to attenuate this bias. For non-euro area countries, which under the Stability and Growth Pact do not face the risk of fines, a bias cannot be established.

These findings point to the importance of further safeguarding the independence of the forecasts that underlie the Stability and Growth Pact and of monitoring and promoting the independence of fiscal councils that are currently being set up throughout Europe.

In recent years, European policy-makers have taken important steps to improve fiscal governance. The Stability and Growth Pact has been strengthened significantly. In particular, the European Commission now plays a more important role in enforcing the rules, at the expense of the more politically oriented European Council. With the strengthening of fiscal rules, the data used in monitoring adherence to the Stability and Growth Pact further gain in importance.

The Commission's fiscal forecasts are at the heart of fiscal governance in the European Union. On the basis of these forecasts, the Commission assesses whether countries comply with European fiscal rules. But in making its forecasts, the Commission depends to a large extent on information conveyed by member states.

Forecasts are constructed by Commission country desk officials, who often consult nationals to obtain information and opinions on forecast items. These nationals, for example, from the central government, may have specific interests in providing information. This raises questions regarding the unbiasedness of the forecasts, in particular when fiscal rules are binding, that is, for expected deficits above the critical value of 3% of GDP as enshrined in the Stability and Growth Pact.

Remarkably however, the effect of the 3% threshold on the reliability of the fiscal forecasts by the Commission has received little to no attention. This study fills the gap and investigates whether the Commission’s budget balance forecasts are biased when the government expects the budget deficit to exceed 3% of GDP.

The study shows that, all else equal, fiscal forecasts for members of the euro area are on average 1.4% of GDP more optimistic when the government expects the rules of the Stability and Growth Pact to bind. For non-euro area countries, which do not face the risk of fines, such an effect cannot be established.

Qualitatively, these results are robust to various ways of controlling for crisis-induced budgetary problems and to the exclusion of various country groups. But the size of the bias in the Commission’s forecasts does appear to be smaller in those euro area countries that have an independent fiscal council preparing national forecasts.

These findings point to the importance of further safeguarding the independence of the forecasts that underlie the Stability and Growth Pact. Increased resources would help to reduce the Commission’s information dependence on member states.

Additionally, as the Commission’s Directorate-General ECFIN is currently responsible for both the enforcement of the Stability and Growth Pact and the preparation of the forecasts on which decisions are based, moving the forecasting team to a more technocratic unit could help to reduce the risk of undue political influence on the forecasting process.

Given that independent fiscal forecasts at the national level appear to reduce the biases in the EC’s forecasts, a pragmatic, ‘no-regret’ alternative to these more fundamental reforms is to monitor and safeguard the independence of fiscal councils that are currently being set up throughout Europe.

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Does the Stability and Growth Pact induce a bias in the EC’s fiscal forecasts?
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