Over-Optimism in Official Budget Agencies' Forecasts

*NBER Digest*, November 2011

Bringing budget deficits under control has been, and is, a difficult task for many advanced countries. In **Over-Optimism in Forecasts by Official Budget Agencies and Its Implications** (NBER Working Paper No. 17239), **Jeffrey Frankel** argues that overly optimistic official forecasts of future budget balances have facilitated complacency and so have contributed to tax cuts and increases in government spending, and therefore to realized budget deficits, during the last decade.

Analyzing data for 33 countries, Frankel finds that the average upward bias in the official forecast of the budget balance, relative to the realized balance, , is 0.2 percent of GDP at the one-year horizon, 0.8 percent at the two-year horizon, and 1.5 percent at the three-year horizon. The longer the horizon, and the more genuine uncertainty there is, the more scope there is for wishful thinking.

The forecast bias results are similar across nations. The bias is not larger for the commodity producers in Frankel’s sample, or for the developing countries, than for others. Both the U.S. and U.K. forecasts have shown positive biases , reaching around 3 percent of GDP at the three-year horizon, which is approximately equal to their actual deficit on average. In other words, on average the U.K. and U.S. forecasters repeatedly predicted a disappearance of their deficits that never occurred.

Frankel argues that one likely reason for the optimism bias in official budget forecasts is an optimism bias in forecasts of economic growth. He finds that a country's growth rate is an important determinant of the budget balance at all three time horizons, so over-optimism in predicting growth appears linked to over-optimism in predicting budget balances. On average, the upward bias in growth forecasts is 0.4 percent when looking one year ahead, 1.1 percent at the two-year horizon, and 1.8 percent at three years. The bias in growth forecasting appears in the United States and most other industrialized countries, but not among the commodity producing countries in the sample.

Frankel also finds that over-optimism is more prominent, for both budget balances and for economic growth, during economic booms. This is especially true as the horizon of the forecast lengthens. This over-optimism in official forecasts can help to explain excessive budget deficits, and especially the failure to run surpluses during periods of high output: if a boom is expected to last indefinitely, then saving for a rainy day is unnecessary. Forecasters over-estimate the permanence of booms, and also underestimate the persistence of busts. Frankel thus finds evidence of over-optimism in downturns as well as booms.

Despite calls for the establishment of rules, such as a formal ceiling for the deficit, Frankel finds that countries subject to a budget rule -- particularly the euroland’s Stability and Growth Path -- make official forecasts of growth and budget deficits that are even more biased and more correlated with booms than do other countries. Evidently when such governments exceed the deficit limits set by the rules, they respond by adjusting their forecasts rather than by adjusting their policies.

Finally, Frankel notes that while advanced economies in his sample have struggled with balancing their budget since 2000, some countries in the South, notably Chile, have carried out countercyclical policy during that time period, taking advantage of the 2002-07 boom years to attain budget surpluses. As a result of budget institutions created in 2000, Chile’s official forecasts of growth and of budget balance have not been overly optimistic, even in booms. (Claire Brunel)

Quote: " Overly optimistic official forecasts of future budgets have facilitated complacency and so have contributed to tax cuts and increases in government spending."