



## Summary:

# The Government's medium term macroeconomic forecasts

## Summary and recommendations

### Background

Development of the central government budget and public finances is to a great extent determined by the macroeconomic trend. Accurate forecasts for public finances therefore require accurate macroeconomic forecasts. The Government's medium term macroeconomic forecasts are used as a basis for determining the fiscal space and submitting proposals for a nominal expenditure ceiling, which provides a link between the medium term forecasts and fiscal policy in the short term. However, the Government's medium term forecasts have not been evaluated to the same extent as the short term forecasts. Therefore a Swedish National Audit Office audit of them is warranted. This audit has a medium term perspective with special focus on the composition effects of the medium term macroeconomic forecast which are of significance for the public finances forecast.

### Audit question

The overall question in the audit is:

Has the Government presented medium term macroeconomic forecasts of high quality in the fiscal policy bills?

The overall question is broken down into the following sub-questions:

- Is there clear overestimation or underestimation in the medium term macroeconomic forecasts?
- Are forecast revisions and forecast uncertainty presented and explained?

There is an additional follow-up question:

- In what way could any overestimation or underestimation in the macroeconomic forecast lead to overestimation or underestimation of general government net lending?

## Observations

The audit of the Government's medium term macroeconomic forecasts in the period 2007–2017 has shown that GDP growth on average has been somewhat overestimated, i.e. somewhat too high in relation to outcome. Among the GDP components, household consumption has been clearly overestimated. On the other hand, central and local government consumption has been clearly underestimated.

The audit period includes the financial crisis of 2009 but it is not possible to assess with certainty the extent of its impact on overestimation and underestimation for the entire period audited.

Potential GDP and the GDP gap are central variables as regards the medium term macroeconomic forecasts. Potential GDP refers to the level of output that represents normal resource utilisation. The GDP gap in turn refers to the deviation between the actual and potential GDP level. The assessment of both these variables, for which there is no official outcome and only estimation is possible, determines how high GDP growth can be in the medium term forecast.

In a clear majority of the government bills audited, the GDP gap was estimated to be negative at the outset. One explanation for this is the financial crisis of 2009, but the extent to which that impacted the average for the entire period audited is not possible to assess reliably. The GDP gaps were subsequently revised upwards. The gaps that were assessed to be positive at the outset became more positive and in most cases the gaps assessed to be negative became less negative.

In addition, the audit showed that the initial forecasts for potential GDP growth in the first years of the medium term period (year  $T + 2$  and  $T + 3$ ) were revised downwards in later forecasts.

The closure of the GDP gap in the forecasts does not show any obvious system in the sense that the gap always closes in a certain predetermined year or at a particular rate between years.

As of the 2011 Spring Fiscal Policy Bill the forecast revisions referring to medium term macroeconomic forecasts are regularly and systematically presented in the fiscal policy bills. This is a considerable improvement compared with previous presentation. In the bills audited, uncertainty in the medium term forecasts has been illustrated in several alternative scenarios, mainly linked to uncertainty and risks in the assessment of the potential variables.

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## Conclusions

The Government's macroeconomic forecasts are prepared on the basis of current and proposed regulations (unchanged rules). This assumption is made since the budget laid before the Riksdag should not only be a forecast but also function as reference material for future decisions. Given this condition, the Government's macroeconomic forecasts cannot, in all respects, be assumed to aim at generating the most unbiased forecast, i.e. the least possible error in relation to the outcome. The Government's forecasts in the medium term perspective are instead aimed at generating the most probable picture given current regulations.

In the forecasts, GDP at overall level is not limited to the assumption of unchanged rules, as GDP in the medium term is estimated from the supply side. The assumption of unchanged rules has not entailed any underestimation of the GDP forecast. The tendency instead is that GDP has been somewhat overestimated. Municipal consumption has been underestimated, but the underestimation does not constitute a real forecast error, but is a consequence of the assumption of unchanged rules. The forecast of municipal consumption rests on and is based on the assumption that consumption cannot develop in a way other than is compatible with the municipal balanced budget requirement. Unchanged rules mean that general government grants, which require discretionary decisions to be changed, are nominally unchanged in the medium term horizon. All in all this entails restrictions on how much municipal consumption can increase in the medium term forecasts.

Household consumption has been clearly overestimated. Indirectly this is an effect of the unchanged rules assumption in combination with the method used to calculate the medium term macroeconomic forecasts. GDP at overall level is not limited by the unchanged rules assumption. As municipal consumption is limited by the unchanged rules assumption, this means that other GDP components, mainly household consumption, are overestimated in the forecasts. This overestimation of household consumption could possibly be avoided if the medium term forecast was made using another method in which GDP as a whole is also limited by the assumption of unchanged policy. The GDP forecasts would then probably be lower. In addition, they would be less unbiased but more consistent with the assumption of unchanged rules.

The Swedish NAO has found that central government consumption was clearly underestimated but the reasons for the underestimation need to be investigated further. The unchanged rules assumption could probably to some extent explain the underestimation but it may also be a matter of difficulties in transforming expenditure in budget terms to national accounts terms.

In one example, the Swedish NAO shows that overestimation and underestimation in the medium term macroeconomic forecasts is of great significance for general government net lending. The example shows that overestimation and underestimation in the medium term macroeconomic forecasts has meant stronger net lending than would otherwise have been the case. The accumulated effect of overestimation on public finances in the final year of the medium term forecast is about SEK 75 billion, corresponding to just under 2 per cent of GDP. Part of the estimated effect refers to underestimation of municipal consumption following from the unchanged rules assumption. This underestimation should thus not be seen as a real forecasting error that could have been avoided, since the forecast is reference material for coming decisions. However, a large part of the estimated effect on general government net lending refers to forecasted macro variables that are far too high, which in turn lead to forecast tax bases that are far too high. In the opinion of the Swedish NAO, the overestimated tax bases cannot be seen as a consequence of unchanged rules but can instead be linked to the method itself used for calculating GDP. This conclusion follows from the consistent and clear overestimation of the tax bases. The exact size of the overestimation is uncertain, however, though a calculation illustrates the effect of the average deviations. As mentioned before, the size of the overestimation is affected by the special circumstances linked with the financial crisis.

The overestimation of general government net lending which, all else being equal, follows from overestimation and underestimation in the macroeconomic variables, and which is not due to the unchanged rules assumption, risks leading to current fiscal policy being far too expansionary. In other words, decisions on tax reductions and expenditure increases may risk being made on the basis of misleading decision-making material.

Often when levels of expenditure ceilings are proposed and decided, the reason given is that they must amount to a certain proportion of potential GDP. The audit has shown that potential GDP growth is often revised downwards in later forecasts. If the margin under the ceiling is filled with ceiling-restricted expenditure, expenditure in relation to potential GDP will thus be higher than intended at the time of the decision.

## Recommendations

- The Government should consider changing the method for forecasting GDP in the medium term forecasts in a direction that to a greater degree than at present is consistent with the unchanged rules assumption. A change in method in this direction would mean less overestimation of public sector income and thus more unbiased forecasts, given unchanged rules, of net lending.

- The Government should investigate the reasons for the clear underestimation of central government consumption and where necessary change the calculation method for this item. The part of the deviation that is due to the unchanged rules assumption should not give rise to any method adjustment.