

## ● FISCAL MARKSMANSHIP

AN ANALYSIS OF THE SOURCES OF ERRORS IN FISCAL FORECASTS OF THE CENTRE SHOWED THAT THE SOURCES ARE NOT DUE TO POTENTIAL BIASES, BUT RATHER DUE TO RANDOM FACTORS

# Analysing budget forecasting errors

**D**OES THE MINISTRY of finance produce biased budget forecasts in India? Does the electoral cycle predominantly determine the fiscal behaviour of the Centre? The answers to these questions can be unlocked only through a fiscal marksmanship analysis. Fiscal marksmanship is the analysis of the accuracy of budgetary forecasts and whether the sources of error in the forecasts are biased or random.

In the context of the European Union, the debate is whether in-house budgetary forecasts by the ministry of finance or an independent agency, like the Fiscal Council, can prepare the fiscal forecasts better. This debate has sprouted against the backdrop of fiscal rules which constrain fiscal deficits and public debt to threshold ratios.

Do fiscal rules help in ensuring prudential fiscal marksmanship is a question researchers are increasingly getting interested in. Fiscal marksmanship analysis is the technical prelude to fiscal governance in managing the deficit numbers with relation to the pre-determined threshold ratios. This analysis across countries reveals that deterioration in public deficits and fiscal forecasting errors have compelled countries to get into more stringent fiscal consolidation measures.

The forecast errors can happen if there is a potential bias in the revenue and expenditure projections. However, if the costs of fiscal forecasting errors are symmetric, meaning the positive errors in revenue are as bad as the negative errors in expenditure, the overall forecasts should present no potential bias in estimates. There is practical evidence to believe that the loss function of ministry of finance may not be symmetric. The potential bias in budgetary estimates could not be optimal. The political economy conundrums of errors in fiscal forecasting could be mixed.

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Empirical studies often determine the fiscal forecasting errors (or only the forecasts) as a function of two factors: one, the deviation between actual and potential GDP which we refer to as “output gap” and, two, the electoral cycles or the fiscal institutional governance structure. However, these independent think tank analyses often lack the in-house insights of the ministry of finance in having reasons for significant deviations between budget estimates (BE), revised estimates (RE) and actual spending.

It is high time that the Economic Survey of India, a significant document that is tabled in Parliament a day prior to the budget presentation, should produce a chapter on fiscal marksmanship and explain the magnitude and sources of fiscal forecasting errors in revenue and expenditure, at aggregate and disaggregate levels. A paper by NIPFP (Chakraborty and Sinha) showed that the magnitude of fiscal forecasting errors is maximum in the case of capital budgets rather than revenue budgets. The magnitude of errors in capital expenditure was prominent. However, the analysis of partitioning the sources of errors in fiscal forecasts of the Centre showed that the sources are not due to the potential bias of the forecaster in the ministry of finance, but rather due to random factors.

This means that the errors in the fiscal forecasts of the government of India is beyond the control of the forecaster. Had the forecasting errors been due to potential biases in the estimates, improving the estimates could have been made possible through improving the forecasting methodologies or revising the assumptions in revenue and expenditure projections. The aberrations in the revenue realisations are due to random determinants. Having

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said that, it is also relevant to highlight that the relatively higher magnitude of errors in capital expenditure is due to the fact that fiscal marksmanship is often attained through downward adjustments in capital spending. Though this reality is known in close circles of the ministry of finance and in academia, the long-term adverse growth consequences of these adjustments in downsizing the capital spending is not holistically responded to, in policy circles. It is also due to the dominant narrative in fiscal policy circles that “fiscal discipline” (by adhering to fiscal rules) is growth-enhancing, when it is not so if the path towards fiscal consolidation is not through tax buoyancy but through public expenditure compression in capital formation.

The story of fiscal marksmanship cannot be confined to the national bud-

gets. Our analysis of the magnitude of deviations between budget estimates and the actual spending at subnational government levels in India—all states—showed that the magnitude of forecasting errors is alarming. The positive forecasting errors in revenue receipts for the period 2011-12 to 2015-16 is as high as 1.20% of GSDP for aggregate/all states. The analysis of sources of these fiscal forecasting errors, state-wise, revealed that it was not random determinants behind these aberrations in many states. This is a matter of concern.

Reducing fiscal forecasting errors is critical for budget credibility and medium-term fiscal policy framework at the state levels. The point to be noted here is that the deviations in revenue forecasts at state levels has happened not exclusively through aberrations in the own tax revenue forecasts/projections of the states, but also through the uncertainties in the flow of intergovernmental fiscal transfers from the Union government to state governments. The state-wise fiscal marksmanship analysis of revenue and expenditure is compelling to examine the fiscal forecasting errors at the state level.

The CAG (Comptroller and Auditor General of India) reports are the reliable sources to go to for the roots of analysing the fiscal marksmanship in India. When CAG reports reveal that the devolution of 42% of the divisible pool to the states recommended by the 14<sup>th</sup> Finance Commission was not fully transferred to the states—the devolution of net proceeds of ₹25,000 crore out of a divisible tax pool was not transferred to the states in the financial year 2015-16—the severity of reasons of lack of fiscal marksmanship is revealed before us. This volatility in the flow of intergovernmental fiscal transfers to the states to the magnitude of ₹25,000 crore has significant impact on the forecasts/projections of public deficits by state governments and, in turn, on their fiscal marksmanship.

