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Enhancing the credibility of fiscal forecasts in South Africa: Is a fiscal council the only way?

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ABSTRACT

The paper investigates whether fiscal credibility in South Africa (SA) would be enhanced by following the international trend of establishing a fiscal council. Given that fiscal councils and numerical fiscal rules are increasingly seen as complementary aspects of fiscal policymaking frameworks, we survey evidence on fiscal councils, with reference to empirical studies and country experience – Chile in particular. Whilst earlier studies generated inconclusive results of earlier attempts about the link between fiscal councils and good fiscal performance, more recent studies found that the involvement of fiscal councils has contributed to more accurate macroeconomic and budgetary forecasts.

In the light of this evidence – in particular, the increasingly recognised need for flexibility in fiscal rules, respect for the country's political environment in considering the appropriateness of fiscal councils and the importance of transparency in any fiscal regime – we discuss lessons for SA, and the mechanics of our proposal. SA's fiscal performance and regime are assessed, with reference to the literature's finding of historical fiscal sustainability and macro fiscal forecasting accuracy and various measures characterising the current transparency-enhancing regime of fiscal discretion. It is recognised that SA does not have numerical fiscal rules and that the National Treasury has not been outperformed by nongovernment economists in forecasting key variables used in drafting the annual budget. Projections nevertheless become increasingly inaccurate over three-year periods. On average, budget deficit forecasting errors have during the previous decade been lower than in European Union countries. The case for a fiscal council on the basis of better short-term forecasting accuracy alone is not strong. Instead of a fiscal council, an institutional innovation is proposed, namely structured bi-annual discussions of government's macroeconomic budget forecasts in public parliamentary hearings, integrated into the budget process. This avoids drainage of scarce resources from Treasury and political pitfalls encountered elsewhere and might strengthen credibility of medium-term projections.

Keywords: fiscal rules, fiscal policy, fiscal council, fiscal transparency, fiscal forecasts
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INTRODUCTION

Calitz, Siebrits and Stuart (2013) show that the forecasting accuracy of the National Treasury compares very well with that of private sector economists, the Bureau for Economic Research at the University of Stellenbosch (BER) and the International Monetary Fund (IMF). Furthermore, budgetary forecasts by the National Treasury show a smaller margin of forecast error than those of the fiscal authorities of New Zealand and member countries of the European Union (EU). National Treasury's budget forecast errors are nonetheless significant and have even increased from 2000/01 onwards. The margin of forecast error in respect of each of revenue, expenditure and GDP had been large at times and fiscal credibility would be severely tested if such errors were to coincide in any particular year.

This paper argues that the establishment of a regular forum for the discussion of official budget forecasts should enhance the credibility of fiscal policymaking in South Africa by contributing to improved projections as well as more mature, non-partisan public discussion of the fiscal outlook. Hence, we propose the introduction of bi-annual discussions of government's macroeconomic budget forecasts in public parliamentary hearings. This innovation would build on South Africa's strong fiscal record, while recognising that appropriate incentives can improve institutional performance. Over time, depending on its usefulness, this forum could expand its remit, or become more formalised.

The remainder of the paper is organised as follows. It first discusses the nature and effectiveness of attempts to incorporate non-partisan forecasts into fiscal policymaking in other countries. Particular attention is given to the role and records of parliamentary budget offices and other types of fiscal councils, as well as Chile's experiments with committees of independent experts. Against this backdrop, we discuss lessons for South Africa and the mechanics of our proposal.

THE EXPERIENCES OF OTHER COUNTRIES

The notion of involving non-partisan agencies in budget-related forecasting is not new: the Bureau for Economic Policy Analysis (CPB), established in 1945, has been providing macroeconomic and fiscal forecasts for the Dutch government since the 1950s (Bos and Teulings, 2010: 9-10). Another well-known agency whose mandate extends to forecasting, the Congressional Budget Office (CBO) in the United States, was created in 1974 (Curristine, Harris and Seiwald, 2013: 43). Interest in this practice has grown dramatically during the past two decades, though, in large part because of the growing popularity of rules-based fiscal policymaking.

Fiscal councils

Non-partisan agencies with monitoring and advisory tasks related to fiscal policy are by far the most common sources of independent forecasts for fiscal policymaking purposes. The interest in involving such agencies, known as "fiscal councils"[2], in fiscal forecasting, has been boosted by the proliferation of rules-based fiscal policymaking frameworks[3]. Independent forecasting has come to be seen as a method for enhancing the credibility of such frameworks by ameliorating policymakers' tendency to circumvent numerical rules by manipulating macroeconomic or budgetary forecasts (cf. Frankel, 2011a; Jonung and Larch, 2006). The objective of charging fiscal councils with the complementary task of monitoring compliance with numerical rules is to make policymakers more accountable by enabling voters to assess their management of the public finances more accurately[4]. The growing popularity of such arrangements was confirmed in March 2013, when the European Parliament and the Council of Ministers of the European Union adopted two regulations that elevated independent forecasting and compliance monitoring by fiscal councils to formal elements of fiscal governance in the euro area (cf. European Commission, 2013: 3). To be sure, fiscal councils can play similar transparency-enhancing roles in the absence of numerical rules. Well-known examples of fiscal councils that were created before the adoption of numerical rules and functioned for long periods in discretionary policymaking environments are the German Council of Economic Experts and the CBO in the United States (Debrun et al., 2013: 22)[5].

Several studies find that the involvement of fiscal councils has contributed to more accurate macroeconomic and budgetary forecasts. According to Debrun et al. (2012), the forecasts of EU countries have improved with the introduction of fiscal councils and such bodies have delivered important fiscal policy messages successfully and in a timely fashion. Similarly, Frankel and Schreger (2013) find that the existence of independent fiscal agencies that

[2] It could be argued that the appellation should be restricted to agencies whose mandates are restricted to fiscal matters (for example, Korea's National Assembly Budget Office and the United Kingdom's Office for Budget Responsibility). This paper, however, follows the common practice of extending it to agencies with broader remits that include the tasks usually associated with fiscal councils, such as the Bureau for Economic Policy Analysis in the Netherlands and the Federal Planning Bureau in Belgium.

[3] The number of countries with rules-based fiscal regimes increased from a mere 5 in 1990 to 76 in March 2012 (Schaechter, Kinda, Budina and Weber, 2012: 10).

[4] Debrun and Kumar (2007) formally model the role of fiscal councils along these lines. The model ties the credibility of rules-based mechanisms to alleviate a deficit bias to the cost of violating the rules, which consists of a loss of electoral support. In practice, though, it is difficult to distinguish between wilful violations of policy rules and breaches caused by shocks to fiscal aggregates. This complicates assessment of the performance of policymakers and undermines the ability of the democratic mechanism to enforce compliance with rules. The model suggests that non-partisan fiscal councils can overcome this problem by ameliorating information asymmetries between policymakers and voters (i.e. by increasing transparency in fiscal policymaking).

[5] The tasks of the CBO include costing of new legislative proposals, re-estimation of the budgets of incumbent administrations based on its own macroeconomic forecasts and other assumptions, and advising Congress on fiscal matters (Debrun, Hauner and Kumar, 2009: 68).

produce budget forecasts at the national level reduces the likelihood that Eurozone countries would announce over-optimistic forecasts while in violation of the rule that prohibits budget deficits in excess of 3 percent of GDP. Having analysed the impacts of 27 fiscal councils in European and other countries, Debrun et al. (2013: 31-34) conclude that the involvement of fiscal councils with high levels of operational or legal independence from the fiscal authorities and strong media profiles enhances the precision and reduces biases in forecasts of primary balances, cyclically adjusted primary balances and real GDP growth. Debrun et al. (2013: 26-29) also found that the inclusion of forecasting tasks in the remits of fiscal councils is a significant determinant of the extent to which such agencies contribute to sound fiscal outcomes (as measured by the level of the primary balance). These findings suggest a plausible explanation for the inconclusive results of earlier attempts to link the presence of fiscal councils to good fiscal performance (e.g. Debrun and Kumar, 2007; Debrun, Gérard and Harris, 2012): fiscal councils are effective when established and designed to overcome country-specific incentive distortions, whereas generic models achieve little.[6]

Existing fiscal councils represent a wide range of models for procuring independent forecasts. These models are the outcomes of design choices that include the following:

- *Institutional placement*. Stand-alone institutions include the German Council of Economic Experts, the Irish Fiscal Advisory Council and the Swedish Fiscal Policy Council. The independence of such fiscal councils is often entrenched in Fiscal Responsibility Laws, and formal links to policymakers are limited to appointment procedures and accountability mechanisms. Other councils are attached to the executive branch of government (e.g. the Danish Economic Council and the Fiscal System Council in Japan) or to the legislature (e.g. the Australian Parliamentary Budget Office and the Canadian Parliamentary Budget Office). Such agencies derive their independence either from legal frameworks and well-defined mandates or from the reputational benefits associated with their roles in fiscal policymaking processes. A third group of councils are attached to other independent institutions such as audit agencies (e.g. the French High Council of Public Finance) and central banks (e.g. the Austrian Government Debt Committee). Provided that the mandates and functions of both agencies are clearly defined, this model allows fiscal councils to benefit from the independence of the host institutions and to reap economies of scale in undertaking some of their tasks.

[6] Similar considerations may explain the mixed record of numerical fiscal rules. As was pointed out by Debrun et al. (2009: 48-50), the mere imposition of constraints on outcomes leaves intact the incentive distortions that are the root causes of fiscal problems in many discretionary regimes. Such distortions include common-pool problems in budgeting, short time horizons among and time-inconsistent behaviour by policymakers, and information asymmetries between policymakers and the voters and market participants affected by fiscal policy decisions (Calmfors and Wren-Lewis, 2011: 656-659). In the absence of complementary mechanisms to address country-specific manifestations of these problems, numerical rules tend to be vulnerable to outright neglect, erratic compliance, changes that weaken their effectiveness, and circumvention.

- *Remits*. The number and nature of fiscal policy-related tasks also differ among councils. As mentioned earlier the scope of an agency's remit may be limited to fiscal matters or broader economic issues. Furthermore, apart from forecasting activities – more than three quarters of all fiscal councils now prepare or assess forecasts (Debrun et al., 2013: 15) – the remits of such agencies include one or more of the following: analysis of current fiscal trends, their short-term macroeconomic context and long-term sustainability considerations; costing of budgetary initiatives[7]; advising policymakers on policy options; and monitoring compliance with numerical fiscal rules (cf. Calmfors and Wren-Lewis, 2011: 667-671; Debrun et al., 2013: 13-17).
- *Status of forecasts*. Governments use the forecasts prepared by fiscal councils in various ways (cf. Debrun et al., 2013: 16). The Belgian fiscal authorities are bound by legislation to use the macroeconomic forecasts prepared by the Federal Planning Bureau on behalf of the National Accounts Institute. In the Netherlands, by contrast, successive governments have opted to use forecasts prepared by the Bureau for Economic Policy Analysis despite the absence of a legal requirement to do so. The government of the United Kingdom has also committed itself to using the fiscal and economic forecasts of the Office for Budget Responsibility as the official forecasts in its Budget Reports. It has retained the right to disagree with the numbers produced by the Office, though, but has promised to explain its reasons for doing so to parliament. Other fiscal councils undertake periodic reviews of official forecasts and forecasting methods (e.g. the Swedish Fiscal Policy Council) or prepare forecasts as benchmarks for assessing official projections (e.g. the CBO, the Canadian Parliamentary Budget Office and the Danish Economic Council).

Such design choices influence councils' resource needs and independence from political interference. As pointed out by Debrun et al. (2013: 35), modest human and financial resources are required to assess the forecasts of the fiscal authorities (it may suffice, for example, to compare these to the forecasts of other reputable institutions). By contrast, agencies that produce forecasts typically employ at least 20 professionals (Debrun et al., 2013: 35). The independence of fiscal councils, which matters greatly for their impact on the credibility of policymaking, is enhanced by strong legal frameworks that cover issues such as appointment criteria and procedures, the terms of office of senior staff members, dismissal procedures and access to information and funding (cf. Calmfors and Wren-Lewis, 2011: 665-666; Debrun et al., 2013: 45-47).

It should be noted, however, that legal frameworks provide only partial protection when criticism by "fiscal watchdogs" moves government to initiate retaliatory action. The history of the Hungarian Fiscal Council, which was established in 2008 as a well-designed and well-resourced agency, starkly shows the vulnerability of such agencies. When the Council

[7] The Bureau for Economic Policy Analysis also analyses the election platforms of Dutch political parties and the coalition agreements of incoming governments (Bos and Teulings, 2010: 16-19).

criticised the medium-term budgetary plans in the 2011 budget bill and other aspects of economic policy, the Hungarian government amended the fiscal responsibility law that governed its work, changed its composition and cut its funding and personnel drastically (Curristine et al., 2013: 21). The agency survived, but the subsequent inadequacy of its resources and pliancy of its approach moved Kopits (2011: 13) – a renowned economist who served as its first chairperson but resigned in protest to the 2011 reforms – to describe these events as the "de facto termination of Hungary's Fiscal Council"[8]. Ultimately, the viability and de facto independence of fiscal councils depend on the value attached to policymaking transparency by governments and voters.

An alternative model: Chile

Chile instituted a notably different model in 2001, when the government adopted a Fiscal Responsibility Law and a rule that prescribed a structural budget surplus of 1 percent of GDP (cf. Hagemann, 2011: 90-91). Instead of establishing a formal fiscal council, the government appointed panels of experts to provide key inputs for the fiscal authorities' macroeconomic and fiscal forecasts in the form of projections of copper prices and the growth rates of capital, labour and total factor productivity. The two bodies – the twelve-member Advisory Committee on Trend GDP and the 16-member Advisory Committee for the Reference Copper Price – are chosen by the Chilean Minister of Finance from local macroeconomists and copper market experts (Schmidt-Hebbel, 2012: 10-11). They attend one technical meeting every year, usually in July or August, and submit individual projections some weeks later. After discarding the two extreme values, the fiscal authorities use the averages of these projections to calculate the output gap, the structural levels of copper revenues and total tax revenues, and the level of expenditure required to reach the surplus target (cf. Schmidt-Hebbel, 2012: 10). As pointed out by Hagemann (2011: 91), the Ministry of Finance still plays a critical role in the process, having remained responsible for the method for determining the output gap. The Chilean parliament monitors compliance with the rule and the Minister of Finance has to provide an explanation in a parliamentary hearing when the target is missed. The members of the two committees do not communicate directly with the press or with Parliament.

Assessments of this aspect of Chile's policymaking framework have varied: Frankel (2011b: 407, 425) argues that it helped the country to avoid over-optimistic forecasts and to achieve countercyclical fiscal outcomes, while Hagemann (2011: 91) claims that regular overestimation of the output gap and copper prices contributed to excessive spending levels and pro-cyclical outcomes. Chile changed the structural balance rule and established a fiscal

[8] In similar vein, the publication of controversial reports about the state of the economy and the public finances as well as the cost of the war in Afghanistan resulted in a marked reduction in the budget of the Canadian Parliamentary Budget Office in 2010, while the Swedish Minister of Finance repeatedly belittled the work of the Fiscal Policy Council in response to criticisms of fiscal policies in 2009 and 2010 (Calmfors and Wren-Lewis, 2011: 676, 683).

council in April 2013 (Debrun et al., 2013: 13), but the two Advisory Committees have retained their forecasting responsibilities.

THE SOUTH AFRICAN CONTEXT

The experiences of other countries suggest that fiscal forecasting can be improved by the involvement of independent experts, that several models exist for doing this and that the existence of numerical fiscal rules is not a requirement. Hence, the notion is worth considering in South Africa. Various aspects of the South African context should be kept in mind when evaluating specific models.

The first of these is the country's good fiscal record. South Africa's fiscus has never run into real crises of non-sustainability over the past century, despite major changes in the international and domestic political environments. This has been achieved despite shifts to and away from Keynesian thinking, globalisation and changes in the international monetary system, major military and social conflicts, financial and trade sanctions against South Africa, and the fundamental change in South Africa's political dispensation in 1994 (Calitz, Du Plessis and Siebrits, 2012). Burger, Stuart, Jooste and Cuevas (2011) find that the South African government has pursued sustainable fiscal policy since 1946 by reducing the primary deficit or increasing the surplus in response to rising debt. While there is some evidence of pro-cyclical spending during the boom years of the mid-2000s, South Africa generally has avoided pro-cyclical fiscal policy during the past three decades (Du Plessis and Boshoff, 2007).

Second, this record extends to good fiscal management more generally (including a high degree of transparency), as has been recognised by international experts and institutions. Tanzi (2004: 539), for example, states in a discussion of successful fiscal reforms that "outside of the Americas South Africa merits a mention because… it has followed, in recent years, a steady path towards fiscal adjustment trying to use its public resources sparingly and efficiently and creating an efficient tax system while resisting the temptation of magic solutions." Furthermore, the South African budget process was ranked the most transparent among 100 countries in 2010 and the second most transparent in 2012[9]. A core element of fiscal management in South Africa is the Public Finance Management Act (PFMA) of 1999 (South Africa, 1999), which aims to address the accountability aspect of fiscal transparency by prescribing greater emphasis on outputs and performance monitoring, regular financial reporting, sound internal expenditure controls, independent audit and supervision of control systems and improved accounting standards and training of financial managers. Article 28 of the Act stipulates that all national and provincial budgets must contain multi-year projections of revenues and outlays and that the national budget should outline the

[9] These rankings are based on the bi-annual Open Budget Surveys conducted by the International Budget Partnership (2013).

macroeconomic projections underlying the estimates. The Medium-Term Expenditure Framework (MTEF), which was introduced in 1998/99 and consists of three-year rolling budgets for the national and provincial governments, accompanied by detailed explanations of the broader macroeconomic and fiscal policy stance, gives effect to this article. More recently, National Treasury has embarked on the formulation of guidelines for sustainable management of the public finances informed by the principles of long-term debt sustainability, inter-generational equity and countercyclicality (National Treasury, 2011: 50). The Government also is committed to publishing a report on South Africa's long-term fiscal dynamics (including risks to fiscal sustainability) and regular reports on public debt management (National Treasury, 2012: 7).

Given South Africa's good fiscal record and transparent budget process, the major benefits of the involvement of independent experts in forecasting are likely to be the enhancement and protection of the credibility of fiscal policy. The purpose of such involvement should be to generate benchmarks for assessing official forecasts: the case for delegating the responsibility for producing forecasts for fiscal policymaking seems weak, especially in the light of the evidence that the forecasting accuracy of the National Treasury compares very well with that of private sector economists and other reputable organisations (cf. Calitz, Siebrits and Stuart, 2013).

At present, South Africa has neither fiscal rules nor a fiscal council. However, the Money Bills Amendment Procedure and Related Matters Act, Number 9 of 2009 (South Africa, 2009), which has the aim of strengthening parliamentary oversight of budget-related matters, established the Parliamentary Budget Office to "… provide independent, objective and professional advice and analysis to Parliament on matters related to the budget and other money bills" (cf. Section 15 of the Act). These are core tasks of fiscal councils. The appointment of the Director of the Parliamentary Budget Office was confirmed on 11 June 2013 (South African Government Information, 2013), and the institution is expected to be fully operational by the end of 2014 (Debrun et al., 2013: 13).

Forecasting-related tasks are compatible with the remit of the Parliamentary Budget Office outlined in Section 15 of the Money Bills Amendment Procedure and Related Matters Act, but are not mentioned explicitly. Some experts regard such tasks as core functions of parliamentary budget offices (cf. Johnson and Stapenhurst, 2008). As was indicated earlier, however, much expertise and other resources are required to produce high-quality forecasts. Given the considerable uncertainty about aspects of the future role and capacity of the Parliamentary Budget Office, we believe that an appropriate starting-point for using independent forecasts in fiscal policymaking in South Africa is a model that involves the Office but draws on existing forecasting expertise to strengthen the oversight function of the legislature (this model is reminiscent of the earlier Chilean one in its emphasis on using existing expertise as an alternative to creating new formal structures). The next section presents a proposal along these lines.

PROPOSAL FOR A PRE-BUDGET PARLIAMENTARY HEARING

In order to improve the credibility of the budget process, we propose that government introduces a parliamentary public hearing on the macroeconomic forecasts that informs the budget. This relatively minor change could incentivise more transparent and credible policy-making over time, while avoiding some of the risks of involving formal agencies in fiscal forecasting activities. The reform would both reflect and build upon South Africa's successful transparency-based discretionary fiscal regime. By giving a wide range of organisations an opportunity to input into the budget-making process, it could promote more inclusive policy-making and accountability. Finally, it would not require significant financial setup costs, nor would it create a new institution that may attract the public sector's most talented economists away from government. Given South Africa's small skilled workforce, this is a significant consideration.

The hearings would take place bi-annually: in January (one month before the Budget Speech) and in August (one month before the Medium-Term Budget Policy Statement). Government, represented by the National Treasury, would open the proceedings by presenting a baseline scenario of the major determinants of the fiscal framework. In line with the medium-term expenditure framework, government would be required to present a four-year forecast (in-year plus three years ahead) of real and nominal GDP, CPI and GDP inflation, and tax revenue. Gross taxes would be presented in aggregate and in its major components: personal income tax, corporate income tax, valued-added tax and customs duties. The tax forecasts should reflect a no-policy change scenario, with tax brackets adjusted upwards for CPI inflation.

We propose that any recognised institution be allowed to send its forecasts and assumptions to parliament, with the deadline set one week prior to the hearing. This could include compulsory submissions to the public debate by certain established interest groups even if they submit an empty document. This is to avoid "free riding" on criticism after the event without having grappled with the issues in advance. Parliament would then invite a broad range of representatives to present their forecasts in parliament, as is currently the case with the post-budget hearings. One hearing could include, for example, the South African Chamber of Commerce and Industry (SACCI), the Congress of South Africa Trade Unions (Cosatu), the Bureau for Economic Research (BER), individual academics, and private economic consultancies. Government would then respond briefly to the other speakers.

The following day, parliament would be required to publish the minutes of the proceedings, including the areas of disagreement and consensus. All forecasts received by parliament would also be published in table form, by variable and by institution. The relative accuracy of the forecasts could be calculated and presented at the next round of hearings by the Parliamentary Budget Office. Over time, the relative forecast accuracy of different institutions would be estimated and ranked. This simple feedback mechanism should incentivise better forecasts.

The first few sets of hearings could be used to test the usefulness of the reform. One quantitative measure of the reform's success could be less biased fiscal projections over the medium term. Even without a significant improvement in forecasts accuracy, however, the hearings could promote more mature, non-partisan public discussion of the fiscal outlook. Over time, the hearings could be formalised and enshrined in the Public Finance Management Act (1999), and perhaps integrated more closely with the work of the Parliamentary Budget Office. Furthermore, should government wish to introduce a structural budget balance rule, the list of required variables could be expanded to include potential GDP.

An obvious question is whether parliament should set the macro fiscal framework after having had the public debate, or whether the results should become mere "advice" to National Treasury. One could also think of a process whereby the debate presents a range of opinions or even a definite macro framework for the budget, with the Finance Minister having to explain significant deviation from it when presenting the budget. Rather than setting these rules at the outset, we propose a "learning-by-doing" approach to developing a platform for constructive discussion on assumptions, policy goals, forecasts and an understanding of the transmission mechanism of fiscal policies.

CONCLUSION

South Africa has a history of fiscal sustainability and transparency without fiscal rules or a fiscal council. The Government is continuing to strengthen its fiscal framework by introducing long-term fiscal outlook and debt risk management reports. Nevertheless, the macroeconomic forecasts that inform the budget have historically been biased and not particularly accurate. To address this, we propose the introduction of bi-annual public parliamentary hearings on the forecasts. This reform builds on the successes of the past, and reflects South Africa's political dynamics. It puts some distance between the generators and users of forecasts, which will enhance the credibility of fiscal policy. Depending on the usefulness of this reform, government can formalise the process in future by writing it into law. Hence, a fiscal council may or may not eventually be the way to enhance fiscal credibility.

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