POLITICS AND TREASURY'S ECONOMIC FORECASTING AND POLICY

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Politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies.

Groucho Marx.

It has been said that politics is the second oldest profession. I have learned that it bears a striking resemblance to the first.

Ronald Reagan.

Politics is for the present, but an equation is for eternity.

Albert Einstein.

One of the penalties for refusing to participate in politics is that you end up being governed by your inferiors.

Plato.

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James Buchanan is credited with the statement that "politics is about the rules of the game, where policy is focused on strategies that players adopt within a given set of rules." When Buchanan created the notion of constitutional political economy,[1] it is likely that the existing rules of the game comprised a "given set." They were established by a clearly recognised majority; they were known with a reasonable degree of certainty by all players; and they were generally accepted as *the* rules of the game. This does not seem to apply today. The rules now are capable of interpretation, reinterpretation, amendment and even repeal. It is far more difficult now to identify a "given set" of rules, and that is almost certain to affect the strategies that players adopt.

From Treasury's perspective, economic policy is easily defined as the ways of achieving economic growth and revenue, combined with a rough order of importance for the various ways and means of achieving them.[2] If the rules of the game are capricious or otherwise poorly defined, there may be a temptation to make up new ones. But in Australia only the Australian Taxation Office has that privilege, subject of course to ultimate approval by the courts.

Questions about what comprises good rules are part of the academic domain known as social philosophy, which has recently produced a number of topics of interest but nothing to

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[1] The subject matter of constitutional political economy is made apparent, though not formally defined, with the academic journal bearing that name: http://ideas.repec.org/s/kap/copoec.html.

[2] As noted by Wanna, whose journal article is discussed below and cited in footnote 7, during John Stone's era as Permanent Head of Treasury, only one option was made public (called the "iron fist" culture). A more pluralistic approach was used later by Ken Henry.

solve problem of regaining a more solid foundation for the rules of the game.[3] It may therefore be necessary for Treasury and other government departments to look beyond the present rule structure and bring in new ideas with the use of lateral thinking. The purpose of this comment on recent critiques of Treasury's forecasting efforts is to ask if such thinking is being considered.

Recent Research on Economic Forecasting Errors

Research by Jeffrey Frankel[4] found evidence consistent with the view that over-optimism in forecasting thrives when uncertainty is higher, and this typically occurs at both highs and lows in the business cycle – in other words, the turning points. The reason given is that forecasters over-estimate the permanence of the booms as well as the transitory nature of the busts. Hindsight in discovering this tendency is apparently ineffective in correcting it for future forecasts. Similarly, instituting a fiscal budget constraint, such as a deficit ceiling as a percentage of gross domestic product, frequently fails as it is too rigid to allow the need for deficits in recessions that are balanced by surpluses in booms.

Frankel was convinced that the over-optimism added more to the budget deficits than would otherwise occur, but the statistical evidence for this is relatively weak. The opinion seems to depend more on the literature on public choice that declares short budgetary planning horizons, arising from the relatively short terms of politicians, to be routinely a result in the politicians' desire to use their respective terms in office to grant favours to constituents who contributed to their electoral success. The most that can be said with reasonable certainty is that if such tendencies exist, then over-optimistic forecasts are likely to make it easier to fulfil them.

Forecasting Experience in Australia

For Australia, the "Review of Treasury Macroeconomic and Revenue Forecasting"[5] – or more simply "The Review" – determined that Treasury tended to under-estimate growth during economic upswings and over-estimate growth during economic downturns. Although these differences averaged out over the cycle, they could be treated, in economic modelling terms, as a bias toward the long term trend. Failure to detect such a bias would improve the ability to balance surpluses and deficits over the cycle, but knowledge that it is occurring may inspire greater government spending on the upswing by using as a rationale the notion the forecasts are more likely to under-estimate GDP growth than to over-estimate it during that phase. This, then, leaves less in the form of government savings for use in moderating the effects of the downswings. Thus, even though the bias toward the

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[3] Recent papers and abstracts for them can be found in a Cambridge journal called *Social Philosophy and Policy* at http://journals.cambridge.org/action/displayIssue?jid=SOY&tab=currentissue.

[4] Jeffrey Frankel, "Over-Optimism in Forecasts by Official Budget Agencies and Its Implications," *Oxford Review of Economic Policy*, Vol. 27, No. 4 (2011), pp. 536-562. Available for purchase at http://oxrep.oxfordjournals.org/content/27/4/536.full.pdf+html.

[5] The Review was completed in December 2012 and released on 22 February 2013. It is available online at: http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2013/forecasting_review/downloads/PDF/forecasting-review.ashx.

long-term trend is in principle beneficial, it may be easily discovered and used in a way that prevents a balance over the full cycle from being achieved. The basic point here is *not* that the system or model is necessarily faulty, but what matters is how Treasury forecasts are put into a context within the political setting and whether or not that context is counter-productive.[6]

The Review also found that Treasury's macroeconomic forecasts have been reasonably accurate. "Over the past two decades, Treasury forecasts of nominal economic growth have exhibited a mean absolute percentage error of 1.6 percentage points." These forecasts are comparable with that of other domestic forecasters. "Treasury's forecasts are also comparable with, or better than, those of official agencies overseas, although some caution is required in making cross country comparisons over a period as short as ten years, and given that official agencies prepare forecasts at different times in the year."[7]

Gareth Hutchens reported information contained in the Review shortly after it was released to the public.[8] A more recent comment from Myriam Robin reflects the added interest in Treasury forecasting after the revised budget deficit for the current year was announced.[9] Her article uses a table borrowed from *Crikey* to show the size of the forecasting error for the budget surplus/deficit from FY 1996-97 to FY2012-13. She reported that the average forecast error over that period was -$2.24 billion, with a negative sign indicating that the average forecast error symbolised a deficit.

This number is relatively high in comparison with -$5.55 billion, which is the average value for the budget outcome during the period, indicating an error of 40 percent of the average budget outcome. This is substantially larger than the 1.6 percentage point error reported in the previous paragraph as calculated in the Review. They differ because they represent different time series with different scale factors.[10] The point is that Treasury's forecasts are sometimes put into an inappropriate context and the result is likely to cause confusion, as it

[6] A similar thought appears in Daron Acemoglu and James A Robinson, "Economics Versus Politics: Pitfalls of Policy Advice", National Bureau of Economic Research Working Paper 18921, March 2013: "The main message is that sound economic policy should be based on a careful analysis of political economy and should factor in its influence on future political equilibria." The study is available for purchase at http://www.nber.org/papers/w18921.

[7] Source cited in footnote 5 above, p. xiii.

[8] Gareth Hutchens, "Treasury Admits Revenue Forecasts Out to Tune of $8b a Year", *The Sydney Morning Herald*, 23 February 2013. Available at: http://www.smh.com.au/national/treasury-admits-revenue-forecasts-out-to-tune-of-8b-a-year-20130222-2ewxh.html.

[9] Myriam Robin, "Economic Pulse: How Do Treasury's Forecasts Stack Up?" *LeadingCompany*, 22 May 2013. Available at: http://www.smartcompany.com.au/economy/055661-economic-pulse-how-do-treasury-s-forecasts-stack-up.html.

[10] The calculations for mean absolute percentage error (MAPE) in the Review were applied to the basic data series of gross domestic product and government revenue, which would then be used in the calculation of a forecast of the deficit/surplus for each respective year. The MAPE calculations were not applied to the forecast of the deficit/surplus, which is almost always much smaller in magnitude than either gross domestic product or government revenue in any given year, and also more volatile. Additional information about such a calculation can be found at http://en.wikipedia.org/wiki/Mean_absolute_percentage_error.

John Wanna published an extensive study[11] of Treasury and its role in economic policy. In it is a quote from one of Treasury's training sessions:

> The *Treasury Line* at one time could be as: *spending*, cut it – *monetary policy*, tighten it – *tax base*, broaden it – *activity*, deregulate it – *foreign investment*, approve it – and *overseas*, visit it.

Wanna's evaluation indicates that this "line" no longer exists and a broader approach acts as a possible entry into the lateral thinking process that was mentioned above. This is examined later, together other suggestions. An important contribution of Wanna's article is his historical approach in which most major events affecting Treasury since the 1980s are mentioned in sufficient detail to provide a more or less continuous account of Treasury policy. For example:

> [U]nder Tony Cole as secretary Treasury badly misread the economic forecasts and symptoms of the 1990–01 recession while Australian politics was immersed in the leadership struggle between Hawke and Keating. This led to the view widely held across government that Treasury's policy advice had been found wanting when Australia faced a major economic downturn. The department did not perform well during the recession and with hindsight admitted it misread the situation and mistimed its policy responses with a belated stimulus worsening the recovery phase.

Treasury nevertheless benefited from this experience and did not repeat the same wrong advice at the beginning of the global financial crisis. Many readers may find Wanna's comments on some of the sources of discord between Treasury and the government of the day to be interesting, and the account should be read before making strong allegations about Treasury people blindingly following their political masters. It is clear from the accounts that they did not do so in the past.

Economics editors and reporters for the major newspapers displayed a moderately aggressive attitude toward those who were quick to criticise Treasury for poor forecasts. The title of Ross Gittins' article[12] is informative – "It Takes No Brains to Kick Treasury", as is these two sentences:

> The obvious truth is no economists are consistently good at forecasting the economy. It's those non-economists who forget this - including Wayne Swan and Julia Gillard - who are the fools, not the economists who cater to humankind's irrational but unquenchable desire to pretend the future can be known.

[11] "Treasury and Economic Policy – Beyond the Dismal Science", *The Australian Journal of Public Administration*, Vol. 70, No. 4, pp. 347-364. Available to subscribers at: http://onlinelibrary.wiley.com/doi/10.1111/j.1467-8500.2011.00747.x/abstract.

[12] Ross Gittins, "It Takes No Brains to Kick Treasury", *The Sydney Morning Herald*, 20 May 2013. Available at: http://www.smh.com.au/business/it-takes-no-brains-to-kick-treasury-20130519-2jutv.html.

Jessica Irvine also uses a clearly stated title of "Stop the Rot on Treasury Forecasts". Her article[13] is particularly useful in outlining the procedure followed in the forecasting unit, which is within Treasury but separately situated.

Recommendations for Improved Forecasting

The Review made a number of recommendations to enhance Treasury's existing forecasting methodology, only two of which are mentioned here. The first is Recommendation 8 for a scenario analysis to provide a way of assessing the risks associated with specific forecasts. The International Monetary Fund, and other intergovernmental organisations, tend to use a "baseline scenario", an "upside scenario" and a "downside scenario" for medium-term projections. These are particularly useful for scenarios that are likely to produce different results for individual series or countries and they help to clarify the probabilistic nature of forecasts.[14]

The second is Recommendation 9: "Treasury should give further consideration to the appropriate balance between the top-down versus bottom-up approaches to forecasting revenue." The focus of the recommendation was on revenue since recent difficulties were more apparent with those projections, but it could be extended to other series and perhaps also to the overall process of reviewing the forecasts. Currently the members of the Joint Economic Forecasting Group meet three times a year with representatives from Treasury, the Reserve Bank of Australia, the Department of the Prime Minister and Cabinet, the Department of Finance and Deregulation and the Australian Bureau of Statistics. This is clearly a top-down approach and serves the dual purpose of informing representatives of various units about recent forecasts and allows discussion and possible critique of the results. However, this is not balanced with bottom-up discussions or by secondments of model-builders from other parts of the government and perhaps also the private sector.

Most model-builders have a tendency to become parental with regard to their own models and seem to adopt a variation of the quote from Albert Einstein shown at the beginning of this comment: *Politics is for the present, but equations [in a macroeconomic model are] for eternity.* An opportunity to ask questions as to why such-and-such was used in Equation X sometimes results in a search for alternatives that was previously neglected as a result of being subconsciously locked into the original structure of the model. Question and answer periods among model-builders could result in the lateral thinking mentioned previously.

Returning to Wanna's article, he evaluated Treasury's ability to transcend big changes in orientation from a globally small and well-ordered economy to one that is far more complex and open to the full range of external disturbances. He suggested that this was achieved as a result of Treasury seeking "to broaden its conception of economic wellbeing and provide whole of government advice rather than rely on narrow economic-ideological doctrine."

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[13] Jessica Irvine, "Stop the Rot on Treasury Forecasts", *Business Spectator*, 24 May 2013. Available at: http://www.businessspectator.com.au/article/2013/5/24/federal-budget/stop-rot-treasury-forecasts.

[14] See, for example, "Euro Area Scenarios" on page 16 of the IMF *World Economic Outlook*, April 2013. Available at: http://www.imf.org/external/pubs/ft/weo/2013/01/pdf/text.pdf.

This seems to have worked during the transition from what we were to what we are now, but what we will become is yet unknown. We would hope that Treasury does more than "keep up" with this continuing transition, and additionally extends itself in helping to inform the pace if not also the direction of the transition. For this, Treasury will probably need help from the business community and possibly also from the general public in establishing out a priority for the various components of economic wellbeing and for a strategy to move beyond the "narrow economic-ideological doctrine" while keeping that doctrine alive. This hints at greater private sector participation in the politics of economic forecasting and policy, with, perhaps, some encouragement from the quote from Plato: *One of the penalties for refusing to participate in politics is that you end up being governed by your inferiors*.

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