

Jochimsen, Beate Regina; Lehmann, Robert

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Do OECD countries cheat with their national tax revenue forecasts?

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Do OECD countries cheat with their national tax revenue forecasts?

March 1, 2015

Abstract: Nowadays, a solid budget serves as an important quality signal for the electorate. Therefore, politicians might face an incentive to influence tax revenue forecasts which are widely regarded as a key element for budget setups. Looking at the time period from 1996 to 2012, we systematically analyze whether national tax revenue forecasts in 18 OECD countries are biased through political distortions. Based on several theoretical approaches drawn from the theories of political economy, we test four hypotheses using panel estimation techniques. We find strong support for partisan politics. Left governments seem to overestimate tax revenues more than right ones to satisfy their electorate with additional expenditure plans. Contrary to the theoretical prediction based on the common pool problem, we find that more fragmented governments and parliaments tend to produce more pessimistic tax revenue forecasts. One reason might be that at least one of the incumbents will stay in office and will be part of the next government, too. We do not find empirical evidence for political business cycles or an influence of the reelection probability on tax revenue forecasts at all.

Keywords: political economy, tax revenue forecasts, fragmentation
political business cycles, electoral cycles

JEL Code: F59, H11, H30, H68, P16

1. Motivation

Nowadays, voters increasingly evaluate the quality of political performance by looking at public budgets. Raising public debts, public bailouts of private banks and the ongoing monetary and economic stress in the Euro Area contribute to shifting the focus of the electorate to sound fiscal policies. Therefore, a solid budget serves as an important quality signal for political performance. Consequently, politicians might face an incentive to influence tax revenue forecasts which are widely regarded as a key element for budget setups (see Auerbach, 1999). This view is confirmed by Chatagny and Soguel (2012) as they find that an underestimation of tax revenues leads to a significant reduction of fiscal deficits in Swiss cantons.

In the parliamentary process, drawing up the budget attains much more attention than controlling budgetary implementation.¹ Usually, drawing up the budget takes around half a year. In early summer the budget plan passes cabinet, and from September onwards it is discussed extensively in parliament before it is adopted at the end of the year. Parliamentarians and the public, thus, only briefly take notice of the report of the Court of Auditors that analyzes budgetary implementation. When the budget is set up its core elements like expenditure and revenue volumes as well as the resulting gap between them, i.e. the public deficit, become obvious. If a sound budget is regarded as a quality signal, politicians face an incentive to influence one or more of these elements. As the tax revenue forecast is the basis for the planned revenue volume, there might be an incentive for politicians to manipulate this forecast. Several arguments for this behavior can be found in the theoretical literature on political economy.

In this paper, we systematically analyze whether national tax revenue forecasts in 18 OECD countries are biased through political distortions for the time period from 1996 to 2012. Explicitly, we test whether tax revenue forecasts are systematically biased with the electoral cycle, for different ideological compositions of the governments, by a higher degree of political fragmentation or the less likely a reelection is. We find strong support for partisan politics. Left governments seem to overestimate tax revenues more than right ones to satisfy their electorate with additional expenditure plans. We do not find empirical evidence for any political business cycle or the common pool problem in fragmented governments. Thus, fragmented governments seem to be more cautious with tax projections because at least parts of their members expect to stay in office and belong to future governments, too.

Up to date, there is a broad empirical literature on the quality of revenue forecasts. A recent survey is provided by Leal *et al.* (2008). Most of the existing studies exclusively focus on rather technical aspects such as unbiasedness, rationality, judgmental and methodological issues (see, e.g., Bretschneider *et al.*, 1989; Feenberg *et al.*, 1989; Mocan and Azad,

¹How forecast errors in Italy vary over the different planning and implementation phases is intensively discussed by Cepparulo *et al.* (2014).

1995; Vorhees, 2004; Chatagny and Siliverstovs, 2013). Only some studies deal with political influences on revenue forecasts (see, e.g., Cassidy *et al.*, 1989; Bretschneider and Gorr, 1992; Ohlsson and Vredin, 1996; Paleologou, 2005; Boylan, 2008; Bischoff and Gohout, 2010; Chatagny, 2013). Most of these studies focus on electoral business cycles (Boylan, 2008; Brück and Stephan, 2006; Cimadomo, 2014) or partisan politics. For the US, some studies mentioned the influence of the dominance of political parties (see, e.g., Bretschneider *et al.*, 1989; Cassidy *et al.*, 1989; Mocan and Azad, 1995; Vorhees, 2004; Paleologou, 2005). Serritzlew (2005) and Goeminne *et al.* (2008) are – to the best of our knowledge – the only studies analyzing political fragmentation. However, they concentrate on local governments only.

International comparative studies mainly focus on the consequences of forecast errors on the budget balance. For the EU, Strauch *et al.* (2004) examine whether forecast errors are triggered by the Stability and Growth Pact. Political biases in GDP forecasts within the EU are discussed by Jonung and Larch (2006) as well as by Brück and Stephan (2006). Pina and Venes (2011) as well as von Hagen (2010) explore institutional and political influences on budget balance forecasts. The study by Jong-A-Pin *et al.* (2012) focuses on 25 OECD countries in a real-time setting. Instead of analyzing forecast errors, they use data revisions of current revenues and find distortions of these revisions with the electoral cycle. Another study which focuses on real-time data is the one provided by Cepparulo *et al.* (2014). Our study differs in several ways. An extensive survey on various forecasts and fiscal policy is provided by Cimadomo (2014). Thus, there are hardly any international comparative studies focusing on tax revenue forecasts. The existing ones mainly discuss the case of developing countries (Kyobe and Danninger, 2005), their underdeveloped institutions (Danninger, 2005) and the political economy behind that (Danninger *et al.*, 2005). Büttner and Kauder (2010) compare OECD countries and analyze how different tax revenue forecasting practices affect forecasting performance. They focus on 12 OECD countries and explain differences in forecasting performances with macroeconomic uncertainty, the importance of different taxes (e.g., the income tax), the timing of the forecast and the independence of tax revenue forecasts. However, Büttner and Kauder (2010) do not analyze any political motivated bias. The study by von Hagen (2010) examines the influence of institutional setups within the budget process on revenue projections. He finds that the position of the finance minister plays a crucial role.²

To the best of our knowledge, we are the first combining political economy arguments with national tax revenue forecasts in an international comparative study as a key aspect. We extend the data set by Büttner and Kauder (2010) by adding more countries as well as four additional years. First, we use data from national budget plans instead of forecasts made by the OECD within their half-year Economic Outlook. Second, we focus on ex-post

²The influence of the finance minister on budget performance is also intensively analyzed by Jochimsen and Thomasius (2014). For tax revenue forecasts in Swiss cantons and characteristics of the finance minister see Chatagny (2013).

observable forecast errors and not on forecast revisions since national real-time data are to the best of our knowledge not observable for all states considered here. At last, we test more hypotheses from the field of political economy (partisan theory, political fragmentation and reelection probability) and not only political business cycles.

The remaining part of this paper is organized as followed: Section 2 introduces the literature on political economy and derives our hypotheses. The institutional background of revenue forecasting is discussed in Section 3. Data and estimation methodology are described in Section 4. Section 5 presents our results, together with a large amount of robustness checks. The last Section 6 concludes.

2. The Political Economy of Revenue Forecasting

Within the literature on political economy different theoretical approaches exist to address the relevant problems. In this paper, we choose on the most suitable approaches for analyzing revenue forecasting. Therefore, we concentrate on the rich literature in the field of political economy explaining the evolution of public deficits. As overestimated future tax revenues can be seen as substitutes for an explicit deficit, this literature is relevant for an analysis of the political economy of revenue forecasting. We use the term 'overestimation' in a broad sense, i.e., tax revenue is either literally overestimated or less underestimated.

Overestimating tax revenues opens up two main options for the incumbent government. First, it might plan higher expenditures or lower taxes keeping estimated deficits constant. Or second, it might keep planned expenditures and tax rates constant and lower the estimated deficit. These two options are both sides of one coin.

Politicians face incentives to overestimate tax revenues to demonstrate their fiscal competence. This competence can be shown at two stages within the budgetary procedure. First, overestimated tax revenues might support the fiscal competence of a politician *in the drafting and planning process* of the budget. If forecasted taxes are high, planned expenditures can be high(er), too, or estimated deficits can be low(er). Thus, the politician shows fiscal competence for the **future**. No real fiscal or economic consequences occur. Second, overestimated tax revenues might support the fiscal competence of a politician *in the implementation phase* of the budget. If forecasted taxes are high, **realized** expenditures during the entire fiscal year can be high(er), too. In this setting, higher expenditures might have had real economic consequences like lower unemployment or higher transfer payments. Consequently, the electorate would not only appreciate the politician's fiscal competence but would also feel a real improvement in living conditions. Of course, overestimated taxes followed by too high expenditures lead to rising deficits. Therefore, the described mechanisms only work if at least some voters are myopic or if voters are rational and there is only a weak and publicly not noticed budgetary control.

In this section, we review the most relevant theoretical literature and derive the hypotheses to be tested later on. We test four theoretical approaches, namely political business cycles, partisan politics, fragmented governments and the probability of reelection.

2.1. Political Business Cycles

Opportunistic governments are primarily interested in being reelected without having any ideological motives (Nordhaus, 1975). Alesina and Perotti (1994) as well as Persson and Tabellini (1997) show that the government has an incentive to boost the economy prior to elections to appear competent to voters and thereby increase the chances of being reelected. Higher expenditures or tax cuts can lead to higher output or lower unemployment in the short-term raising popularity of the incumbent government (Hibbs, 1977; Franzese, 2002). Let us assume that year t is an election year. Then, the government has an incentive to overestimate revenues for year t with the forecast made in $t - 1$ because this way spending options seem to be larger in t than otherwise. Voters might be impressed by the large expenditure plans in the budget and might assume that these planned higher expenditures drive output and unemployment in the desired directions. Consequently, it is more likely that they vote for the incumbent government. Therefore, we can derive the following first hypothesis:

Hypothesis 1: *Tax revenues are overestimated for election years.*

Normally, this strategy only works with fiscal illusion. Then, voters do not (completely) anticipate two aspects. First, planned expenditures are not realized and consequently output and unemployment are not driven in the desired directions. Second, higher expenditures lead to higher debt and that these higher debt burdens must be borne after elections. However, Rogoff and Sibert (1988) showed that political business cycles may also exist under rational expectations. Their theoretical approach is based on temporary information asymmetries between government and voters. Keeping expenditures constant and overestimating taxes, the government tries to exploit its information advantage by apparently running lower deficits. Thereby, the incumbent signals competence as, seemingly, expenditures can be provided more efficiently, i.e. with lower deficits.

For other years, politicians do not face an incentive to overestimate tax revenues. Particularly if voters are myopic (van Dalen and Swank, 1996; Galli and Rossi, 2002), popularity gains in non-election years do not increase the reelection probability in election years. Empirical evidence for political business cycles is rather mixed. Amongst many, Brender and Drazen (2008), find in an extensive study no support whereas de Haan (2014) does.

Recently, this rather traditional theoretical approach to political business cycles has been challenged by Brender and Drazen (2005). They argue that the empirical finding of opportunistic behavior is driven by the inclusion of young democracies. Fiscal manipulation

can only work in the absence of data availability or of the ability to report and analyze the relevant data (this might refer to Rogoff and Siebert's asymmetric information) or in lack of deeper understanding an electoral system. 'Old' or more experienced democracies do not show these characteristics. Following this approach, we might not find political business cycles as the 18 OECD countries of our sample are mainly 'old' democracies.

2.2. Partisan Theory

According to partisan theory, government politics are primarily driven by ideological motives. It predicts a more expansionary policy for left governments than for right ones because left governments are typically more inclined to redistributive policies. Therefore, public spending may be used to mitigate income inequality by increasing transfers. Furthermore, left parties are more willing to run deficits since their voters benefit more from declining unemployment than they are harmed by the impacts of higher deficits or inflation (see, e.g., Hibbs, 1977).

As parties also care about winning the next elections, it might be short sighted to assume that a party's policy is solely driven by ideological motives. In an electoral competition both parties, equally well informed and caring to win the elections, will adopt the same platform – the one that maximizes the probability of being reelected. Once elected, the governing party will deviate from the announced platform and implement their most favored policies. Irrational voters may not anticipate the party's incentive to deviate and partisan effects may result. Alesina (1988) extend this theoretical attempt to rational voters. He explored that partisan politics might also occur under rational expectations if the parties' discount factor is rather low, i.e., in a situation where reputation only plays a minor role.

Still, empirical evidence for this theory is rather weak. For the members of the European Union, de Haan and Sturm (1994), for example, find that government's ideology does not affect budget deficits. Analyzing 22 OECD countries, Volkerink and De Haan (2001) also conclude that left governments do not run higher deficits than right-wing incumbents. According to their study, only in the seventies, government ideology seemed to have mattered. Then, right governments ran lower deficits than left ones.

In our setting, running deficits can be substituted by overestimating tax revenues. Therefore, we can write our next hypothesis as:

Hypothesis 2: *Left governments tend to overestimate tax revenues more than right governments.*

2.3. Political Fragmentation

In the theoretical literature as well as in the political discussion, the fragmentation of the policymaking process is often made responsible for loose fiscal policy (e.g., Roubini and Sachs, 1989a,b; Volkerink and De Haan, 2001; Perotti and Kontopoulos, 2002). Perotti and

Kontopoulos (2002) define 'fragmentation' as the degree to which each politician internalizes the cost of one dollar of aggregate expenditures. In a coalition government, for instance, each coalition partner tries to allocate as much of the budget as possible to its supporting interest groups. Coalition partners suggest spending proposals that are asymmetric in the way that benefits primarily go to their favorite interest groups whereas costs are equally shared amongst all coalition partners. Consequently, costs are not fully internalized. Thus, coalition governments face a common pool problem. This common pool problem is likely to increase with the number of coalition partners because the fraction of internalized costs decreases with coalition size. Instead of looking at the sheer number of coalition partners, one could also take the number of spending ministers in a government as an indicator for fragmentation. Each spending minister tries to serve his or her constituency. In this case, a similar common pool problem emerges. Following Perotti and Kontopoulos (2002), we test different definitions of fragmentation in our setup. They also look at procedural fragmentation. However, this is not the focus of this paper.

Most fragmentation theories are based on the assumption that governments draft the budget and – as they usually have a majority in parliament – thereby de facto set them. However, parliamentarians might criticize the government's budget drafts. Depending on factors like size of the majority of seats, strengths of the whip or political culture parliamentarian's influence on the final budget might be substantial. Volkerink and De Haan (2001) discuss the potential influence of the parliament's fragmentation on fiscal performance in detail. If the government faces a more fragmented parliament, it is the less likely that the opposition forms a unity against the incumbent. We refer to the discussion by Volkerink and De Haan (2001) and extend our hypothesis from fragmented governments to fragmented parliaments.

The theoretical idea can be applied to tax revenue forecasts as well. More optimistic forecasts ease budget negotiations within the government because the common pool of resources seemingly expands. More coalition members or more spending ministers can bring forward policies to satisfy their electorate which eases the drafting of the budget and prevents difficult budget negotiations. Analogously, budget implementation in parliament is eased by simply overestimating tax revenues. This argumentation leads to our next hypothesis:

Hypothesis 3: *More fragmented governments or parliaments tend to overestimate tax revenues more heavily.*

2.4. The Reelection Perspective

The more the incumbent government doubts that it will be reelected, the higher are its incentives for using debt strategically. By raising debt prior to elections to an inefficient high level, the incumbent can afford more spending programs or tax cuts and, thereby, limit the scope of action of the following government (Persson and Svensson, 1989). From the literature of strategic use of debts we can derive that an overestimation of tax revenues is

expected when the chance of reelection of the incumbent party is unlikely. This theory is known as the 'stubborn conservative governments'-hypothesis (Tabellini and Alesina, 1990). The conservative incumbent wants to prevent the left-wing successor to spend money on expenditures which they believe to be unnecessary (Pettersson-Lidbom, 2001; Sutter, 2003). This argument is also valid vice versa, i.e., an incumbent left government wants to bind future governments to pursue left policies by increasing the deficit prior to elections. Ideally, to empirically test this argument, reelection probabilities should be taken as independent variables that might influence overestimation in revenue forecasting. As these reelection probabilities are not available we have to look for best proxies. We elaborate more on this when it comes to describe our data. Here, in the theoretical background chapter, we can derive the following general hypothesis:

Hypothesis 4: *The lower the reelection probability for the incumbent government is, the more it tends to overestimate tax revenues.*

3. Institutional Background of Revenue Forecasting

Although it is not the focus of this analysis, institutional characteristics will have an impact on forecasting performances. Therefore, we provide a broad overview on crucial institutional settings and describe their variation within our country sample.

One important institutional aspect of revenue forecasting is, whether forecasts are independent from political actors and influence. Revenue forecasting is assigned to agencies differing widely in their political independence. The least independent option is to allocate responsibility for forecasts directly to the government, e.g., to a department of the Ministry of Finance as in Belgium, France, Iceland, Ireland, Italy, Japan, New Zealand, Norway, Switzerland or the UK. In those cases, political actors can easily influence tax revenue forecast results. In other countries, responsibility is divided between the government, experts from academia, forecasting agencies and the central bank (e.g., Germany) or between different government agencies like in Australia. By delegating revenue forecasts entirely to independent research institutes, the Netherlands most strictly limit the influence of the executive branch (see among others Büttner and Kauder, 2010, for more details). Independence of revenue forecasts is equally challenged if macroeconomic forecasts produced by the government or government agencies have to be used in the revenue forecasting process. In our sample, only few countries use external macroeconomic forecasts (e.g., Austria, Belgium, Canada).

A second institutional characteristic of revenue forecasts varying between the sample countries are technical and organizational conditions like estimation methods or the number of taxes that is forecasted. The first ranges from basic extrapolation methods based on past developments to sophisticated econometric methods like time series analyses. Thus, in all

countries a mix of different forecasting methods is used, mostly because tax revenue forecasts are broken down into many tax types. Austria, for example, mostly uses trend extrapolation; whereas Canada heavily relies on elasticity methods and the UK on micro simulations (see Büttner and Kauder, 2008). Norway takes into account various behavioral effects.

Third, the timing within the budget process influences tax revenue forecasting quality (Danninger *et al.*, 2005). Across countries, there are differences in the time span between tax revenue forecasts and the start of the forecasted fiscal year. Whereas in Ireland, in the UK and in Sweden revenue forecasts are made less than a month before the budget is set up, in Germany and the US, tax revenues are forecasted roughly eight months before the budget passes parliament. Büttner and Kauder (2010) find that the timing of forecasting significantly influences forecasting quality. The earlier the forecast is carried out, i.e., the larger the time span between forecast and budget endorsement, the larger is the forecasting error.

Finally, our sample countries show a wide variation in their general institutional setup. For our analysis we choose two aspects to illustrate these differences. First, the tax structure of the country may differ. Instead of relying on a few large taxes, a country might have many small taxes. This might reduce forecast errors provided that the tax bases of those small taxes are not closely correlated (Büttner and Kauder, 2010). Second, the centralization of countries is different. Canada, the US, Belgium, Switzerland, Spain and Germany, for example, are fiscally decentralized countries where not only the central government but regions or local jurisdictions have tax setting power. This may lead to less accurate tax revenue forecasts if actors from different layers of government have to be involved in the forecasting process as coordination effort gravely increases. However, in Germany, Belgium, and Switzerland, for example, tax revenue forecasts are fully centralized although all of them fiscally decentralized countries. Thus, effects of centralization on tax revenue forecasts might be negligible.

All the described varying institutional backgrounds of our sample countries do not change over time or only have minor variation. The focus of our analysis is not to determine characteristics of revenue forecasting accuracy **between** countries but to test if forecasts are influenced by political economic factors **within** countries. We elaborate more on this in the section where our estimation strategy is presented. However, we provide a large amount of robustness checks. Among other things we show estimation results for different sub-samples.

4. Data and Empirical Strategy

We start our empirical analysis by expanding the data set from Büttner and Kauder (2010). They have tax revenue forecasts and tax revenues for 12 OECD countries for the time period from 1996 to 2008. However, the panel data set is not strongly balanced since some countries did not report tax revenue forecasts for several years. We add six more countries and four

more years. In the end, we can rely on a panel data set of 18 OECD countries, running from 1996 to 2012.³ Our panel data set offers a rich source of variation to find potential political distortions in revenue forecasts among countries. First, the large cross-section dimension covers many countries with different government sizes and political systems. Second, the time span of our data comprises on average more than four elections per country.

Before we describe our data in detail, we start by presenting our baseline specification to measure potential political distortions in tax revenue forecasts. Our basic empirical model has the following form,

$$\begin{aligned}
 FEPERC_{s,t} = & c + \beta_1 CYCLE_{s,t} + \beta_2 PARTISAN_{s,t} + \beta_3 FRAG_{s,t} \\
 & + \beta_4 REELECT_{s,t} + \sum_{i=5}^9 \beta_i X_{i,s,t} + a_s + \nu_t + \varepsilon_{s,t}.
 \end{aligned} \tag{1}$$

As the dependent variable, we use the ex-post percentage forecast error (*FEPERC*). It shows the over- or underestimation of tax revenues in terms of realized revenues for every state s in year t and is calculated as followed:

$$FEPERC_{s,t} = \frac{PTR_{s,t|t-1} - RTR_{s,t}}{RTR_{s,t}},$$

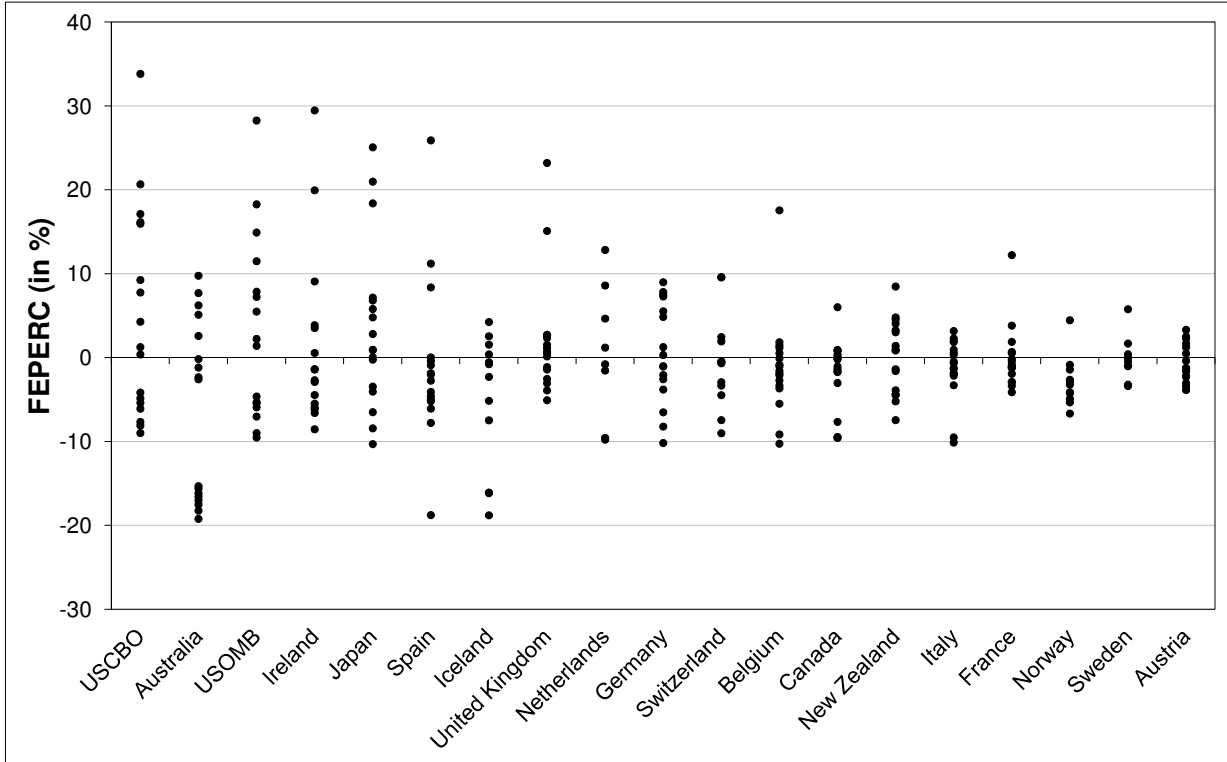
with $PTR_{s,t|t-1}$ = in $t-1$ projected tax revenues of state s for the fiscal year t and $RTR_{s,t}$ = realized tax revenues of state s for year t . Rather than looking at forecasts made within the actual fiscal year, we use $PTR_{s,t|t-1}$ from the previous fiscal year $t - 1$. For example, if 2012 is the year of interest, then we look at $PTR_{s,2012|2011}$ obtained in 2011. We look on ex-post forecast errors since we cannot account for different data vintages. Therefore we do not analyze a real-time setting as in Jong-A-Pin *et al.* (2012) or Cepparulo *et al.* (2014).

Our dependent variable is a typical forecast error with a natural interpretation. Whenever *FEPERC* shows a positive (negative) sign, future tax revenues were overestimated (underestimated). We cannot divide the forecast error in different sources (e.g., macroeconomic uncertainty or technical issues) as in Auerbach (1999). So we decided to use the total forecast error in our analysis. Table 7 in the Appendix provides some descriptive statistics of all variables in our data set. On average, the percentage forecast error is slightly negative (-0.2%) but shows a high standard deviation of 7.9%. The root mean squared percentage forecast error (*RMSPFE*) reaches almost 8.0%. Figure 1 presents the percentage forecast errors for each country in the sample. The countries are arranged in descending order by the standard deviation of individual forecast errors. Each dot in the figure represents one single forecast error from a specific year. In terms of standard deviation in forecast errors,

³Our countries in the sample are: Australia, Austria, Belgium, Canada, France, Germany, Iceland, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom and the United States of America. However, our cross-section dimension is 19, since we have two competing forecasts for the US: one from the executive and the other from the legislative.

the US and Australia show the less accurate tax revenue forecasts. On average, the best forecasts are produced in Norway, Sweden and Austria. All in all, the data offer a rich source of variation to find possible political distortions in tax revenue forecasts. We elaborate more on this when it comes to describe our estimation methodology.

Figure 1: Percentage forecast errors for each state



Source: Büttner and Kauder (2010), authors' calculations, extensions and illustration.

Before we introduce our variables of interest, we briefly discuss our bunch of control variables ($X_{i,s,t}$). With our data set we are not able to observe national gross domestic product (GDP) forecasts and, therefore, cannot detect to what extend national GDP forecast errors are responsible for tax projection errors. To solve this problem, we choose nominal GDP growth forecasts for each state s , provided by the OECD ($GDPFORE_{s,t}$) as a suitable proxy. The OECD publishes its GDP forecasts twice a year, in June and in December, in their OECD Economic Outlook. To be in line with the timing of tax revenue forecasts, we decide to use OECD's GDP forecasts for year t made in June in $t - 1$. As one can see from the descriptive statistics in the appendix, there is a huge variation in GDP forecasts observable (Std. Dev. 1.92%). A more optimistic forecast for economic output leads to higher projected tax revenues in a given year. Holding projected tax revenues fixed, a higher growth rate of nominal GDP causes a less positive or more negative forecast error of tax revenues. Whenever the economy develops worse than expected, tax revenue forecasts will be biased upwards. We expect a positive sign of $GDPFORE_{s,t}$.

As it was brought forward by Boylan (2008), the unemployment rate ($UR_{s,t}$) plays a crucial

role for the accuracy of fiscal forecasts. The average unemployment rate in our sample is 6.55%. Boylan (2008) has shown that in times of high unemployment, states in the U.S. overestimate tax revenue changes. We expect a positive sign of the unemployment rate.

The next variable is the population of a country ($POP_{s,t}$), controlling for potential size effects. In our sample we have countries with a very small number of inhabitants (e.g. Iceland) or countries with a very large population size (e.g. the US). As mentioned by Goeminne *et al.* (2008), the sign of the coefficient of $POP_{s,t}$ is not certain. Rising complexity and therefore more difficult forecasts lead to overoptimism in tax projections (Duru and Reeb, 2002; Goeminne *et al.*, 2008). This causes a positive effect of population. A negative sign can be possible due to a more efficient tax administration. Whenever the performance of tax authorities rises, $RTR_{s,t}$ must be relatively higher in relation to $PTR_{s,t|t-1}$. If this is true, then population has a negative effect on tax revenue forecast errors.

We control for possible tax base changes by introducing the population growth rate $POPGR_{s,t}$. A negative sign is expected. Whenever population growth is wrongly anticipated ex-ante, this leads to smaller or more negative tax revenue forecast errors ex-post. A growing population (e.g. through a positive net migration) increases tax revenues, thus, ceteris paribus, reducing $FEPERC_{s,t}$. We observe on average a population growth in our sample.

Furthermore, we introduce the tax quota of a country ($TAXQ_{s,t}$) measured as tax revenues divided by nominal GDP. We apply this variable as a proxy for tax revenue elasticities to a certain tax base (here: nominal GDP). Since elasticity-based methods are the most important techniques and often used by different countries (see Büttner and Kauder, 2008; Leal *et al.*, 2008), we try to capture wrongly anticipated elasticities with this proxy variable. An upward-biased elasticity used to generate the forecast leads, ceteris paribus, to overoptimistic forecasts, thus, the sign of the coefficient should be positive. However, in line with the argumentation of $POP_{s,t}$, higher tax quotas represent size effects. The higher the tax quota of a certain country, the more important are tax revenues for the economy. This importance may cause a more efficient tax administration, thus, leading to a negative sign. We leave this as an empirical matter. Our sample comprises countries with a low tax quota (e.g. Japan) or countries with a very high share of taxes to GDP (e.g. the Scandinavian countries such as Norway and Sweden).

Our main hypotheses derived in Section 2 are tested with the following political variables that are all taken from either the *Comparative Political Data Set III 1990-2012* (see Armingeon *et al.*, 2014) or the *Political Data Yearbook*.⁴ All political variables are measured at the central government level.

Possible political business cycle effects are covered via the variable $CYCLE_{i,s,t}$. In a first step, we code election years ($ELCTY_{s,t}$) with a dummy variable. As an example, the variable

⁴The data from the Political Data Yearbook can be downloaded from the interactive data base under <http://www.politicaldatayearbook.com>.

$ELCTY_{s,t}$ takes a value of one when t is a year where an election took place. The descriptive results reveal that almost one third of all years in our sample are election years. We expect a positive sign in election years ($\beta_1 > 0$). In a second step, we consider the exact election dates. If an election took place within the first six months of a year t , the year $t - 1$ is coded as the election year. So July 01 is the cut-off date for the election. We therefore name this variable $ELCTYCUT_{s,t}$.

The variable $PARTISAN_{s,t}$ stands for the effects presumed by the partisan theory. First, we test the hypothesis by introducing the Schmidt-Index ($SCHMIDT_{s,t}$), representing cabinet composition. This index is defined as followed: $SCHMIDT \in \{1, 2, 3, 4, 5\}$ (see Armingeon *et al.*, 2014). It takes a value of one when a hegemony of right-wing and center parties governs a country. The value of two is obtained when left wing parties have less than 33.3% of total cabinet posts. The Schmidt-Index takes a value of three, when a balance between left- and right-wing parties is observed in a country. Values four (left-wing parties with more than 66.6% of all cabinet posts) and five (hegemony of left-wings) are constructed in a similar way to values one and two. The average of the Schmidt-Index in our sample is 2.32. Thus, on average, more right-wing governments are present in our data. Second, we substitute the Schmidt-Index through a simple Ideology-Dummy ($IDEO_{s,t}$). It takes a value of one, when the governing party is left-wing. Right-wing incumbents are denoted with zero. As stated in Section 2, we expect positive signs for $SCHMIDT_{s,t}$ and $IDEO_{s,t}$ ($\beta_2 > 0$). Thus, left governments are more optimistic or less pessimistic than right-wing incumbents.

The different forms of political fragmentation are covered by $FRAG_{s,t}$. We measure fragmentation with six different attempts. Five of these six attempts capture fragmentation of the ruling government, one captures legislative fragmentation. We start by describing the attempt for legislative fragmentation. To measure legislative fragmentation we use a Rae-Index ($RAE_LEG_{s,t}$). It takes into account the share of seats (p) of every party m in parliament and is defined as $RAE_LEG = 1 - \sum_{m=1}^M p_m^2$ and possibly measures the position of the government against the opposition. To account for governmental fragmentation, we follow the literature in several ways. First, we simply count the number of coalition members ($NUMCOAL_{s,t}$) of the ruling government. Second, we apply the effective number of coalition partners in a government ($EFFNUMCOAL_{s,t}$). Instead of simply counting coalition members, the number of each party's spending ministers serves as the weighting scheme. We apply a standard inverse Hirschman-Herfindahl-Index: $EFFNUMCOAL_{s,t} = 1 / \sum_{j=1}^J sm_{j,s,t}^2$, whereas $sm_{j,s,t}$ is the share of the number of spending ministers each coalition member j supplies. Thus, we explicitly account for the distribution of political power within a coalition. We predominantly find two party coalitions in our data. However, we observe a maximum of five coalition members. Third, we use the sheer number of spending ministers as a measure of fragmentation ($SPENDMIN_{s,t}$). Fourth, we apply the concept of the Rae-Index to governmental fragmentation ($RAE_GOV_{s,t}$), measuring how fragmented the incumbent government is. Assuming that optimism is unlikely

to increase linearly in the number of parties, ministers or parliamentarians, we also test for a possible non-linearity in the effect of fragmentation by, fifth, including two dummy variables: (i) $SINGLE_{s,t}$ has a value of one whenever a single majority is the incumbent and (ii) $LARGE_{s,t}$ has a value of one whenever more than two parties are represented in government with two party governments as the reference category. In sum, we have four variables and two dummies ($NUMCOAL_{s,t}$, $EFFNUMCOAL_{s,t}$, $SPENDMIN_{s,t}$, $RAE_GOV_{s,t}$ and $SINGLE_{s,t} + LARGE_{s,t}$) measuring the fragmentation of governments and one variable ($RAE_LEG_{s,t}$) for parliament's fragmentation. For all variables, we expect $\beta_3 > 0$; for the two dummies, we expect a negative sign for $SINGLE_{s,t}$ and a positive sign for $LARGE_{s,t}$. This would imply a positive linear effect of fragmentation. Thus, whenever the two dummies show other signs, the fragmentation effect has either a U-shaped or inverse U-shaped form.

The most obvious proxy for the reelection probability is the election result itself. Assuming that incumbents correctly anticipate election results, we can take these results as a proxy variable for reelection probabilities ($REELECT_{s,t}$). Assume that election results clearly confirm the government in office. If these results were correctly anticipated than the pre-election government had no incentive to overestimate taxes. If, contrariwise, the pre-election government correctly anticipated that it won't be reelected, it had an incentive to overestimate revenues. Therefore, the election results of the incumbents enter the baseline regression with a time lead of one year. We expect that $REELECT_{s,t}$ has a negative sign. Armingeon *et al.* (2014) also provide a dummy variable whether the ideological composition of the cabinet has changed from one to another year ($NEWGOV_{s,t}$). We use this dummy variable also with a time lead of one year to capture the potential anticipation of the incumbent due to a changing government in the future. Since $NEWGOV_{s,t}$ is coded in another way than $REELECT_{s,t}$, we expect a positive sign here. If the incumbent anticipates that the ideological composition will change in the next year, then we should observe an overestimation of tax revenues.

One might also think of taking the number of coalition partners as a suitable proxy for reelection probability. The more parties form a coalition, the higher the likelihood that one coalition partner will be part of the post-election government, too. Particularly, if it is unsure for the existing coalition partners whom of them will be part of the post-election government, none of them has an incentive to overestimate tax revenues any more. Therefore, tax revenue forecasts might be less optimistic or even underestimated. Following this idea, we take the five variables of fragmentation not only to measure government's fragmentation but also to account for reelection probability. However, to confirm Hypothesis 4 the coefficient of these variables should be negative, i.e. the more fragmented the government, the less overestimated or the more underestimated are tax revenues.

a_s are country fixed-effects, covering the unobservable heterogeneity between the countries in our sample. Every non-time varying effects such as tax revenue estimation techniques, independence of the forecasts, institutional frameworks etc. are covered by those fixed-

effects. In the end, all these factors will not influence the coefficient estimates of our political variables. Additionally, a fixed-effects approach is a suitable way to measure the effects of our political economic hypotheses since we are interested in the within variation of the countries. We introduce year dummies ν_t to capture potential business cycle effects or macroeconomic shocks. c is a constant and $\varepsilon_{s,t}$ an idiosyncratic error term. We performed stationarity tests on the variables to avoid the problem of spurious regression. Our baseline model from Equation (1) is then estimated via standard OLS techniques. Among others, we apply other estimation techniques as robustness checks. We elaborate more on this point in Section 5.2.

5. Results

5.1. Political Distortions in Tax Revenue Forecasts

Table 1 presents our baseline regression results obtained from Equation (1). In this baseline regression, we use the standard election dummy ($ELCTY_{s,t}$), without taking care of the election date, the Schmidt-Index for partisan effects and in models (1) to (4) the Rae-Index for legislative fragmentation ($RAE_LEG_{s,t}$). In the models (3)' and (4)' we substitute the Rae-Index for legislative fragmentation with the two dummies $SINGLE$ and $LARGE$ to detect potential effects of governmental fragmentation. All regressions include country fixed-effects ($C-FE$). Models (1) and (2) do not include any control variables. All even-numbered models incorporate time dummies, indicated by the row $T-FE$.

From Table 1 we can conclude that no political business cycles exist at all. The election dummy fails to reach any statistical significant level in all considered models. Additionally, it has the wrong sign. Hypothesis 1 can therefore not be confirmed.⁵ We find a positive and robust coefficient for partisan effects ($SCHMIDT$), so that left-wing governments tend to produce more optimistic or less pessimistic tax revenue estimates than right-wing incumbents. This is a clear verification of Hypothesis 2. The effect of legislative fragmentation shows the opposite sign as theoretically predicted from Hypothesis 3. However, it is in line with our Hypothesis 4 and the existing literature (see Goeminne *et al.*, 2008). A higher level of fragmentation leads to less optimistic or more pessimistic revenue forecasts for the following reasons: First, larger coalitions represent – in parliament as well as in the government – a broader part of the population. So, minor interest groups have limited power to influence policy. This circumstance makes over-optimistic revenue forecasts and thus a higher expenditure level less attractive. Second, more parties in a coalition and the resulting struggle of those, increase the power of the finance minister (see von Hagen, 2010; Chatagny, 2013; Jochimsen and Thomasius, 2014). Because this minister has no incentive to bias the forecasts, overoptimism should decrease with more coalition members. Third, as

⁵Instead of using $FEPERC$ as the dependent variable, we also tested the political business cycle hypothesis with the absolute percentage error. However, we find no significant effect at all.

mentioned in Section 2, probably one party from a broad-based coalition will stay in office in the next legislative period. Thus, overoptimistic revenue forecasts and therefore higher deficits ex-post are no longer attractive for them. This leads to the negative coefficient of $RAE_LEG_{s,t}$.

Table 1: Baseline estimation results

Variable	(1)	(2)	(3)	(4)	(3)'	(4)'
ELCTY	-0.0024 (0.0062)	-0.0038 (0.0062)	-0.0066 (0.0059)	-0.0066 (0.0060)	-0.0086 (0.0063)	-0.0086 (0.0061)
SCHMIDT	0.0099 (0.0067)	0.0099* (0.0049)	0.0096** (0.0044)	0.0094** (0.0041)	0.0076* (0.0042)	0.0078* (0.0041)
RAE_LEG	-0.0031*** (0.0009)	-0.0018 (0.0012)	-0.0036** (0.0015)	-0.0027** (0.0012)	–	–
SINGLE	–	–	–	–	0.0459** (0.0166)	0.0361** (0.0151)
LARGE	–	–	–	–	0.0304 (0.0274)	0.0201 (0.0233)
REELECT	-0.0009 (0.0008)	-0.0006 (0.0009)	-0.0004 (0.0011)	-0.0004 (0.0011)	0.0011 (0.0011)	0.0007 (0.0010)
GDPFORE	–	–	0.0087** (0.0031)	0.0056 (0.0070)	0.0086** (0.0034)	0.0048 (0.0076)
UR	–	–	0.0056** (0.0023)	0.0039 (0.0039)	0.0062** (0.0027)	0.0047 (0.0040)
POP	–	–	1.05e-09 (8.33e-10)	2.28e-09** (8.57e-10)	1.40e-09 (9.32e-10)	2.58e-09** (9.62e-10)
POPGR	–	–	0.7510 (0.7370)	0.0236 (0.7150)	0.5591 (0.8533)	-0.1532 (0.8577)
TAXQ	–	–	-0.0257*** (0.0054)	-0.0168*** (0.0046)	-0.0227*** (0.0056)	-0.0142*** (0.0047)
c	0.2170** (0.0754)	0.1290 (0.0993)	0.9880*** (0.2940)	0.5920** (0.2340)	0.5384** (0.2524)	0.2401 (0.2041)
C-FE	YES	YES	YES	YES	YES	YES
T-FE	NO	YES	NO	YES	NO	YES
R ² (within)	0.0420	0.3349	0.3213	0.4667	0.3174	0.4628
Obs.	283	283	281	281	281	281

Note: Robust standard errors in parentheses.

***, **, * indicate statistical significance at the 1%, 5%, 10% level.

This result is confirmed by the two dummies for governmental fragmentation. The *SINGLE* dummy is positive and highly significant, meaning that single party governments tend to be more optimistic than larger governments. The *LARGE* dummy fails to be statistically significant. In total, fragmentation seems to have a negative non-linear impact on tax revenue forecast errors. For Flemish municipalities, such as result has also been found by Goeminne *et al.* (2008). At last, the reelection variable has the right sign but fails to be statistically significant different from zero. This result is not in line with our fourth hypothesis.

We suggest that reelection probabilities have no additional explanatory power apart from the fragmentation argument.

Turning to the control variables, we find that *GDPFORE* has the expected positive sign. This variable seems to have a significant impact. However, this impact vanishes after controlling for time fixed-effects. The same result holds for the unemployment rate (*UR*). It has the expected sign but fails to reach significance after estimating a two way fixed-effects model. Population (*POP*) seems to have a positive impact on forecast errors thus with rising complexity the more overestimated tax revenues are. The coefficient of population growth varies heavily between the different models and fails to have any significant impact. Instead of showing the expected negative sign, in most cases population growth seems to have a positive impact on tax revenue forecast errors. A possible explanation is provided by Goeminne *et al.* (2008) for firm growth. They suggest that forecasters may overestimate the movement of local firms. For our purpose it could be the case that population forecasts are too optimistic, thus leading to overestimated tax projections. Turning to the last control variable, the tax quota (*TAXQ*), we find a highly significant and robust negative effect in all baseline specifications. The negative sign can be an expression of a more efficient tax administration thus leading to more pessimistic or less optimistic tax revenue forecasts. Another explanation is an underestimation of the overall tax elasticity of tax revenues to GDP. An underestimation leads *ex ante* to a lower level of predicted tax revenues. Holding this constant, higher tax revenues *ex post* lead to more negative or less positive forecast errors. We leave this for further investigations and now turn to several robustness checks.

5.2. Robustness Checks

To confirm or even strengthen our baseline results, we run several robustness checks. In detail, we check the robustness of our results via three different approaches. First, we run robustness checks on the variables of interest and the controls. Second, we experiment with different methodological approaches. And at last, we estimate the effects for different sub-samples just to confirm that the results are not driven by outliers.

5.2.1. Robustness Checks on the Variables

(a) Robustness on the GDP control variable

To check the validity of our results, we perform robustness checks by changing the control variable for GDP. Instead of using the sheer forecast of nominal GDP, we experiment with four different types of models. First, we substitute the forecast via the percentage forecast error of nominal GDP (*GDPERR*). Second, we use the estimated output gap (*OGAP*) as a proxy to detect whether tax revenue forecast errors are driven by the capacity utilization of the specific economy. In the third model we just use the growth rate of nominal GDP as a control variable (*GDPGR*). At last, we simply exclude GDP or any measure to capture false

predicted output growth. Table 2 presents the result of these four models. All in all we can confirm our baseline results from the previous section. Left-wing incumbents overestimate tax revenues even more, or are less pessimistic, than right-wing governments. We still find the negative fragmentation effect in the data. Not only legislative fragmentation matters, governmental fragmentation also has a negative impact. However, the latter effect is not significant in all specifications and is thus not shown here. As in the baseline regression, our measures for election and reelection probabilities have no significant effect.

Table 2: Estimation results – robustness on the GDP control variable

Variable	(1) GDPERR	(2) OGAP	(3) GDPGR	(4) without
ELCTY	-0.0048 (0.0059)	-0.0077 (0.0062)	-0.0062 (0.0061)	-0.0076 (0.0064)
SCHMIDT	0.0087* (0.0044)	0.0088** (0.0042)	0.0085* (0.0043)	0.0093** (0.0042)
RAE_LEG	-0.0027** (0.0012)	-0.0025** (0.0012)	-0.0025* (0.0012)	-0.0026** (0.0012)
REELECT	-0.0004 (0.0009)	-3.77e-05 (0.0010)	7.46e-05 (0.0010)	-0.0001 (0.0009)
c	0.6150** (0.2400)	0.6190** (0.2190)	0.6430** (0.2410)	0.6100** (0.2240)
Controls	YES	YES	YES	YES
C-FE	YES	YES	YES	YES
T-FE	YES	YES	YES	YES
R ² (within)	0.4924	0.4680	0.4866	0.4629
Obs.	281	281	281	281

Note: Robust standard errors in parentheses.

***, **, * indicate statistical significance at the 1%, 5%, 10% level.

(b) Robustness on the political variables

The next robustness checks cover the modification of the political variables. Instead of presenting another table, we only discuss our results in a qualitative way. The substitution of our election dummy through the cut-off coded variable (*ELCTY**CUT*) does not reveal any new insights. The coefficient of the cut-off variable fails to reach any level of statistical significance. All other results remain the same as in the baseline regression.

Now let us turn to the partisan variable. Substituting the Schmidt-Index with a simple ideology dummy (*IDEO*) confirms our results for the partisan theory. The coefficient of the ideology dummy is positive in any specification, i.e. left governments overestimate tax revenue more than right ones. However, the dummy shortly fails to reach statistical significance (p-value 0.126). Obviously, the dummy is less able to capture the complete ideological spectra than the Schmidt-Index. Therefore and since in almost all other specifications the Schmidt-Index is highly significant, we concentrate our discussion on the Schmidt-Index results.

Instead of using the two dummies *SINGLE* and *LARGE* for governmental fragmentation, we substitute those two by our four other variables (*NUMCOAL*, *EFFNUMCOAL*, *SPENDMIN*, *RAE_GOV*). Overall, our results are confirmed as the coefficient shows the anticipated negative sign in all specifications and is mostly significant, too.

Finally, we discuss the 'robustness' of our reelection variable. The dummy *NEWGOV* also fails to be statistical significant as the *REELECT* variable. Thus, we confirm that the reelection probability plays no role for national tax revenue forecasts.

5.2.2. Methodological Robustness

The estimation results for various techniques are presented in Table 3. Altogether, we present five different model outcomes. First of all, we can expand the standard two way fixed-effects model by interaction terms between the cross section and time dimension (FE-INT). Since we lose a large amount of degrees of freedom by interacting all years with all countries, we just focus on the economic crisis of the year 2009. Since the economic crisis hit the countries with different intensities, this should also influence tax revenue forecast errors in different ways. To account for it, we introduce in Equation (1) an interaction term between the cross section dimension and the time dummy for the year 2009.

As brought forward by Goeminne *et al.* (2008), tax revenue forecast errors and, therefore, the behavior of tax forecasting institutions are not independent over time. So we secondly include the lagged forecast error in Equation (1); we expect a positive sign. Goeminne *et al.* (2008) state that estimating a dynamic panel data setup (DYNAM) accounts for slow adjustment processes of governments. Optimistic tax revenue forecasts are not immediately followed by pessimistic tax revenue forecasts, so we think that a positive path dependency is present. In a dynamic panel setup, standard fixed-effects techniques lead to biased and inconsistent coefficient estimates (see Nickell, 1981). A valid set of instrumental variables is necessary to avoid such a bias. We follow the literature and apply the generalized method of moments (GMM) estimator proposed by Arellano and Bond (1991). Specifically, we rewrite the model in Equation (1) in first differences to eliminate the country fixed-effects a_s and then use lags of $FPERC_{s,t}$ as viable instruments for the percentage forecast error. The employed instruments are only valid when no autocorrelation in the error term is present. We estimate the model in such a way that autocorrelation and the weak instrument problem are no longer present. Since the estimation technique by Arellano and Bond (1991) is developed for short time series, it suits our analysis perfectly. We apply the GMM estimator in its one-step version, since Arellano and Bond (1991) stated that the two-step estimator produces downward biased standard errors.

Our third methodological robustness check concerns the problem of correlated error terms between countries. This phenomena is called cross section dependence (CSD). Whenever we do not control for potential panel correlated error terms, standard errors of the coefficients and therefore the inference are biased. But what could be a plausible reason for an existing

correlation between countries? One possible explanation is the usage of similar methods. As stated before, elasticity-based methods are common practice in forecasting tax revenues. However, the estimation of tax elasticities is not an easy task especially when dealing with short and long term elasticities (for the German case see Koester and Priesmeier, 2012). If all countries face these problems, then it could be the case that the forecast biases are correlated between states. To test whether cross section dependence is present or not, we employ the test by Pesaran (2004). The test reveals that cross section correlation is present. To account for this, we apply the estimator proposed by Driscoll and Kraay (1998). This nonparametric estimator corrects the variance-covariance matrix for heteroscedasticity, auto- and panel correlation. The estimator can be used for very general forms of cross section dependence and requires no knowledge of their form. It is possible to apply the estimator in a fixed-effects or pooled OLS setup. We decided to use the former one.

Table 3: Estimation results – methodological robustness

Variable	(1) FE-INT	(2) DYNAM	(3) CSD
FEPERC _{t-1}	–	0.2407*** (0.0746)	–
ELCTY	-0.0017 (0.0075)	-0.0047 (0.0066)	-0.0066 (0.0052)
SCHMIDT	0.0098* (0.0048)	0.0117*** (0.0037)	0.0094*** (0.0025)
RAE_LEG	-0.0028** (0.0013)	-0.0021* (0.0011)	-0.0027** (0.0009)
REELECT	-0.0007 (0.0012)	-0.0003 (0.0017)	-0.0004 (0.0010)
c	0.9440*** (0.3020)	0.5850*** (0.2030)	0.5920*** (0.1760)
Controls	YES	YES	YES
C-FE	YES	YES	YES
T-FE	YES	YES	YES
R ² (within)	0.5026	–	0.4667
Obs.	281	243	281

Note: Robust standard errors in parentheses. ***, **, * indicate statistical significance at the 1%, 5%, 10% level.

In general, our baseline results are confirmed by the various estimation techniques. We find no significant political business cycle effect and no distortion if reelection is unlikely. Models (1) to (3) clearly verify that left-wing governments produce more optimistic or less pessimistic forecast errors than their right-wing counterparts. We furthermore find that negative fragmentation effect as in the baseline regression.

After applying other estimation techniques, we stick to the discussion on interaction models. Since we are interested in the within variation, maybe the interaction of our political

variables shed some more light on political distortions in national tax revenue forecasts. Our results clearly suggest that left-wing incumbents are more optimistic than their right-wing counterparts. For political business cycles, we find no effect at all. However, maybe the overestimation of left-wing governments varies across the electoral cycle. Another interesting point is the interaction of our partisan variable with one of the fragmentation variable. It is conceivable that the incumbent party may behave in a different way if the composition and therefore the fragmentation of the parliament varies. Such questions can easily be answered with standard interaction models. Thus, our baseline regression from Equation (1) is enlarged with the interaction terms $ELCTY * SCHMIDT$ and $SCHMIDT * RAE_LEG$ separately. The following Table 4 presents the estimation results from the interaction model.

Table 4: Estimation results – with interaction terms

Variable	(1)	(2)
ELCTY	-0.0168 (0.0114)	-0.0070 (0.0054)
SCHMIDT	0.0086** (0.0038)	0.0740** (0.0308)
RAE_LEG	-0.0027** (0.0012)	-0.0006 (0.0012)
REELECT	-0.0004 (0.0011)	-0.0003 (0.0011)
ELCTY*SCHMIDT	0.0045 (0.0049)	–
SCHMIDT*RAE_LEG	–	-0.0009** (0.0004)
c	0.5960** (0.2330)	0.3990* (0.2000)
Controls	YES	YES
C-FE	YES	YES
T-FE	YES	YES
R ² (within)	0.4680	0.4810
Obs.	281	281

Note: Robust standard errors in parentheses.

***, **, * denote statistical significance at the 1%, 5%, 10% level.

The interaction model reveals two interesting results. First, the missing political business cycle effect exists independent from the ideology of the incumbent. Additionally, the results for partisan theory and legislative fragmentation still hold. This confirms our baseline results and we can conclude that no political business cycle effect is present. Second, the interaction between ideology and legislative fragmentation is negative and statistically significant. Thus, for a given level of the Schmidt-Index, a higher fragmentation in the parliament reduces the overestimation of the incumbent. This result confirms our former finding that – contrary to standard theory – overestimation decreases the more fragmented a parliament is. We provided reasons for this result in the former section.

5.2.3. Sample Composition

In order to check whether our results are not driven by single countries, we first re-estimate Equation (1) by successively excluding each single country. In a second step, we exclude those countries which are classified by Büttner and Kauder (2010) as the most independent ones (*ExINDEP*) to produce their tax revenue forecasts (Austria, Germany, Netherlands and Norway). Third, we rerun our estimation by excluding the least and most fragmented countries (*ExFRAG*). At last, we estimate the effects by only looking at the countries with the most independent forecasts (*onlyINDEP*). The results can be found in Table 5 and Table 6. To save space, we decided to give only qualitative results for exclusion of one single state. For the regression *ExINDEP*, *ExFRAG* and *onlyINDEP* we show the point estimates.

Let us first stick to results by exclusion the most independent and most fragmented forecasts. As in all robustness checks before, the results are in most cases robust to these two sub-samples. We find no political business cycles as well as no effects from the reelection probability. The partisan coefficient is always positive and statistical significant in nearly all cases. Legislative fragmentation again has a negative impact on tax revenue forecast errors. All in all, these robustness checks perfectly confirm our baseline results.

In a second step, we look at the results for the most independent forecasts (Austria, Germany, Netherlands and Norway). The independence of the tax revenue forecast seems to matter since none of the political variables is statistically significant; however, the Schmidt-Index has a p-value of 0.107 and thus only shortly fails to reach a conventional level of significance. Especially the last result confirms the view of Büttner and Kauder (2010) that independence matters for the preparation of tax revenue forecasts. This view is confirmed by Merola and Pérez (2013) who favor the preparation of fiscal forecast by national institutions rather than international organizations. Thus, in our setup, a straightforward policy recommendation would also be to source out budget forecasts, and here especially tax revenue forecasts, to independent national institutes.

Table 5: Estimation results – exclusion of each single state

Variable	ExAT	ExAU	ExBE	ExCA	ExCH	ExDE	ExES	ExFR	ExIE
ELCTY	(-)	(-)	(-)	(-)	(-)	(-)	(-)*	(-)	(-)
SCHMIDT	(+)**	(+)	(+)**	(+)**	(+)**	(+)*	(+)	(+)*	(+)**
RAE_LEG	(-)**	(-)**	(-)**	(-)**	(-)**	(-)*	(-)**	(-)*	(-)**
REELECT	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)
c	(+)**	(+)*	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**
Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES
C-FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
T-FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
R ² (within)	0.476	0.474	0.462	0.474	0.486	0.466	0.466	0.466	0.459
Obs.	265	265	264	264	270	264	264	264	266
Variable	ExIS	ExIT	ExJP	ExNL	ExNO	ExNZ	ExSE	ExUK	ExUS
ELCTY	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)
SCHMIDT	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)*	(+)**	(+)**
RAE_LEG	(-)**	(-)*	(-)*	(-)**	(-)**	(-)**	(-)**	(-)**	(-)
REELECT	(-)	(-)	(+)	(-)	(-)	(-)	(-)	(-)	(-)
c	(+)*	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)**	(+)
Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES
C-FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
T-FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
R ² (within)	0.464	0.479	0.484	0.463	0.486	0.474	0.470	0.516	0.401
Obs.	269	265	265	274	270	264	272	265	247

Note: Robust standard errors in parentheses.

***, **, * indicate statistical significance at the 1%, 5%, 10% level.

Abbreviations: AT...Austria, AU...Australia, BE...Belgium, CA...Canada, CH...Switzerland, DE...Germany, ES...Spain, FR...France, IE...Ireland, IS...Iceland, IT...Italy, JP...Japan, NL...Netherlands, NO...Norway, NZ...New Zealand, SE...Sweden, UK...United Kingdom, US...United States.

Table 6: Estimation results – independence and fragmentation

Variable	ExINDEP	ExFRAG	onlyINDEP
ELCTY	-0.0069 (0.0072)	-0.0050 (0.0085)	0.0184 (0.0150)
SCHMIDT	0.0121** (0.0045)	0.0049 (0.0040)	0.0162 (0.0071)
RAE_LEG	-0.0027* (0.0015)	-0.0033** (0.0012)	-0.0028 (0.0024)
REELECT	-0.0011 (0.0012)	-0.0005 (0.0015)	0.0004 (0.0026)
c	0.6250** (0.2440)	-0.0002 (0.3200)	4.4590 (2.3720)
Controls	YES	YES	YES
C-FE	YES	YES	YES
T-FE	YES	YES	YES
R ² (within)	0.4970	0.4890	0.7940
Obs.	230	147	51

Note: Robust standard errors in parentheses.

***, **, * indicate statistical significance at the 1%, 5%, 10% level.

Finally, let us discuss the role of EU member states. Maybe the surveillance of member states via EU fiscal rules, e.g. the Stability and Growth Pact, influences national tax projections. To control for this potential effect we add the fiscal rule index (FRI) provided by the European Commission, Department for Economic and Financial Affairs (ECFIN) to our baseline regression. In any specification, the FRI fails to reach a meaningful level of statistical significance. The point estimates for our political variables remain robust. However, they are not significant in all estimated specifications. This can be explained with multicollinearity issues raised by introducing the FRI into the estimation. Thus, the regression is not able to clearly distinguish the variation from the political variable from those of the FRI. In the end, this causes the estimated standard errors to be biased upwards, thus, resulting in a wrong inference of the variables. However, the significance of our variables of interest is in almost all cases not far away to reach conventional levels of significance.

6. Conclusion

This paper has its relevance in two research areas. First, analyzes of the government's tax revenue forecast accuracy have strongly concentrated on technical aspects, paying little attention to political-economic factors (such as political business cycles, ideology, government fragmentation or the influence of reelection probabilities) as potential explanations. Secondly, the few existing studies on the relation between political-economic factors and tax revenue forecast errors mainly focus on national analyzes and do not include international comparative aspects.

Looking at the time period from 1996 to 2012, we systematically analyze whether national tax revenue forecasts in 18 OECD countries are biased through political distortions. We find strong support for partisan politics. Left governments seem to overestimate tax revenues more or to underestimate tax revenues less compared to right ones to satisfy their electorate with additional expenditure plans. We do not find empirical evidence for political business cycles. At first sight, this might look as a contrast to the results of Jong-A-Pin *et al.* (2012). However, this might be explained by the fact that Jong-A-Pin *et al.* (2012) focus on real-time data whereas we use ex-post percentage forecast errors. We also find no empirical evidence for any influence of the reelection probability on tax revenue forecasts.

Interestingly, there seems to be no common pool problem in fragmented governments. Instead, fragmented governments seem to be more cautious with tax projections. This is well in line with the existing literature (Goeminne *et al.*, 2008) and might have several reasons. First, at least parts of the incumbents expect to stay in office and will be part of future governments. Additionally, more coalition partners might strengthen the position of the finance minister within the cabinet as they are occupied with internal battles. And the finance minister has no incentive to over- or underestimate tax revenues. This interpretation is supported by the findings of Chatagny (2013). He also stresses the importance of the finance minister for tax revenue projections. Lastly, large coalitions are likely to represent a broader part of the population. Then the usual common pool problem of coalitions loses its attraction. All of our results are robust to various robustness checks.

In total, we find empirical evidence for political distortion in the national tax revenue projection process leading to politically biased tax revenue projections. Therefore, the focus of good financial government attempts should be widened in two ways: First, towards institutional and personal independence of tax revenue projection bodies; second, towards strengthening public and parliamentary awareness of budget implementation and budget control.

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A. Descriptive statistics

Table 7: Descriptive statistics and forecast errors

Variable	Obs.	Mean	Std. Dev.	Min.	Max.
FEPERC	283	-0.0017	0.0788	-0.1922	0.3382
ELCTY	323	0.2972	0.4577	0	1
ELCTYCUT	323	0.2941	0.4564	0	1
SCHMIDT	323	2.3251	1.5209	1	5
IDEO	323	0.3746	0.4850	0	1
RAE_LEG	323	68.3858	11.0962	48.3438	88.9761
NUMCOAL	323	2.3591	1.4212	1	9
EFFNUMCOAL	323	1.9493	1.0798	1	5.4000
SPENDMIN	323	18.1331	5.7611	7	39
RAE_GOV	323	31.0034	28.2701	0	81.7600
REELECT	323	35.0631	9.0433	10.9000	52.9000
NEWGOV	323	0.2198	0.4148	0	1
SINGLE	323	0.3437	0.4757	0	1
LARGE	323	0.3715	0.4840	0	1
INDEP	323	0.2105	0.2571	0	0.7500
QUALGOV	323	1.6769	0.3489	0.2136	2.2176
GDPGR	323	2.2395	2.4503	-6.5895	11.3422
GDPFORE	323	4.5541	1.9249	-2.6100	12.6200
GDPERR	323	-2.3146	2.4589	-12.3800	5.5900
OGAP	323	0.2385	2.6563	-7.8659	10.2728
ALQ	323	6.5549	3.1121	2.0072	25.0272
POP	323	5.966e+07	8.647e+07	268,927	3.14e+08
POPGR	323	0.0073	0.0059	-0.0219	0.0329
TAXQ	320	35.7899	6.8017	23.7550	51.4370
TAXN	323	17.7895	4.2811	10	25
FISCDEC	323	42.3560	19.7466	5.3872	77.5577
MPFE ^a			-0.0017		
MAPFE ^b			0.0534		
SDPFE ^c			0.0788		
RMSPFE ^d			0.0787		

Calculations based on the whole sample (1996–2012).

a) mean percentage forecast error; *b)* mean absolute percentage forecast error;

c) standard deviation of MPFE; *d)* root mean squared percentage forecast error.

Source: Armingeon *et al.* (2014), Büttner and Kauder (2010),

National Budget Plans, OECD Economic Outlook, Political Data Yearbook.