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Forecast fault lines

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Would you trust your life to U.S. government forecasts? The 2006 federal government fiscal year ended Sept. 30 with a deficit of $248 billion, which was $175 billion, or 71 percent smaller than that forecast by the Office of Management and Budget (OMB) in February of this year, a mere eight months earlier. The Clinton administration failed to predict the recession that began in the first quarter of 2001 as they were leaving; and as a result, the deficit went from a projected $283 billion surplus, as forecast by the Congressional Budget Office (CBO) in February 2001, to a deficit of $159 billion for fiscal year 2002, or a change of a whopping $441 billion in 19 months.

In May of this year, the National Weather Service predicted that we would have 13-16 Atlantic hurricanes or tropical storms this year. In August, they reduced their prediction to 12-15 storms, yet now, at almost the end of the season, we have only had nine.

U.S. Government Forecasts		
Federal Budget Deficit	Forecast	Actual (Oct.)
FY 2006 (Feb. 2006 forecast)	-$423b	-$248b
FY 2002 (Feb. 2001 forecast)	+$283b	-$159b
Hurricane Forecast (Atlantic named storms)		
May 2006 forecast	13-16	9
Aug. 2006 forecast	12-15	9

Those who make both economic forecasts and weather forecasts rely on mathematical models to make their predictions. If the model is not correctly designed, or leaves out crucial factors, it will provide the wrong answers. If policy makers rely too much on flawed models, they will make the wrong decisions, whether they regard tax cuts or climate change.

The budget deficit is now only 1.9 percent of GDP, less than the average of 2.3 percent of the last 40 years. Two years ago, the president claimed he would cut the budget deficit in half by 2009. At the time, his critics derided him, claiming it was impossible, yet it has now been accomplished three years ahead of schedule. If the truth be told, even many people in the Bush administration were surprised, because many of them, and most of their Democrat opponents, do not fully understand how incentives affect behavior. The economic models used by the Congress and the administration still fail to incorporate "dynamic" or behavioral changes people make in response to tax incentives or disincentives. As a result, these models always overestimate the revenue from a tax rate increase and overstate the loss from a tax rate cut.

The deficit reduction came about because of an "unexpected" surge in tax revenue due to greater economic growth, more capital gains realizations and higher dividend payments because of the 2003 tax rate reduction on capital gains and dividends. CBO's own studies show that they consistently underestimated economic growth in the years following the Reagan tax cuts, the 1996 Clinton capital gains rate cut, and the Bush 2003 rate cuts.

Most people would change their forecast model if it had been wrong, in the same direction, for more than three decades. The reason the tax revenue forecast models have not been changed is that there is a political interest in economic ignorance. A properly constructed model is likely to show that high marginal tax rates and taxes on capital are destructive, which is an inconvenient fact for the "tax the rich crowd." (Actually, high tax rates on earned income do not tax people who are already rich -- e.g., Edward Kennedy and John Kerry -- but only penalize the entrepreneurs who are trying to become rich by providing people with new goods and services they want. Left-leaning members of Congress have resisted funding good dynamic tax models, but fortunately the Treasury has now begun what appears to be a serious effort to build a better model.

The Democrats have said they want to repeal exactly those tax rate reductions that have resulted in more economic growth and more tax revenue than had been projected. If they get control and succeed in increasing taxes, you can expect lower economic growth, more unemployment and higher deficits. The empirical evidence is clear for those who wish to study it, so you can make your own judgments about whether the Democrats' economic ignorance is willful or not.

Finally, since Katrina we have been told by both the end-of-the-world-global-warming crowd and the official agencies that we would have more and more destructive Atlantic hurricanes hitting our shores this year. It didn't happen. They now say the reason it didn't happen was because the Atlantic Ocean was cooler than they expected ... hmmm. Building a climate model is a lot more complex than building a tax model because there are many more variables and the data is not as good. Perhaps, government economists with their tax forecasting models and the climate model builders should be a bit more modest with their predictions and recommendations.

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