

ECONOMIC BRIEF NO. 9

# Revenue Forecasting & State Budgets

This series of economic briefs explores fundamental concepts in economics and community and economic development.

*Midyear cuts in the state budget have become so common of late that it is obvious something is wrong with the state's budgeting system. But what?*

*Many people point the finger of blame at the Board of Economic Advisors who forecast state revenues. But before blaming the revenue forecasters for the state's budget woes, it might be well to learn something about the science and art of economic forecasts.*

*Economic forecasting is the modern descendent of the ancient art of reading the omens. Today, with modern computers, there is more science and less art or hocus-pocus than when priests used to examine the entrails of a goat.*

*If past trends can be identified and if they hold steady, the forecasts can be quite accurate. Those are two big ifs, and under the best of circumstances, there will be intervening occurrences which no one can foresee that cause errors in forecasts.*

*The expected performance of the national economy is the most important element in predicting the future of the South Carolina economy. Today, economic forecasting makes use of huge mathematical models containing thousands of equations relating certain leading economic indicators such as new housing starts, the money supply, and interest rates to economic*

*activities 12 to 24 months into the future.*

*Economic activity in South Carolina is then estimated based on its historical relationship to the national economy and certain local indicators such as population growth, recent retail sales, etc. Finally, state revenues are predicted based on the past relationships between economic activity in South*

*cent of the forecast, the forecasters perform well. To do better, they would need to be very lucky.*

*By that standard, South Carolina's forecasters have performed brilliantly. Even the most recent estimated revenue shortfall necessitating a 3.9 percent midyear cut falls within the range of expected forecast error. The problem is that even a small percentage error in forecasting for a \$3.6 billion annual budget amounts to hundreds of millions of dollars and causes a great deal of dislocation and pain for South Carolinians.*

*Are the revenue forecasters to blame for this dislocation and pain or are the state budget makers who fail to allow for forecast error in putting the budget together? There is always subtle—and sometimes not so subtle—pressure on the forecasters to “find” a few million dollars of additional revenue in the forecast so that the pet projects of various pressure groups can be funded. To say that the state revenue forecasters should do a better job is to say the obvious. But by the standards of their trade, the South Carolina Board of Economic Advisors is doing about as good a job as anyone reasonably has a right to expect. The problem with the state budget process is not in the forecasts; it is in the way the forecasts are used.*

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*Carolina and the yields of various state taxes and other revenue sources.*

*In principle, the procedure is very logical and straightforward. In practice, however, problems arise because past trends may not be identified correctly, past trends may not hold steady into the future, and intervening occurrences or shocks that no one can possibly foresee are always affecting the economy.*

*As a result, all forecasts contain some errors. If 95 percent of the time the actual number turns out to be within plus or minus 5 per-*