My Experience With Government Forecasting

Paul Craig Roberts

When Jim Dorn asked me to briefly relate my experience with government forecasting, he thought that perhaps my background might cast some light on the question of whether better models and active policy management can produce a more successful economy than clear-cut rules in harmony with normal incentives.

I must confess that I am amused with the notion of myself as a forecaster. Nevertheless, I have had two government jobs that forced me to deal with the world of forecasting. In 1976, I was the Republican party's economist on the House Budget Committee. Because the committee had only one economist, that qualified me for the grand title of chief economist. And in 1981 I was assistant secretary of the Treasury for economic policy where I learned that sometimes when you get in a job that is not your specialty, you learn more about it than anybody ever wanted you to know.

The CBO Spending Bias

The Budget Control Act had been passed in 1974, and in 1975 there was a dry run on how the new budget process would work. The new process began in earnest in 1976 and led the Republicans to conclude that they needed an economist. The expectations the Republicans had for the budget process bore no relation to reality. They thought they had pulled a coup on the Democrats, because they had gotten the Democrats to vote for the act. The Republicans were convinced that this act meant no more deficits; their theory was that the Democrats caused deficits as they voted on a lot of individual spending bills that allowed them to overspend the revenues on a piecemeal basis. Republicans thought Democrats would

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lack the courage to vote for a deficit if they actually had to vote for one in a budget resolution.

Of course, the process did not work that way. What it did was to institutionalize Keynesian fiscal theory. The first budget resolution that came forward was really a choice of deficits. There was a moderate deficit path, which was the path policymakers had decided they wanted. The moderate deficit path produced the appropriate Phillips curve tradeoffs between employment and inflation. Then, to show why Congress should choose this moderate path, the Congressional Budget Office (CBO) would bracket the moderate deficit with a low deficit and a high deficit. The low deficit had low inflation, but it had an unacceptable unemployment rate. The high deficit showed a booming economy and good employment, but inflation was too high. The Republicans were quite shocked when they discovered that, if they rejected the moderate deficit, they were faced with arguing in favor of a small deficit with unacceptable unemployment or a big deficit with unacceptable inflation.

The process was more or less rigged in favor of spending because, having determined that Congress must choose a deficit, policymakers wanted to be sure that members of Congress chose the right way. Multiplier rankings from the CBO's multipliers' project showed that government purchases and public service employment programs were much more effective stimulants to the economy than a reduction in the tax rate. Indeed, CBO reports and testimony said that cutting income tax rates was an inefficient way to stimulate the economy. Society would not get much bang for the buck. Moreover, the CBO produced simulations showing that cutting corporate taxes would reduce investment. After various model runs showed that cutting corporate taxes would reduce investment and cause the GNP to fall, I began investigating what kind of an economy that was. I discovered it was one in which investment was not sensitive to better after-tax earnings, but was very sensitive to the interest rate. If corporate taxes were cut, the deficit went up. If the deficit went up, the interest rate went up. If the interest rate went up, the investment rate went down, and GNP fell.

Finally, to make sure there was no alternative to the expansion of government spending (the only question was how much each year it would expand), policymakers argued that incentives simply could not work because a tax cut would let people meet their income and saving targets with less work. In other words, if Congress cut taxes, people would increase their leisure. I used to ask policymakers how taxpayers could maintain their existing levels of income if, in the aggregate, they responded to a tax cut by working less. This question was a long time catching on.

That was the nature of my experience with the forecasting models used to actively manage U.S. economic policy during the 1970s. The experience provides an understanding of why the supply-siders were able to bring the Keynesian models into question.

Soon after this experience, Karl Brunner asked David Meiselman and me to write an assessment of the CBO and its approach to macroeconomic policy for one of the Carnegie-Rochester Public Policy Conferences. David and I wrote:

> [I]n the CBO analysis there is demand without supply, inflation without money, interest rates without capital, output without inputs, employment without wage rates or a labor market, and investment without saving or any change in capital stock. Expectations are assumed to be static and consumption is assumed to depend only on current disposable income. Fiscal policy is seen as affecting aggregate demand with no incentive or disincentive effects on supply [Meiselman and Roberts 1979, p. 283].

The Troika Process of Forecasting

Things began to change in May 1980. One of my principal projects as an aide in the Senate (where I moved after the House Budget Committee) was to get hearings on econometric models. This was a multiyear effort, because the CBO did not want any hearings on the nature of the models. However, the Democrats reached the point where they were upset with stagflation and the fact that conventional wisdom had no answer as to how to end it. They did not like the Phillips curve tradeoffs, and politically stagflation was very disappointing. Democratic committee chairmen, such as Lloyd Bentsen who was chairman of the Joint Economic Committee and Russell Long who chaired the Finance Committee, started changing the tune. As soon as they changed, the forecasting community changed its tune. Hearings began in May 1980. People who had been fighting the supply-siders now claimed to have supply-side models. At the hearings, Otto Eckstein and other econometric forecasters explained the importance of supply-side economics and why it was in their models.

But this change of attitude did not carry forward into the executive branch. Forecasting was based on the troika process. First, the Treasury, Office of Management and Budget, and Council of Economic Advisers (CEA) staffs would make a forecast. It would come up to my level and then go to the secretary of the Treasury, the budget director, and the CEA chairman. I was struck by the power of tradition in forecasting. We were supposed to be a supply-side regime, but still the language was Keynesian demand management. The Treasury never produced anything but a static revenue forecast. The Reagan administration received a bum rap for making a Laffer curve forecast that the tax cuts would pay for themselves. Actually, the administration predicted that the tax cuts would lose every dollar of revenue, and that was the only forecast you could get out of Treasury. The Phillips curve won over the Laffer curve, and the administration overestimated the inflation rate. That overestimation caused revenues to be overpredicted. In the first drafts of our economic program, the supply-side policy was described in Keynesian demand management terms, and there was little anyone could do about it.

Ending the Status Quo

A summary of my experience in public policy leads me to conclude that two chief factors drive that policy: One is to expand the government's power, and the other is tradition. Even if the first driving force is stalemated, tradition itself can carry on.

We all know about the problems of public choice that James Buchanan, Ronald Coase, and Robert Lucas have raised. There is also the problem of information. When I was in graduate school at Berkeley, some professors tried to get us to study econometrics. But one professor had us read Oscar Morganstern's book, *On the Accuracy of Economic Observation,* which was published in the 1950s. That book made it difficult for us to study econometrics, because Morganstern showed that the data were so bad you could not get valid econometric results. The data seemed to range from bad to fabricated. He related an experience with a Third World official who said that since the United States was so insistent on statistics as a basis of foreign aid, his country would simply produce whatever statistics were necessary to get the aid.

Scientists discount intuition and stress the power of empirical facts, but, in their own discoveries, they rely on instinct. Empiricism led us to believe that we could improve on the invisible hand if only governments had the power to order economic affairs. I think it is time to try a few rules that are well attuned to normal human incentives, and to get as far away as we can from the status quo of active policy management.

Reference

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Has Macro-Forecasting Failed?

Victor Zarnowitz

What to Ask, Why, and How?

The title of my paper, "Has Macro-Forecasting Failed?" serves a good purpose, even though it seems to be somewhat provocatively phrased. We are reminded that claims to predict the future must be properly modest or they will prove disappointing. The more that forecasts matter and the more people that depend on them, the greater the dangers of having overstated promises and unrealistically high expectations—and macroeconomic forecasts matter greatly when used as guides by public and private decisionmakers.

The question deserves a straightforward, but careful, answer. A simple "yes" or "no" lacks meaning. Forecasting the economy's course, even short-term and in the broadest outline, is a mixture of art and science that can be very imperfect and sophisticated at the same time. Thus, we face a problem whose solution depends on the treatment of more fundamental questions about (1) what the forecasts are and why they are needed, and (2) what we can reasonably expect of them.

It is easy to think of needs, uses, and standards associated with macro-forecasting that will readily show it as a failing enterprise. What is more difficult but also more important is to decide which legitimate and credible applications of forecasting would, in principle, allow our title question to be interesting (i.e., capable of being answered either positively or negatively according to some sensible and, so far as possible, quantifiable criteria).

To establish what forecasters can and should do, we must study the record and assess the probable future of their endeavors. I can sum up these large subjects only selectively in this paper. Thus, I

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