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March 2010

Removing the Rose-Coloured Glasses In Budget Forecasting

By David Macdonald

One of the most fundamental questions for federal budget planning is: "How much will the economy grow in future years?" The 2010 Federal Budget has placed that question in closer relief as federal forecasts, particularly on the revenue side, have been put into doubt. Some have argued that the Budget's five-year estimates, instead of the usual three-year ones, may overstate what can reasonably be known that far ahead.

If the economy is growing faster, more program spending can occur without raising taxes. If growth is slower, stimulus spending may be necessary to boost economic growth, resulting in deficits.

Since the global economic crisis hit Canada in 2008, forecasts of government revenue in particular have been wildly optimistic.

The federal government does not make its own forecasts of GDP growth. Instead, it relies on the "consensus estimates" or "private sector outlook" from private sector forecasts. Those forecasts are calculated by the big Canadian banks, investment houses, universities, and economic forecasting firms. Some of the GDP forecasts are available free online, and some cost thousands of dollars.

While these forecasts all originate outside government, "consensus" is a misnomer. Consensus implies that the forecasters agree on what the GDP growth should be. One might imagine that several times a year they congregate in a plush Bay Street boardroom amid a fog of cigar smoke to determine how the Canadian economy will behave in the future.

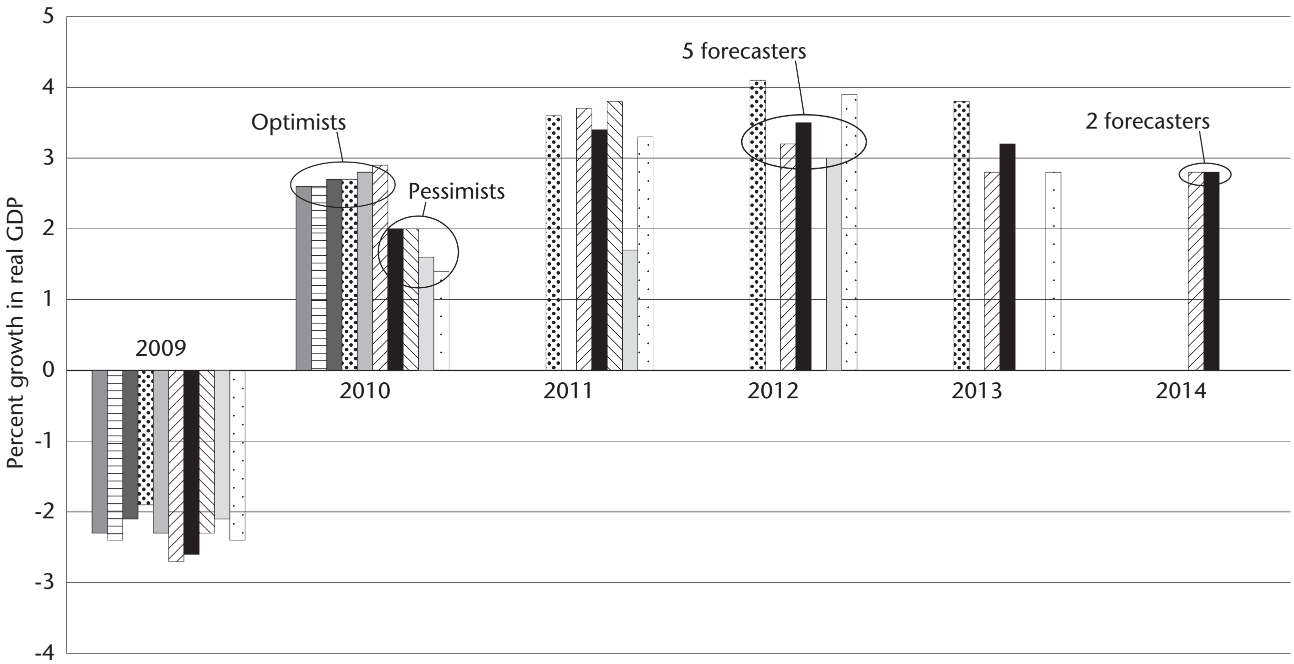
However, if we open that fictional oak boardroom door and clear away the illusory cigar smoke, a far more nuanced scene emerges. Instead of consensus, it is almost always just an average of the various forecasts. Forecasters do not agree on a common number and, in fact, disagree by a large margin, particularly in their most relevant forecasts of one to two years out.

Obviously, a straight average of GDP forecasts completely papers over what might be instructive disagreements among the experts on where Canada's economy is headed.

To its credit, the Parliamentary Budget Office (PBO) publishes the high and low forecast in its survey of 10 sources. The Department of Finance does not, even though it surveys 17 sources.[1]

The chart draws on the 10 sources the PBO surveyed in September 2009. The 2009 growth estimates are fairly clustered, although they still vary by 0.8%. This was to be expected, as nine months of the year had already passed. The 2010 "private sector outlook," or average, was 2.3%. Interestingly, there is no forecaster who is actually estimating 2.3% real GDP growth. All forecasts are either below 2.1% or above 2.5%.

Chart 1: Divergences Between Private Sector Forecasters



Source: PBO September 2009 Real GDP Growth Survey

In fact, the average obscures two clearly delineated groups in 2010: those at 2.6% or above, and those at 2% or below. They are of roughly equal size: four pessimists and six optimists. The pessimists, on average, see real GDP growth for 2010 at 1.8% instead of 2.3% as the overall average might suggest. For their part, the optimists, on average, estimate real GDP growth in 2010 to be 2.7%. The difference between the two camps is worth 1% of real GDP—at least $16 billion for 2010[2].

The three out of the four forecasters who had pessimistic forecasts for 2010 maintained their pessimism for 2011. The cynics' view of 2011 stays below the forecasts of any of the optimists, although four of the six optimists have given up the ghost. By 2012, all bets are off, and by 2014 there is a strong convergence towards Canada's long-term average real GDP growth rate of 3%.

In the near term, the camps established in 2010 persist. As such, 1% lower GDP growth year after year starts to add up. The cumulative effect over several years can be substantial and may play out in the real economy in the form of fewer jobs and higher unemployment.

To its credit, the PBO does estimate two scenarios for the federal budget balance, based on the highest forecast real GDP growth and the lowest.[3] By 2013–14, the difference in the federal deficit as calculated by the PBO is substantial.

If one chose the most optimistic forecasts of real GDP growth every year, the deficit in 2014–15 would be $7.3 billion, based on status quo spending and revenue measures. If one did the opposite and chose the most pessimistic forecasts, we would be dealing with a much more substantial deficit of $33.5 billion five years out.

This substantial deviation illustrates the importance of real GDP growth estimates to the federal budgeting process, and how that rate of growth is based on pessimistic or optimistic assumptions about what will drive future economic trends.

The other interesting effect of averaging is that it obscures how many forecasters are weighing in for any given year. In 2009 and 2010, 10 forecasters predicted how real GDP would change. By 2012, however, only half that number—five forecasters—were confident enough in their ability to meaningfully forecast three years out. By 2014, five years ahead, there are only two left of the original 10.

If there is any value in averaging the various forecasts to obtain a more accurate mean, half of that value is lost by the third year. After that, there may simply be too few forecasters to create an accurate representation of what the Canadian economy is likely to experience.

However, the challenges presented by too few forecasters reporting is not discussed at all, or even revealed in Budget documents, either by the PBO or the Department of Finance. Although forecasts may go out five years, the foundation for looking that far ahead is shaky, with few forecasters willing to venture a guess that far into the future.

There is no such thing as a private sector consensus forecast. It's a meaningless term. An average is not a consensus. To use the term "private sector outlook" is to give a sense that the private sector knows something more than everyone else and can be relied upon to get things right.

There is uncertainty in forecasting, to be sure, but forecasts are based on assumptions, and those assumptions reveal biases, not facts. Those varying assumptions, over time, come to quite different conclusions.

As a result, government reports that casually incorporate the private sector "consensus" without discussing the implications provide Canadians with a false sense of security. It's time to remove the rose-coloured glasses.

Notes

1. The difference in the number of sources is due to the PBO using only publicly available forecasts that are, for the most part, free.

2. Assuming Canada's Current GDP of approximately $1.6 trillion

3. See Parliamentary Budget Office, November 2, 2009, *Economic and Fiscal Assessment Update*, pg 8.