

## Revenue Forecast Uncertainty Report

December 2017

### Summary of Revenue Forecast Uncertainty for the Current Biennium

In Minnesota's November 2017 *Budget and Economic Forecast*, total revenues for FY 2018-19 are forecast to be \$44.447 billion. This forecast was constructed 20 months before the current biennium closes. If this forecast turns out to have the same degree of accuracy as the average of our 20-months-ahead forecasts, we can expect FY 2018-19 closing revenues to be between \$42.907 and \$45.987 billion (+/- \$1.54 billion).

### Estimating Revenue Forecast Uncertainty

The difference between the level of revenues forecast and the amount actually collected at the end of a biennium—the forecast error—is a gauge of forecast accuracy. The mean absolute error (MAE) is the average of the errors' absolute values (that is, treating negative and positive errors the same). Since accuracy in forecasting a single biennium's revenues improves the closer we get to the end of the two-year period, we calculate separate errors for each time a biennium is part of the forecast: 32, 29, 20, 17, 8 and 5 months from actual. We then average those errors over FY 1990-91 to the most recent closed period, FY 2016-17.

We measure our forecast error as the difference between forecast and actual non-dedicated revenues, while the focus in the *Budget and Economic Forecast* is on total revenues. The items making up the difference between these two measures are dedicated revenues, transfers, and prior year adjustments. We base our forecast error on non-dedicated revenues, because it includes all general fund tax and non-tax revenues—the sources that are the most challenging to accurately forecast. For FY 2018-19, non-dedicated revenues are forecast to be \$44.084 billion, and the forecast for total revenues is \$44.447 billion, with a difference of \$363 million.

The current forecast for FY 2018-19 is the 2<sup>nd</sup> November forecast, 20 months ahead of closing. The MAE for 20-months-ahead forecasts is 3.5 percent of non-dedicated revenues, or about \$1.54 billion for the current biennium. Consequently, the range of closing values for FY 2018-19 total revenues is \$44.447 billion +/- \$1.54 billion, or \$42.907 to \$45.987 billion.

Another way to measure the degree of forecast uncertainty is to calculate a confidence range (CR) for our estimates. A 90 percent CR for our revenue forecast is the range of values that will contain the actual value for total revenues 90 out of 100 times. As with the MAE, we calculate the CR as a percentage of non-dedicated revenues. Both the percentage and the CR get smaller the closer we are to the end of a biennium. The range calculated with the MAE is approximately a 67 percent CR for FY 2018-19 (20-months-ahead forecasts). For FY 2018-19, the 90 percent confidence range is \$44.447 +/- \$2.56 billion (5.8 percent), or \$41.887 to \$47.007.

Note that all of the error measures reported here relate to the state's revenue forecasts. They do not include estimates of errors in forecasting state expenditures.

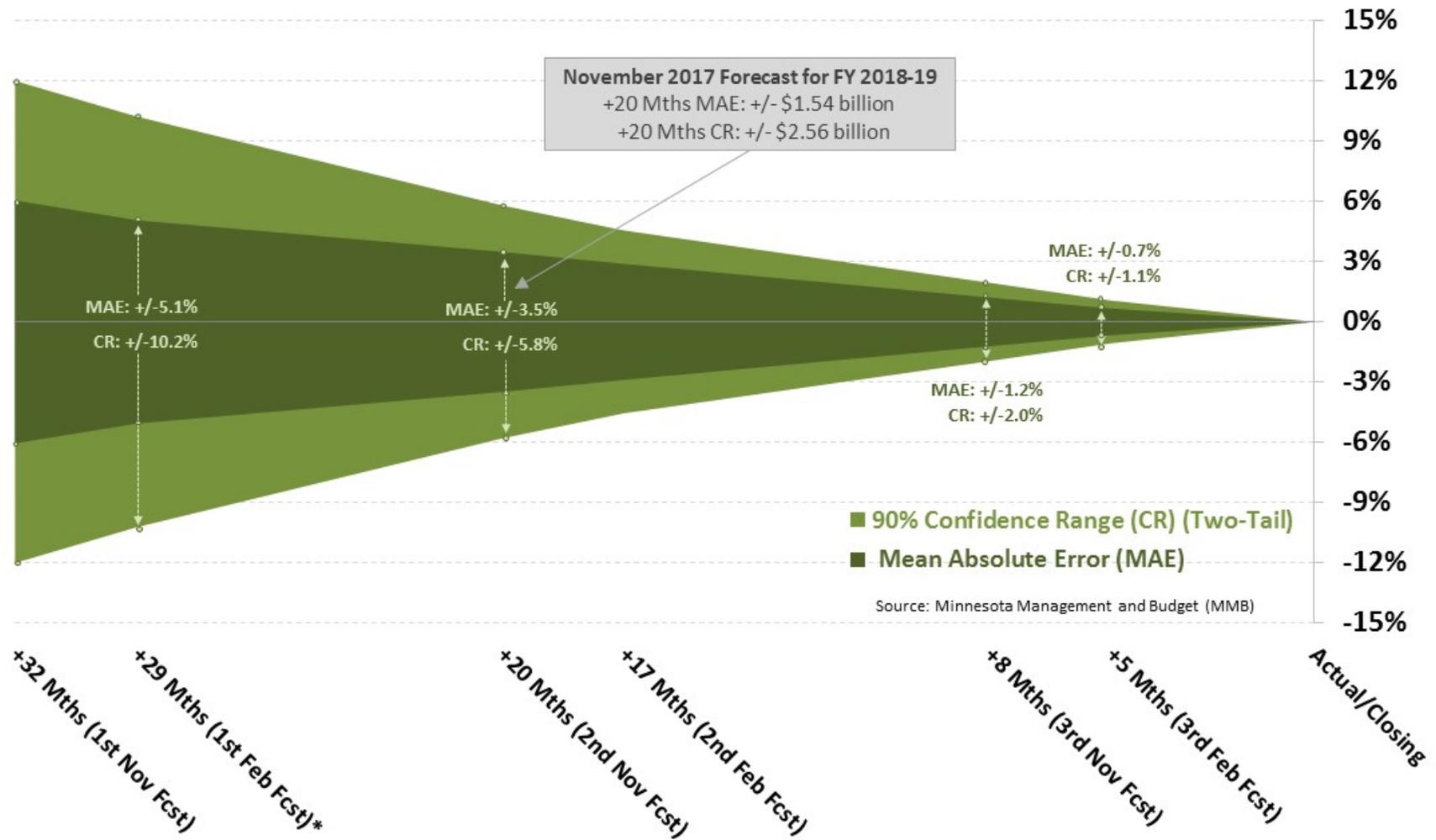
**Sources of Revenue Forecast Uncertainty**

Actual revenue collections never *precisely* match the forecast for a wide range of reasons. First, economic data from time periods preceding a forecast (such as employment or consumer spending data) are not perfectly measured and are frequently revised after we have used them to construct a forecast. Second, even if past U.S. economic data *were* perfectly measured, modelling errors and the inability to foresee all future impacts on the economy would prevent our macroeconomic consultant from perfectly forecasting the U.S. economy. Third, errors in the U.S. forecast and in Minnesota's data history and our own imperfect modelling introduce inaccuracies into our forecast of the state's economy. Fourth, even if the Minnesota economy *were* forecast with perfect accuracy, our forecasts of Minnesota tax revenues would still contain some error. This is because of imperfections in our revenue forecasting models, mis-matches between the economic and tax definitions of income and spending items, inconsistencies in the timing of receipts from a given year's tax liability, and uncertainty about the revenue impacts of changes in state tax laws.

Minnesota's November 2017 economic and revenue forecasts carry a large degree of uncertainty related to U.S. tax policy. The November 2017 U.S. outlook, which informed our current economic and revenue forecast, was released before the U.S. House and Senate passed their tax bills, and incorporates no change to U.S. tax policy relative to current law. So, the economic impact of federal tax law changes remains a source of forecast risk.

## Average Revenue Forecast Uncertainty over Minnesota's Budget Cycle

% of Net Non-Dedicated Revenue, Sample Period: FY1990-91 to FY2016-17



\* +29 months (1st February forecast) is the MMB forecast on which the original budget for the biennium was based.

Notes: Adjusted for the effects of legislation. MMB uses the mean-absolute error (MAE) as a measure of accuracy in its evaluation of forecast uncertainty. MAE is calculated by averaging forecast deviations from actual without regard to arithmetic sign. Under the assumption that tax policies do not significantly change, a 90 percent confidence range (CR) for our revenue forecast is the range of values (the light area) that will contain the actual value for total revenues 90 percent of the time. The range calculated with the MAE (darkest area) is approximately a 67 percent CR for FY 2018-19.