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## An Error Model

A simple error model is developed here in order to illustrate the types of error that GNP estimates may contain and some of the properties of the errors. First considered is the nature of the errors that would be associated with the use of a related series to interpolate between two benchmark estimates; next, the errors that are introduced when the related series consists of preliminary data and is used to extrapolate the last benchmark; and finally, the change in errors when a new benchmark is introduced.

Let  $\psi$  denote a variable whose value is known only in benchmark periods  $0$  and  $N$ ; and  $\chi$ , a related variable for which there is a continuous series. Suppose an estimate of the value of  $\psi$  in each of the periods between  $0$  and  $N$  is obtained by first interpolating arithmetically and then using deviations in  $\chi$  from its simple arithmetic trend to estimate the corresponding deviations in  $\psi$ .<sup>1</sup> More specifically, suppose that the trend values of  $\psi$  and  $\chi$  in period  $i$ , denoted  $\psi_i^T$  and  $\chi_i^T$ , respectively, are estimated as

$$(1) \quad \psi_i^T = \psi_0 + \frac{i}{N}(\psi_N - \psi_0) \quad \text{and} \\ \chi_i^T = \chi_0 + \frac{i}{N}(\chi_N - \chi_0), \quad i = 0, \dots, N.$$

<sup>1</sup> This procedure, which is the one considered by Friedman ("The Interpolation of Times Series"), may or may not be the one actually followed. The specific method used to interpolate and extrapolate the benchmarks is described only as "by means of related series" in the detailed descriptions of how GNP estimates are constructed (*National Income* and *U.S. Income and Output*). However, it is sufficient for the present purpose, which is to illustrate the types of error that the estimates may contain, rather than to estimate the magnitude of the errors or to replicate GNP estimates. Other methods, as Friedman has shown, can be reduced to special cases of his more general one.

If the deviations from these trend values are defined,

$$(2) \quad u_i = \psi_i - \psi_i^T \quad \text{and} \quad v_i = \chi_i - \chi_i^T,$$

and if the unknown  $u_i$  were estimated from the known  $v_i$  as in

$$(3) \quad u_i = bv_i,$$

then  $\hat{\psi}_i$ , the estimated value of  $\psi$  in period  $i$ , would equal

$$(4) \quad \hat{\psi}_i = \psi_i^T + bv_i.$$

If the true relation between  $u_i$  and  $v_i$  were not an exact one as in (3), but equal instead to

$$(3') \quad u_i = \beta v_i + w_i,$$

then the error in estimating  $\psi_i$  would equal

$$(5) \quad \hat{\psi}_i - \psi_i = (b - \beta)v_i - w_i.$$

Thus according to (5), the error in  $\hat{\psi}_i$  would consist of the error that would arise if the relation between the movements in the two variables were incorrectly estimated (i.e., if  $b \neq \beta$ ) and because the relation is inexact ( $w \neq 0$ ).

Suppose we now assume that the true values,  $\psi_0$ ,  $\psi_N$ , and  $\chi_i$  are unknown, but that they are estimated as

(6)  $Y_k = \psi_k + \xi_k$  and  $X_i = \chi_i + \eta_i$  for  $k = 0, N, \dots$  and  $i = 0, \dots, N, \dots$ , where  $\xi_k$  denotes the error in the benchmark estimates ( $Y_k$ ), and  $\eta_i$ , the measurement error in the related series ( $X_i$ ). Using these data, the estimate of  $\psi_i$  would then become

$$(7) \quad Y_i = \left[ Y_0 + \frac{i}{N} (Y_N - Y_0) \right] + b \left[ X_i - X_0 - \frac{i}{N} (X_N - X_0) \right]$$

and the error, defined as  $E_i = Y_i - \psi_i$ , would equal

$$(8) \quad E_i = \left[ \xi_0 + \frac{i}{N} (\xi_N - \xi_0) \right] + b \left[ \eta_i - \eta_0 - \frac{i}{N} (\eta_N - \eta_0) \right] \\ + [(b - \beta)v_i - w_i].$$

The error in estimating  $\psi_i$  would thus consist of errors in the benchmark estimates ( $\xi$ ), measurement errors in the related variable ( $\eta$ ), and errors due to an inexact or incorrectly estimated relationship between the movements in the two variables.

Let  $\xi_k$  and  $\eta_i$  be stationary to the second order with means  $\mu_\xi$  and  $\mu_\eta$  and variances  $\sigma^2(\xi)$  and  $\sigma^2(\eta)$ . The expected value (denoted  $E$ ) of  $E_i$  would then equal

$$(9) \quad E(E_i) = \mu_\xi, \text{ provided that } E(v_i) \text{ and } E(w_i) \text{ are zero for all } i.$$

As (9) shows,  $Y_i$  would be a biased estimate of  $\psi_i$  unless  $\mu_\xi$  equals zero. But even if  $\mu_\xi \neq 0$ , it is readily shown that the implicit estimate of the change in  $\psi$  from period  $i$  to period  $i + 1$  would be unbiased. Since  $Y_{i+1}$  would equal

$$Y_{i+1} = \left[ Y_0 + \frac{i+1}{N} (Y_N - Y_0) \right] + b \left[ X_{i+1} - X_0 - \frac{i+1}{N} (X_N - X_0) \right],$$

the implicit estimate of change would equal

$$(10) \quad \Delta Y_{i+1} = \frac{1}{N} (Y_N - Y_0) + b \left[ X_{i+1} - X_i - \frac{1}{N} (X_N - X_0) \right],$$

and the error would equal

$$(11) \quad E_{\Delta i+1} = \frac{1}{N} (\xi_N - \xi_0) + b \left[ \eta_{i+1} - \eta_i - \frac{1}{N} (\eta_N - \eta_0) \right] \\ + [(b - \beta)(v_{i+1} - v_i) - (w_{i+1} - w_i)].$$

On the previous assumption of stationarity, the expected value of  $E_{\Delta i+1}$  is

$$(12) \quad E(E_{\Delta i+1}) = 0, \text{ provided } E(v) \text{ and } E(w) \text{ are zero for all } i.$$

The change estimates would therefore be unbiased even if the level estimates were not.

It might be tempting to conclude that this result supports the widespread notion that estimates of changes (say, in GNP) are more reliable than estimates of levels. However, this is not necessarily true. The accuracy of change estimates relative to that of levels depends on the relative importance of the error components and bias is only one element of over-all error. If, for example, benchmark errors were by far the most important source of error, then the mean square error levels would exceed the mean square error of changes. On the other hand, if the relation between the movements in  $\psi$  and  $\chi$  were not strong and if it were incorrectly estimated, then benchmark errors (and errors in measuring  $\chi$ ) could be relatively minor components of the error in estimating levels

and changes in  $\psi$ . In this case, the mean square error of changes could exceed that of levels.<sup>2</sup>

### Errors in Provisional Estimates

Thus far we have considered the errors in estimating  $\psi$  when movements in a related series  $X$  are used to interpolate between two known benchmarks,  $Y_0$  and  $Y_N$ . These, however, are the errors that could be expected in "final" or benchmark revised estimates rather than in the estimates that are published on a current basis. Provisional estimates of the current value of  $\psi$  in each of the periods between 0 and  $N$  must be made without benefit of  $Y_N$ . Such estimates are essentially extrapolations rather than interpolations, and their errors will differ accordingly.

To illustrate, suppose that a provisional estimate, made in period  $i$ , of the value of  $\psi_i$  were constructed by first extrapolating the last known benchmark period estimate and then using the deviation in the related series from its extrapolated trend to estimate the corresponding deviation in  $\psi_i$ .<sup>3</sup> In addition, suppose that only preliminary estimates of  $\chi$ , denoted  $X^\circ$ , are available at the time the provisional estimates of  $\psi$  are prepared. The provisional estimate,  $Y_i^\circ$ , would then be

$$(13) \quad Y_i^\circ = \left[ Y_0 + \frac{i}{N} (\psi_N^* - Y_0) \right] + b \left[ X_i^\circ - X_0 - \frac{i}{N} (\chi_N^* - X_0) \right],$$

where  $\psi_N^*$  and  $\chi_N^*$  denote predictions of  $\psi_N$  and  $\chi_N$ , respectively. If the prediction errors and the errors in the preliminary estimates of  $\chi$  are defined as

$$\epsilon(\psi)_N = \psi_N^* - \psi_N; \quad \epsilon(\chi)_N = \chi_N^* - \chi_N; \quad \text{and} \quad \eta^\circ = X_i^\circ - \chi_i,$$

the error in the provisional estimate, defined as  $E_i^\circ = Y_i^\circ - \psi_i$ , would equal

$$E_i^\circ = \left[ \xi_0 + \frac{i}{N} (\epsilon(\psi)_N - \xi_0) \right] + b \left[ \eta_i^\circ - \eta_0 - \frac{i}{N} (\epsilon(\chi)_N - \eta_0) \right] \\ + (b - \beta)v_i - w_i.$$

<sup>2</sup>If  $\xi$  and  $\eta$  were relatively unimportant, the mean square errors would be

$$M(E_i) \approx (b - \beta)^2 \sigma^2(v_i) + \sigma^2(w_i) \\ M(E_{\Delta i}) \approx (b - \beta)^2 \sigma^2(v_{i+1} - v_i) + \sigma^2(w_{i+1} - w_i).$$

Unless there is strong positive serial correlation in  $v$  or in  $w$ ,

$$M(E_{\Delta i}) > M(E_i).$$

<sup>3</sup> See footnote 1 on p. 97.

Using (8),  $E_i^{\circ}$  can also be expressed as

$$(13) \quad E_i^{\circ} = E_i + \frac{i}{N} [\epsilon(\psi)_N - \xi_N] - b[\epsilon(\chi)_N - \eta_N] + b(\eta_i^{\circ} - \eta_i).$$

With the aid of (13), the differences in accuracy between the provisional and the revised estimates of  $\psi$  become fully visible. The error in the provisional estimate ( $E_i^{\circ}$ ) would exceed the error in the revised estimate ( $E_i$ ) as long as: (1) the errors in the predictions, made in period  $i$ , of the values of  $\psi_N$  and  $\chi_N$  exceed the error in the benchmark estimate,  $Y_N$ , and the measurement error in  $X_N$  (i.e., if  $\epsilon(\psi)_N$  and  $\epsilon(\chi)_N$  exceed  $\xi_N$  and  $\eta_N$ , respectively) and; (2) the error in the estimate based on preliminary data exceeds the error in the revised estimate of  $\chi_i$  (i.e.,  $\eta_i^{\circ} > \eta_i$ ).

It is often contended that merely the fact that national accounts estimates are revised offers no guarantee that the revised estimates are more accurate than the initial figures. We have seen, however, that within the framework of the present model, the major revisions could be viewed as replacing predictions, made before period  $N$  occurs, with estimates, based on data from period  $N$ , of  $\psi_N$  and  $\chi_N$ . In order for the revised estimates to be only as accurate as the initial figures, the predictions,  $\psi_N^*$  and  $\chi_N^*$ , would have to be as accurate as the later estimates,  $Y_N$  and  $X_N$ . Since the predictions would rely to some extent on the last known benchmark estimate,  $Y_0$ , and on preliminary estimates of  $\chi$  ( $X^{\circ}$ ), any errors in these data would be transmitted to the predictions and become a component of their errors. Thus in the absence of evidence that the accuracy of the benchmark estimates and data for the related series has deteriorated over time (such that  $Y_0$  and  $X^{\circ}$  are more accurate than  $Y_N$  and  $X$ ), it is reasonable to suppose that predictions would be less accurate than estimates of  $\psi_N$  and  $\chi_N$  and hence to reject the contention that the revised estimates are no more accurate (let alone *less* accurate) than the provisional estimates

### *Errors Measured by the Revisions*

The revisions are defined as the difference between provisional and revised estimates. Both  $Y_i^{\circ}$  and  $Y_i$  can be expressed as

$$Y_i^{\circ} = \psi_i + E_i^{\circ} \quad \text{and} \quad Y_i = \psi_i + E_i,$$

the sum of the true value and the respective errors of estimate. The revision would then equal

$$Y_i^{\circ} - Y_i = E_i^{\circ} - E_i,$$

which, using (13), can be expressed

$$(14) \quad Y_i^o - Y_i = \frac{i}{N} [\epsilon(Y)_N - b\epsilon(X)_N] + b\epsilon_i,$$

where  $\epsilon(Y)_N = \epsilon(\psi)_N - \xi_N$ ;  $\epsilon(X)_N = \epsilon(\chi)_N - \eta_N$ ; and  $\epsilon_i = \eta_i^o - \eta_i$ . Since  $\epsilon(Y)_N$  and  $\epsilon(X)_N$  would also equal  $\psi_N^* - Y_N$  and  $\chi_N^* - \chi_N$ , respectively,<sup>4</sup> the revisions would be a measure of the errors in predicting  $Y_N$  and  $X_N$  and of the reduction in measurement errors in the preliminary data on  $\chi$ . The prediction errors  $\epsilon(Y)$  and  $\epsilon(X)$  would be a common component of the revision in the provisional estimates of  $\psi$  in each period between 0 and  $N$ , and thus a source of positive serial correlation in the revisions. Moreover, the importance of the prediction error would increase with  $i$  and hence the revisions would grow larger as  $i$  increases.

It is readily shown that the revisions in estimates of period-to-period changes would not depend on  $i$  and that they would be smaller than the revisions in level estimates, provided prediction errors were a major component of the revisions. Since

$$Y_{i+1}^o - Y_i = \frac{i+1}{N} [\epsilon(Y)_N - b\epsilon(X)_N] + b\epsilon_{i+1},$$

the revision in  $\Delta Y_{i+1}^o$  would equal

$$(15) \quad \Delta Y_{i+1}^o - \Delta Y_{i+1} = \frac{1}{N} [\epsilon(Y)_N - b\epsilon(X)_N] + b(\epsilon_{i+1} - \epsilon_i).$$

Let both the predictions and the preliminary data be unbiased. The mean square revision of the level would then be

$$(16) \quad M = \left[ \frac{i+1}{N} \right]^2 \sigma^2(\epsilon(Y)_N - b\epsilon(X)_N) + b^2 \sigma^2(\epsilon),$$

and of the change,

$$(17) \quad M_\Delta = \frac{1}{N^2} \sigma^2(\epsilon(Y)_N - b\epsilon(X)_N) + 2b^2 \sigma^2(\epsilon),$$

provided  $\text{Cov}(\epsilon, \epsilon(Y)_N - b\epsilon(X)_N)$  and  $\text{Cov}(\epsilon_{i+1}, \epsilon_i)$  are zero. Thus  $M$  would exceed  $M_\Delta$  if the prediction errors were the major component, and more specifically if  $\sigma^2(\epsilon(Y)_N - b\epsilon(X)_N) > \frac{2N^2}{i(i+2)} b^2 \sigma^2(\epsilon)$ .

<sup>4</sup> This is seen by writing

$$\epsilon(Y)_N = \epsilon(\psi)_N - \xi_N = \epsilon(\psi_N^* - \psi_N) - (Y_N - \psi_N) = \psi_N^* - Y_N$$

and

$$\epsilon(X)_N = \epsilon(\chi)_N - \eta_N = (\chi_N^* - \chi_N) - (X_N - \chi_N) = \chi_N^* - X_N.$$

Finally, if the predictions were extrapolations of the last known benchmark period estimates, the variance of their errors would be

$$(18) \quad \sigma^2[\epsilon(Y)] = (1 - \rho_Y^2)\sigma^2(Y) \quad \text{and} \quad \sigma^2[\epsilon(X)] = (1 - \rho_X^2)\sigma^2(X),$$

where  $\rho_Y$  and  $\rho_X$  are the coefficients of serial correlation. In this case then, the magnitude of the errors would depend on the variability and the strength of the serial correlation in the series to be predicted.

# Index

- Anticipation series, 28
- Auto and appliance maintenance and repairs, 10–11
- Balance of payments, net exports data and, 13
- Benchmark estimates
  - errors in, 14, 18
  - revisions of, 49
- Bias in estimates of changes in GNP, 94–95
- Biennial Survey of Education, 11
- Budget of the U.S. government, 13
- Building permits, new construction estimates and, 11
- Bureau of the Census, *see* U.S. Bureau of the Census
- Bureau of Labor Statistics, *see* U.S. Bureau of Labor Statistics
- Business cycles, 23
  - and GNP estimates, 6, 69*t*, 70, 71*t*, 72*t*, 73, 74*t*–79*t*, 80–81
  - bias in, 94–95
  - errors in, 6, 22–23, 23*t*, 26, 91–92
  - and postwar trends, 84–90
  - and seasonal factors, 81
- Business and Defense Administration, 11–12
- Business fixed investment, construction components of, 11
- Business forecasts of GNP
  - accuracy of, 92–93
  - compared with provisional estimates, 29, 30*t*, 31*t*, 32*t*, 32–33, 34*t*, 35, 92–93
  - error statistics for, 22*t*
  - errors in, 36*t*
    - overestimation and underestimation and, 26
    - and forecasts of seasonal patterns, 84
- Business inventories estimates
  - errors in, 25*t*
    - compared with naive model projection errors, 43*t*
    - and gains over time, 58*t*
    - and successive revisions, 50*t*, 52*t*
  - and GNP estimates, 12–13
  - and seasonal patterns of GNP, 82, 83*t*, 84
- Census Bureau, *see* U.S. Bureau of the Census
- Cloos, George W., 80*n*
- Cole, Rosanne, 26*n*, 96*n*
- Commodities, benchmark estimates for, 8–10
- Commodity flow estimates, 8–9
  - of producers' durables, 12
- Construction, *see* New construction; Public utility construction; Non-farm residential construction
- Consumer durables estimates
  - errors in, 24*t*
    - compared with errors in naive model projections, 41*t*
    - and gains over time, 57*t*
    - and successive revisions, 53*t*
- Consumer goods expenditures, *see* Personal consumption expenditures
- Consumer nondurables estimates
  - errors in, 24*t*
    - compared with errors in naive model projections, 42*t*
    - and gains over time, 57*t*
    - and successive revisions, 53*t*
- Consumer services estimates
  - errors in, 24*t*
    - compared with errors in naive model projections, 42*t*

- and successive revisions, 53*t*  
*See also* Personal consumption expenditures
- Contract awards, construction estimates and, 11
- Contractions, *see* Business cycles
- Council of Economic Advisers, 16, 29*n*
- Cyclical changes, *see* Business cycles
- Cyclical errors, *see* Business cycles and gross national product estimates
- Deane, Phyllis, 4*n*
- Definitional changes in GNP, 35*n*
- DeJanosi, Peter E., 4*n*
- Direction-of-change errors, 23, 24*t*, 25*t*, 25–27
- Dodge series, 11
- Domestic investment, *see* Gross private domestic investment
- Domestic service expenditure estimates, 10
- Durables, *see* Consumer durables
- Dutch GNP forecasts, 48
- Economic Indicators*, 16
- Economic Report of the President*, 16, 29*n*, 32*n*
- Employment data, 11
- Error model, 18, 97
- Error statistics  
 for business forecasts of GNP, 22*t*  
 for estimates of GNP, 20*t*  
 compared with forecasts, 29, 30*t*, 31*t*, 32*t*, 32–33, 34*t*, 35  
 and successive revisions of GNP estimates and forecasts, 48–56  
*See also* Errors in GNP estimates
- Errors in GNP estimates  
 and business cycles, 94–95  
 calculation methods, 100–103  
 compared with errors in forecasts and naive model projections, 36*t*, 41*t*  
 and errors in expenditures and income estimates, 62, 63*t*, 63–64  
 and gains over time, 56–61  
 trend and cyclical, 90–92  
 and use of preliminary data, 96  
 use of statistical discrepancy to measure, 64–68
- See also* Error statistics; Gross national product estimates, errors in
- Expenditures estimates  
 errors in, 62, 63*t*, 63–64  
 and GNP estimates, 95–96  
*See also* Government expenditures; Personal consumption expenditures
- Exports, net, *see* Net exports of goods and services
- Extrapolation errors, 15*n*  
 and errors in early GNP data, 56  
 and errors in GNP estimates, 17–22  
 and GNP revisions, 28, 62, 64–68
- Farm inventory estimates, 13
- Farm and public utility construction data, 11
- Federal Aviation Administration, 10
- Federal Reserve Board  
 Index of Industrial Production, 80  
 Survey of Consumer Finances, 11
- Final expenditures estimates, 63*t*
- Final purchases, season pattern of GNP and, 83*t*, 84
- Forecaster, task of, 29
- Forecasts of GNP, *see* Business forecasts of GNP
- Friedman, Milton, 14*n*, 97*n*
- F. W. Dodge Corporation, 11
- GNP, *see* Gross national product; Business forecasts of GNP; Gross national product estimates; Gross national product extrapolations
- Goldberg, Simon, 4*n*
- Goods and services, *see* Government expenditures on goods and services; Net exports of goods and services
- Government expenditures on goods and services  
 error statistics for estimates of, 20*t*  
 error statistics for forecasts of, 22*t*  
 errors in estimates of, 25*t*  
 and cyclical characteristics of quarter covered, 23*t*  
 and gains over time, 58*t*

- Government expenditures on goods and services, errors in estimates of (cont.)  
 and successive revisions, 48, 50*t*, 52*t*, 54*t*, 89*t*  
 errors in forecasts and estimates compared, 31*t*, 36*t*  
 errors in naive model projections and estimates compared, 36*t*, 44*t*  
 and GNP estimates, 13–14  
 overestimates of, 32
- Gross national product (GNP)  
 average rates of change of, 86–87, 88  
 decline in, 68–81  
 exclusive of statistical discrepancy, 87*t*  
 peak to trough changes in components of, 72*t*, 74*t*  
 postwar trends in, 84–90  
 seasonal pattern of, 82, 83*t*, 84  
*See also* Business forecasts of GNP;  
 Gross national product estimates
- Gross national product estimates  
 accuracy of, 4–5, 92–93  
 based on expenditures and income data, 64–68  
 bias in, 94–95  
 and business cycles, 69*t*, 70, 71*t*, 72*t*, 73, 74*t*–79*t*, 80–81  
 and change in business inventories, 12–13  
 of changes and levels compared, 99–100  
 compared with extrapolations, 35–47  
 compared with GNP forecasts, 29, 30*t*, 31*t*, 32–33, 34*t*, 35, 92–93  
 and comparison of trend and cyclical errors, 90–92  
 construction of, 97*n*  
 data and methods used in, 8–14  
 data sources, 7–8  
 and definitional changes, 17  
 error statistics for, 20*t*  
 errors in, 38*t*–39*t*, 41*t*–45*t*  
 characteristics of, 18  
 compared with errors in naive model projections, 41*t*  
 created by limitations of concepts, definitions, and coverage, 3  
 cyclical characteristics of, 22–23, 23*t*  
 and errors in expenditures and income estimates, 62, 63*t*, 63–64  
 major sources of, 14  
 measurement of, 64–68, 100–103  
 overestimation, underestimation, and direction-of-change errors, 23, 24*t*, 25*t*, 25–27  
 resemblance to extrapolation errors, 17–22  
 revised estimates as measure of, 4–5  
 types of, potential of revisions and, 14–17  
 establishment of, 7  
 evaluation of, 91–92  
 and federal government purchases of goods and services, 13  
 first, 16, 87*t*  
 and gains over time, 56–61  
 and gains through successive revisions, 48–56  
 and incorporation of new benchmarks, 16–17  
 and major patterns of change, 6  
 major revisions in, 17  
 minor revisions in, 15  
 and net exports of goods and services, 13  
 and new construction, 11–12  
 peak to trough decline in, 6  
 and personal consumption expenditures, 9–11  
 and producer's durable equipment expenditures, 12  
 and revisions of seasonal factors, 81–82, 83*t*, 84  
 and state and local purchases of goods and services, 13–14  
 and successive revisions, 93–94  
 turning-point dates in, 78*t*–79*t*  
 and use of expenditures and income data compared, 95–96  
 and use of preliminary data, 96–100  
 uses of, 3
- Gross national product extrapolations compared with provisional estimates, 35–47

- Gross national product forecasts, *see* Business forecasts of GNP
- Gross private domestic investment  
 error statistics for average business forecasts of, 22*t*  
 error statistics for estimates of, 20*t*  
 errors in estimates of, 24*t*  
   compared with forecast errors and naive model projection errors, 31*t*, 36*t*, 42*t*  
   and cyclical characteristics of quarter covered, 23*t*  
   and gains over time, 57*t*  
   and successive revisions, 50*t*, 52*t*  
 first estimates compared with revised average annual rates of increase in, 89*t*  
 long-term changes in, 88–89  
 successive revisions in estimates of, 53*t*
- Home rental value estimates, 10
- Household utilities expenditure estimates, 10
- Housing statistics, 11–12
- Income estimates  
   compared with consumption estimates, 10*n*  
   errors in, 62, 63*t*, 63–64  
   and gross national product estimates, 95–96  
   as predictions of final expenditures, 63*t*  
   and product estimates, 7–8
- Input-output data, 17
- Interest paid by consumers, 17*n*
- Internal Revenue Service tax return data, 12–13
- Interstate Commerce Commission, 10
- Investment, *see* Gross private domestic investment
- Jaszi, George, 4, 4*n*
- Kuznets, Simon, 8
- Laundry expenditures estimates, 10–11
- LIFO inventories, 13
- Magnitudes of business cycles, 69–70
- Maintenance and repairs, *see* Auto and appliance maintenance and repairs
- Mean square errors  
   in forecasts of GNP, 29  
   in GNP estimates, business cycles and, 23*t*  
   in naive projections of GNP, 34*t*  
   *See also* Error statistics; Errors in GNP estimates
- Mincer, Jacob, 26*n*
- Moore, Geoffrey H., 40*t*, 81
- Morgenstern, Oskar, 4*n*
- Naive model projections errors, 34*t*, 36*t*
- Nassimbene, Raymond, 4
- National Housing Inventory, 12
- National income estimates, 14*n*
- Net exports of goods and services estimates, 13, 32*n*–33*n*, 52*t*  
 error statistics for, 20*t*  
 errors in, 25*t*  
   compared with forecast errors, 32*t*  
   compared with forecast and naive model projection errors, 37*t*  
   compared with naive model projection errors, 45*t*  
   and cyclical characteristics of quarter covered, 23*t*  
   and gains over time, 58*t*  
   and successive revisions, 50*t*, 54*t*
- Net exports of goods and services business forecasts, 32*t*  
 error statistics for, 22*t*
- New construction estimates  
 errors in, 24*t*  
   compared with naive model projection errors, 43*t*  
   and gains over time, 57*t*  
   and successive revisions, 50*t*, 52*t*  
   and GNP estimates, 11–12  
   successive revisions of, 54*t*
- Noncorporate sector business inventories data, 12
- Nonfarm residential construction, 11
- Overestimation, 86–87  
   of GNP components, 88–90  
   of GNP decline, 70, 73

- Overestimation (cont.)  
 in GNP estimates, 23, 24*t*, 25*t*, 25-27  
 and use of preliminary GNP data,  
 96-100
- OBE, *see* U.S. Department of Commerce, Office of Business Economics
- Oil and gas well drilling estimates, 11
- Passenger car expenditures, 12
- Payroll data, 11  
 and government purchases estimates,  
 14
- Peak to trough changes in GNP, 71*t*,  
 74*t*-77*t*
- Personal consumption expenditures estimates  
 error statistics for, 20*t*  
 errors in, 24*t*  
 compared with errors in forecasts  
 of, 31*t*, 36*t*  
 compared with errors in naive  
 model projections of, 36*t*, 41*t*  
 and cyclical characteristics of quarter  
 covered, 23*t*  
 and gains over time, 57*t*  
 and GNP trend errors, 6  
 and successive revisions, 50*t*, 52*t*  
 first estimate compared with revised  
 average annual rates of, 89*t*  
 and GNP estimates, 9-11  
 underestimation of, 2-3
- Personal consumption expenditures, 22*t*
- Plant and equipment outlays estimates,  
 15
- Policy-makers, GNP estimates and,  
 80-81
- Prediction error, 18
- Preliminary data in GNP estimates,  
 96-100
- Private domestic investment, *see* Gross  
 private domestic investment
- Producers' durable equipment estimates,  
 94  
 errors in, 24*t*  
 compared with errors in naive  
 model projections of, 43*t*  
 and gains over time, 57*t*  
 and successive revisions, 50*t*, 52*t*,  
 53*t*  
 and GNP estimates, 12
- Product estimates compared with income  
 estimates, 7-8
- Product flows, 16*n*
- Production, interest and, 17*n*
- Professional services expenditures estimates,  
 10
- Public utility construction estimates, 11
- Recoveries, *see* Business cycles
- Recreation expenditures, 10-11
- Retail sales estimates  
 and consumption expenditures estimates,  
 9-10  
 revisions in, 15  
 "Revision errors," 5
- Revisions, successive, 48-56, 93-94
- Root mean square errors in GNP  
 estimates, 35, 51  
 compared with errors in naive projections,  
 38*t*
- Ruggles, Nancy, 3*n*, 8*n*, 91
- Ruggles, Richard, 3*n*, 8*n*, 91
- Sales, 16*n*, 17*n*
- Sampling error, 14
- Seasonal factors and GNP estimates, 59,  
 81-82, 83*t*, 84
- Shiskin, Julius, 40*t*
- Spearman coefficients, 19
- Statistical discrepancy and error measurement,  
 64-68
- Statistics of Income*, 12
- Stekler, H. O., 4*n*, 5, 51*n*, 56, 80
- Survey of Current Business*, 16, 32*n*
- Teeter, Benjamin T., 4
- Theil, Henri, 48, 51*n*
- Timing adjustments, new construction  
 estimates and, 11
- Trade associations, annual reports of, 10
- Transportation expenditures estimates,  
 10
- Trend errors, 90-92
- Trough to peak changes in GNP, 72*t*, 73
- Turning-point dates in GNP, 73, 78*t*-  
 79*t*, 80