

# Economic Models Available for Analyzing Tax Reform Proposals

Testimony to the U.S. House of Representatives  
Committee on Ways and Means

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## **Introduction**

Chairman Camp, Ranking Member Levin and members of the Committee, I am pleased to have the opportunity to appear today. In this testimony, I wish to make three major points:

- The economic impacts of tax reforms are extremely important. The principle of dynamic scoring is a good one that would potentially bring into the process greater information regarding beneficial tax policies,
- Dynamic scoring models are difficult to operationalize and would require difficult (but not impossible) “budget process-like” decisions to be implemented as the Ways and Means Committee considers tax reform, and
- For many reasons, dynamic scoring will not provide a panacea for the policy decisions regarding the U.S. fiscal outlook, the most important of which is that the dynamic impact over 10 years can be relatively small.

I will pursue each in additional detail.

## **Dynamic Scoring is Good Science**

Budget “scores” are estimates of the change in the federal unified budget that would result from the passage of specific statutory language. Under current practice, the budgetary effects of all proposals are measured relative to a single, fixed baseline outlook for the budget, which is, in turn, built upon a projection for the United States economy. A key feature of scoring is that in evaluating legislation, the aggregate amount of economic activity – total production and income – is assumed to be unchanged from its baseline values. That is, the proposed legislation is assumed to have no effect on the macro economy and hence there is no accounting for potential feedback from changes in the macro economy to the budget.

It is this feature that has led some observers to refer to current scoring procedures as “static.” Unfortunately, this label has caused certain critics to mistakenly conclude that current procedures do not recognize any of the incentive effects of legislation; i.e., that firms, workers, investors, and households continue their economic lives as if nothing had changed. Nothing could be further from the truth.

For example, during my tenure at the Congressional Budget Office (CBO) the CBO scored the impact of the Medicare Modernization Act (MMA). To do so, the staff necessarily had to incorporate the decision of firms to offer insurance contracts for the cost of outpatient pharmaceuticals and bid for customers, the willingness of seniors to purchase such insurance, changes in the amount of drugs prescribed and

purchased, take-up of low-income subsidies, and a myriad other decisions by households, firms, and governments. However, in keeping with current practice, the overall level of gross domestic product and national income was assumed to be unchanged.

Dynamic scoring for tax reform proposals by the Ways and Means Committee (“the Committee”) would expand the range of economic impacts to include the pace of economic growth – that is, it would involve explicitly estimating the change in the aggregate level of economic output and income, and incorporating estimates of any second-round effects of these changes on budget aggregates. This has some desirable features. In estimating the impact of the legislation, analysts would (a) consider the direct impacts on program costs and tax receipts; (b) evaluate the effects on incentives to work, save, invest, legally or illegally avoid paying taxes, and generally conduct economic affairs; (c) estimate the resulting change in the overall level of economic activity; (d) compute the impact of this higher or lower level of economic activity on program costs and tax receipts; and (e) calculate the net impact of the legislation on the unified budget. The key difference is step (d), which is in turn built upon (c).

A virtue of dynamic scoring is that it extends analysis of tax policy to include economic policy dimensions. Specifically, dynamic scoring requires that analysts incorporate into their evaluation of legislation all of the economic feedbacks at the individual, household, firm, and national level. For this reason, it has the potential to distinguish between those policies that are equal in their budget cost, but very different in their overall economic incentives. Indeed, one of the most attractive aspects of dynamic scoring is its promise of allowing policymakers to distinguish between economically efficient tax policies that promote growth, and those that work to reduce the living standards of future generations.

The federal government has only dipped its toe into the waters of dynamic scoring. The CBO has undertaken dynamic scoring as part of its analysis of the President’s annual budget submission since 2003, and the Joint Committee on Taxation did a study of the dividend and capital gains tax reduction in 2003. Nevertheless, for many years private research groups and think tanks have performed such analyses. Private consulting firms, such as Macroeconomic Advisers, and think tanks, such as the Heritage Foundation, have performed macroeconomic evaluations of proposed policy changes. However, those analyses typically focused more on the economic effects than the budgetary implications. In this sense we have seen dynamic scoring of major policy proposals already, but on a somewhat *ad hoc* basis.

For purposes of the Committee, and more systematic approach is desirable. While dynamic scoring is better suited to evaluate pro-growth tax reforms, it is still *scoring*. That is, the basic mission remains to rank competing proposals in a systematic fashion so that policymakers can identify which proposals are better or worse from a growth and budget perspective. Accordingly, it would be useful for

the Committee to make the decisions necessary to implement dynamic scoring as a regular part of its deliberations.

### **Difficult Decisions Need for Dynamic Scoring**

To be consistent and effective, the Committee will have to address four important areas.

*Time.* The scale of the analysis involved in preparing baseline budget projections points to the first problem with wholesale adoption of dynamic scoring: time. It is inevitable that statutory language continues to evolve throughout the legislative process: committee deliberation and reporting, floor amendments and votes, and conference committee negotiations. Often there is a need for very quick and timely scoring information. The scale of a dynamic scoring effort may be in conflict with this need.

*Adopting a Single Approach for Estimates.* A practical difficulty with dynamic scoring has been the absence of a single, consensus approach to the estimates. The attraction of dynamic scoring is its ability to reveal the impact of legislation on economic growth. However, this impact depends crucially on the overall foresightedness of U.S. households and firms. To take an extreme case, imagine legislation that cuts all marginal tax rates by five percentage points, with the cut to take effect five years from now, but sunset ten years in the future. If people are extremely myopic, this policy has no impact on incentives to work, save or invest and there is no dynamic feedback. If they are moderately forward-looking, they may anticipate lower taxes and respond to these incentives. If they are even more forward-looking, they will recognize both the tax reduction and the subsequent rise. As a result, they will work especially hard during the intervening years – yielding a larger increase in output, incomes, and taxes – with a sharper decline when taxes rise again.

One approach to this problem, exemplified by the CBO's macroeconomic analysis of the president's budget proposals, is to provide a variety of estimates, each corresponding to a different degree of foresight. However, the Committee scoring process requires a single set of estimates. Thus, at the outset of its work it is necessary that agreement be reached on the approach to be employed regarding foresightedness, the pace of international capital flows, saving responses of households and firms, and so forth. Choosing a single approach would require resolution of some very knotty technical and philosophical issues.

*Balancing the Budget.* The example sketched above highlights another issue in the conduct of dynamic scoring: the need for an "offsetting policy." Over the long-term, if individuals have foresight, then government debt (relative to the economy) must stabilize. Legislative proposals that upset this requirement by increasing spending or reducing taxes (at least relative to their impact on economic growth) will produce

debt that will grow explosively. Similarly, spending cuts or tax increases (relative to their impact on the economy) will cause debt to spiral down. Since the government can neither borrow nor save unboundedly large amounts, it is necessary to put a stop to either spiral by introducing an offsetting budget policy at some point in the future.

The choice of offsetting policy – spending increases or decreases and the pace at which they take place, tax reductions or increases and their timing, or some combination of these – will have differential effects on the behavior of individuals and firms and influence the score. Since a primary objective of scoring is to treat all legislative proposals equally, it will be necessary to pick a single type of offsetting policy and use it for all proposals.

An equally important – but often overlooked – aspect of this problem is *getting the debt stabilized to begin the analysis*. Some approaches to dynamic scoring, particularly forward-looking growth approaches, simply will not work (i.e., the computer algorithms will not function) when the government budget is on an explosive debt trajectory. The federal budget *is* on such a trajectory. Thus, even to begin the work of analyzing tax reform it would be necessary to assume an answer to the basic task facing the Committee: how can the debt be stabilized?

*Supply-side versus Demand-side Dynamics.* Another challenge in implementing dynamic scoring is the degree to which the score reflects only supply-side growth, or also includes demand-side cyclical influences. Broadly speaking, economies grow in one of two ways. Supply-side growth occurs when there is an increase in the capacity to produce goods and services through the addition of greater labor supply (labor force participation, hours worked, higher effort per hour, greater skills per worker, better efficiency in the use of labor effort and skills, and so forth), greater physical capital (more or better equipment, software, buildings, and so forth) and improved technical prowess (new technologies or superior organization and management). These responses are at the heart of pro-growth tax policies.

Demand-side growth (or contraction) reflects business cycle fluctuations in the extent to which existing labor supply, capital, and technical prowess are utilized. Obviously, these are also at the center of attention for the Committee in the current economic setting. The attention paid to monetary and other stabilization policies is clear tribute to the fact that recessions are costly and faster recoveries are desirable.

As noted above, the Committee will need to settle on a single way of conducting its dynamic scoring. In light of the need for growth of both types to be incorporated into the analysis, it will require adding business-cycle considerations to growth-style modeling approaches. Conventional approaches to these problems have kept these responses separate, so the staffs will be forced to develop a feasible, if *ad hoc*, manner of merging the two approaches. This work should begin immediately.

Finally, the ultimate size, direction, and character of demand-side effects of fiscal policy changes depend as well upon the assumed path of monetary policy. In a manner similar to offsetting budget policies, it would be necessary to make assumptions regarding the response of monetary policy to the legislative changes.

### **Dynamic Scoring Will Not Be a Panacea**

One occasionally hears that dynamic scoring is desirable because it will be more accurate. While dynamic scoring will more fully incorporate a wider range of behavioral responses, it is not likely to improve accuracy. First, the mechanical nature of scoring – evaluating different policy proposals using a baseline fixed at the beginning of the legislative process – is necessary for even-handed evaluation of alternative proposals, but hardly a recipe for improved accuracy in an ever-changing economy. That is, adopting dynamic scoring does not mean that the baseline should or would be updated. Accordingly, it will continue to be “out of date” and estimates based on it will suffer inaccuracy.

Further, as noted earlier, the same level, legislative playing field necessarily entails identical and “unrealistic” assumptions regarding offsetting budget policies and monetary policy.

Similarly, any move to dynamic scoring would not eliminate the need for analysts making judgment calls in the course of the analysis. Quite the contrary, as noted above, in addition to the plethora of issues that already exist (e.g., how fast will legislation become law; how quickly will administrative rule-making be completed; how fast will awareness spread?) additional decisions will be needed on the model of economic growth policies’ ability to influence that growth.

Neither the failure to improve accuracy or the expanded need for judgment is bad. The combination of baseline projections and budget scores is intended to support the legislative process, not forecast the economy. There are far more parsimonious and accurate forecasting procedures available. Evaluating innovative legislative proposals necessarily requires analytic judgment because there is literally no policy track record on which to rely. Dynamic scoring may reflect a change in the desired content of the budget process; it does not change the fact that scoring supports that process.

Finally, the greatest reason that dynamic scoring is not a panacea is that it is unlikely to change the bottom line very much over the budget window. Most legislative proposals don’t have enough overall “bang” to generate much dynamics. Of course, some have superior incentive effects – a big “bang for the buck.” But even the dynamics of these proposals are not likely to look very large. Over the period from 1820 to 1998, output per capita in the United States grew an average of 0.4 percentage points faster than in the United Kingdom (1.74 versus 1.35 percent per

year). Thus, 0.4 percentage points per year if maintained long enough is a big supply-side growth-effect. Big enough to transform the global economic order! But a superior tax policy that generates such a permanent increase in growth will have only modest impacts over the first 10 years.

## **Conclusions**

I believe the Committee will benefit from the use of dynamic scoring in its deliberations regarding tax reform. However, to do so, it must move quickly to make important decisions regarding the process by which the scoring will be done.

Thank you for the opportunity to appear today. I look forward to answering any questions the Committee may have.