economic perspective

by Gene Steuerle

Score-Keeping and Spending

Dynamic score-keeping — the recording of budget feedback effects as people react to government actions such as tax cuts — is a hot topic again, fueled in part by the recent release of a Congressional Budget Office study of the revenue effects of the president's tax proposals. The topic is also one of the most misunderstood. Some Republicans like to believe that almost any tax rate cut has very large feedback effects that make its costs significantly lower. Some Democrats like to believe that there is no issue here worth discussing. *The Wall Street Journal* editorial page takes a special interest in the issue, and I am only the latest among those it has honored by being attacked personally for not being enough of an "agent of change" in pushing for some simplistic vision of dynamic scoring. As is usual when an issue becomes politicized to this extent, things are more complicated than they appear.

Here I wish to concentrate on one particular issue — how spending is handled in these models — and how the extremes on both sides of this issue are likely to find themselves burned by two spending implications of the models that are usually not discussed:

1. If tax cuts merely raise deficits and are not eventually financed by spending cuts, the long-term impact on the economy will be negative.
2. Spending increases (and tax cuts other than tax rates) generally do much worse for the economy than tax rate cuts.

The CBO report on the eventual effect on revenue effects of the president's tax cuts walked a tight rope, attempting to provide an academic discussion of an extremely sensitive political issue. Quite appropriately, it reported results from a number of models under a variety of assumptions. Guess what? To no knowledgeable person's surprise, the results were all over the map. Not only wasn't there much convergence toward a single number, it wasn't even clear whether the net dynamic effect on revenues was greater or less than the static effect, as if nothing had happened to the economic behavior.

Driving this ambiguity more than anything else is that much depends on what happens to spending. When tax cuts are considered in isolation, some assumptions must be made. In effect, it doesn't make a lot of sense to apply a dynamic score to one-half of a balance sheet and pretend that the other half doesn't exist. In most models, the effect on the economy then depends on how the tax cut is financed, how long until it (and the interest costs it raises) is financed, and whether the financing is in the form of more tax increases in the future or spending cuts.

All models of this type are of limited value. All rely on literally thousands of assumptions over which there is no economic agreement — including the reaction of people to the changed tax regime, the speed of their reaction, the effect of budgetary changes on saving in the near- and long-term, the mathematical form of the relationships between each government reaction and each behavioral response, and much more. Still, if one accepts the state of the art as it is and understands the extent to which judgment drives the way models are designed, then it is not hard to understand intuitively why spending is such a dominant factor.

If a tax cut merely increases the deficit, then it does several things to the economy. It draws from an existing pool of saving. How negative that impact is in the short run depends on assumptions as to whether people somehow make up for government action by saving more and how much international saving can be tapped. Of course, the latter is a dangerous game, as declines in international saving may also reduce international growth and other countries' demands for imports. More importantly, one can box oneself into the silly position of arguing that every country should run larger deficits to finance tax cuts since they all can rely — in a beggar-thy-neighbor type of spiral — on other countries' saving to prop up their own.

Regardless of the international reaction, a tax cut considered by itself raises the deficit or lowers the surplus and must eventually be financed. The later the financing, the more that interest costs add to what must be paid (regardless of what happens to interest rates). To argue that one can ignore this future impact on the budget is downright silly.

In some models run by both the Congressional Budget Office and the Council of Economic Advisers, tax cuts considered in isolation eventually cause a long-term slow down in economic growth — either because of the widening deficits or the tax increases that come along later to pay for them. In some cases, the models assume that this occurs with a long lag, so growth still occurs for a few years. In other words, workers and savers respond positively now to a cut in tax rates, and only gradually over time, as interest costs rise or tax increases eventually come along, is there a negative effect on the economy. In some cases, there is pressure to present only the results for the first years and to ignore the long-term consequences.

Of course, it is the long term that should be of most interest. Current generations should not be taking from future generations and hiding the costs. Moreover, the nature of the lags is so uncertain that pushing the negative impact out beyond a few years is more in the nature of an assumption than a result of the models.

Think about what is really being said: *If spending does not matter, then economic growth is generated by paying for expenditures later.* From a demand-side or Keynesian perspective on stimulating an economy that is in need of priming, this might make sense on occasion. But from a supply-side perspective, it seems awfully strange to claim that people's efforts to save and work can best be encouraged by hiding the consequences of their spending. When, then, do we stop?

Some more liberal spenders may take delight in the conclusion that simple increases in the deficit — even if they finance tax rate cuts — are likely to hurt long-term growth. Certainly it puts a damper on any extreme supply-side claim. But they had best be careful. If they want to deride supply-siders for ignoring the deficit consequences of tax cuts, then consistency requires that they use the same logic on increased expenditures, where it applies in spades. You see, if spending increases are financed out of higher deficits or out of tax increases later, then most of these models as currently designed would predict an even worse effect on the economy than with a tax rate cut.

Why? The tax rate cuts are generally assumed to have some positive impact (the modesty of which depends on the model being used) on work and saving, which at least partially offset the negative effect of a deficit increase. But a pure spending increase by itself will have all of the negative deficit impact, without the behavioral offset. If one wants to raise the deficit issue against the president's tax proposals, then it should be raised as well against both discretionary spending proposals and the automatic growth in entitlement program.

In sum, when it comes to predicting economic growth and future revenues that derive from that growth, spending matters. Considered in isolation, tax cuts today paid for out of deficits and future tax increases are unlikely to be growth-enhancing. But then, in isolation, automatic or discretionary spending increases are likely to be even worse for the economy in most of these models. Only a full budgetary framework — in which tough choices are clearly aligned against each other, and benefits and costs of alternative actions compared — can deal with these issues.