



economic perspective

by Gene Steuerle

Making the Right Case for Dynamic Analysis

A recent Congressional Budget Office report presented many estimates, both positive and negative, for the effect of the president's proposed tax cut on the economy. In issuing this report, CBO indirectly called into question many of the more naïve statements made about the ability of Congress to "dynamically" score tax cuts in a way that significantly lowered their budget cost. One reason is that much depends on what will happen to spending immediately and down the road. Few economists, conservative or liberal, are comfortable with the claims made by more radical advocates of dynamic scoring that a tax cut operates independently from government's corresponding need over time to cover the cost of a tax cut by paying more in interest, collecting more later in taxes, or reducing spending.

Unfortunately, the debate over dynamic scoring has become so political that knee-jerk reactions, rather than reasoned response, are now expected no matter where one comes out on the issue. By overstating their arguments, moreover, the radical advocates have hurt their own case. That is, there is a case to be made for recognizing the "dynamic" aspects of budgetary actions, although it is one they seldom make.

What is the case? Taxes by their very nature distort. They generally cost the economy more than the cash that is raised. Similarly, spending affects behavior and generally distorts decisionmaking. While the additional distortions are almost certain, gains from the expenditures cannot simply be assumed. Therefore, the burden of proof for government action is on the proponent, who should be able to suggest gains to society — social or economic — over and above monetary costs as calculated in the budget.

Suppose that all individuals in the economy had equal incomes of \$10,000 each and were subject to the following tax/transfer regime: Each individual would be taxed at a rate of 20 percent on income, and then each would be granted \$2,000 to purchase many more widgets than they otherwise would buy with their own money.

In this economy, there are really no net transfers taking place. But there are a lot of distortions caused by the government's actions. The 20 percent tax rate is liable to discourage some work and saving. In a related manner, so also does the grant affect behavior, as one can receive it even without working or paying tax.

Finally, the extra purchases of widgets in this economy distort what is produced and consumed. At least in this example, it is not clear why the government should be encouraging widgets and effectively reducing the amount left over to buy other goods and services.

In a traditional budget, of course, the net cost of the two transactions initially will be zero: \$2,000 in tax and \$2,000 in widget transfers for each taxpayer. Over time, however, it is likely that taxes would go down as people worked less, and the deficit would rise. Thus, the fall in revenues would be more than \$2,000 per taxpayer. Moreover, the value of what the government provides would be less than \$2,000 because of the excessive production of widgets, although national income accounting may not catch this distinction. These losses to the economy are worth knowing as elected officials begin debating and voting on this tax-and-widget-spending program.

On a few occasions, taxes may also distort "away" from some private distortion already existing. For instance, if a private company does not recognize the cost of pollution to society, the tax might be set at a rate that makes the tax cost to the company equal to the pollution cost to society. It is not that the tax fails to distort, simply that its effect happens to be offset by a societal distortion in the other direction. Few taxes, however, can avoid adding to distortions in some fashion.

The distortions caused by taxes — and almost all taxes distort — do not make government inherently bad. But they do mean that governmental spending, in turn, must be worth more than the dollars that are spent. In effect, government action must achieve some additional good that would not be achieved otherwise by private individuals acting without governmental interference. The gain might be in national defense. Or, in enforcing contracts, government might produce an economic gain far above their cost. Redistribution to the poor may produce a gain to the poor that, from a society's viewpoint, is worth more than the losses to those making the transfer. Energy subsidies may help the country maintain some energy independence. And so on.

Admittedly, the gains on expenditures are hard to calculate and often exaggerated by those lobbying for them. Nonetheless, they should be there or the governmental activity — including raising taxes to finance the action — cannot be justified. In the end, one must compare the additional losses due to taxes to the additional gains due to the expenditures. If the net is not

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positive, then the government interference hurts. The burden of proof is on those who want to interfere with higher expenditures and higher taxes. Knowing of

these dynamics is important to the decisionmaking process regardless of whether it can be summarized in some simple number known as a dynamic score.