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How Budgetary Choices Affect Work, Saving, and Growth
The Real Purpose of 'Dynamic' Estimating
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Introduction

Chairman Nussle, Ranking Member Spratt, and Members of the Committee, it is an honor to testify before you on the potential usefulness of including estimates of the macroeconomic effects of tax and expenditure policies in the budget process. Dynamic scoring is theoretically preferred to the current budget scoring process; however, many questions remain about how best to implement a consistent and practical framework that allows macroeconomic effects to be included in the budget process. In my testimony, I propose that it is more reasonable to begin by focusing on consistent and timely use of dynamic analysis in the budget process, rather than adopting dynamic scoring initially, for the following reasons:

- Dynamic analysis, if used appropriately, can provide useful information about the efficiency and distributional effects (within and across generations) of alternative tax proposals under either the current budget process or a process based on dynamic scoring,
- Dynamic analysis is far less controversial because it can highlight the inherent uncertainty involved in estimating the macroeconomic effects of various policy initiatives, and
- Dynamic analysis is a necessary component in any budget process that includes dynamic scoring because it would be used to analyze and relay information about the macroeconomic effects of tax proposals, which are not currently included in conventional revenue estimates.

Implementing a budget process that encourages the adoption of efficient, fair, and simple tax and spending policies is critical given the fiscal gap facing the nation, which has been estimated to be as high as \$98 trillion in present value terms (Auerbach et al 2006). This is equivalent to 10.8 percent of the present value of the sum of projected Gross Domestic Product (GDP).

It is important to note that dynamic analysis is already used on a limited scale. For example, CBO and JCT have produced dynamic analyses of several significant tax proposals. More recently, the Department of the Treasury's Office of Tax Analysis (OTA) has published dynamic analyses of the reform proposals made by the President's Advisory Panel on Federal Tax Reform and the proposal to permanently extend the President's tax relief.

Comparing Alternative Policy Options

A useful example is the OTA report (July 2006) that examines the dynamic effects of the President's proposal to permanently extend a variety of tax provisions enacted in 2001 and 2003. The report provides information on the macroeconomic effects of the various tax provisions as well as the aggregate macroeconomic effect of all the provisions. This information allows for a comparison of the macroeconomic effects of various policies and, if used appropriately, could prove useful in structuring efficient tax policy. For example, the OTA report analyzes the following three groups of provisions:

- Extension of lower capital gain and dividend tax rates;
- Extension of lower ordinary income bracket rates for the 25, 28, 33, and 35 percent brackets and an extension of the repeal of the phase-out of personal exemptions and itemized deductions; and,
- Extension of the increase in the child credit from \$500 to \$1,000 per child, the increased standard deduction and bracket width for joint filers, and the 10 percent rate bracket.

The OTA report showed that lowering capital gains and dividend taxes, coupled with a decrease in government consumption after 10 years, increased gross national product (GNP) by 0.4 percent in the long run as lower effective tax rates on capital income increased saving and investment. By comparison, if the revenue losses were offset by an across-the-board tax increase after 10 years the report predicts a 0.3 percent increase in real GDP in the long run. In fact, permanently extending the dividend and capital gains tax cuts increased real GNP in the long run for all of the options considered in the OTA analysis. However, as noted by OTA, changes in a variety of simplifying assumptions underlying the economic model used in this report could strengthen or weaken these results. This includes assumptions about the economic effects of dividend taxes and a variety of other economic distortions that are not included in the model.

For the base case parameter values, the report showed that permanently extending the cuts in the top four ordinary income tax brackets and the repeal of the phase-out of personal exemptions and itemized deductions increases real GDP by 0.7 percent in the long run if the tax cuts are financed by reductions in government consumption. However, if the tax cuts are financed by an across-the-board tax rate increase after 10 years the policy has a negligible impact on real GDP. By comparison, permanently extending the increase in the child credit, the increase in the standard deduction and bracket width for

joint filers, and the 10 percent rate bracket reduces real GNP by 0.4 percent if financed with government consumption after 10 years and by 1.2 percent if financed by an across-the-board tax rate increase after 10 years.

Purely from an efficiency perspective, a permanent reduction in dividend and capital gains tax rates is preferred to lowering the four highest ordinary income tax rates coupled with the repeal of the phase-out of personal exemptions and itemized deductions in most cases presented in the report. Similarly, a permanent reduction in dividend and capital gains tax rates or the changes to the top four brackets are preferred to an increase in the child credit, the marriage tax relief, and the 10 percent bracket, as the latter are inframarginal changes for most individuals. However, efficiency is not the only important factor in determining fiscal policy—fairness and simplicity in administration and compliance are also factors that should be considered.

Policy Guidelines for Implementing Dynamic Analysis

House Rule XIII.3.(h)(2) of the Rules of the House of Representatives, adopted January 4, 2005, in the 109th Congress, includes the following requirement:

- (2)(A) It shall not be in order to consider a bill or joint resolution reported by the Committee on Ways and Means that proposes to amend the Internal Revenue Code of 1986 unless—
- (i) the report includes a macroeconomic impact analysis;
 - (ii) the report includes a statement from the Joint Committee on Internal Revenue Taxation explaining why a macroeconomic impact analysis is not calculable; or
 - (iii) the chairman of the Committee on Ways and Means causes a macroeconomic impact analysis to be printed in the Congressional Record before consideration of the bill or joint resolution.
- (B) In subdivision (A), the term ‘macroeconomic impact analysis’ means—
- (i) an estimate prepared by the Joint Committee on Internal Revenue Taxation of the changes in economic output, employment, capital stock, and tax revenues expected to result from enactment of the proposal; and
 - (ii) a statement from the Joint Committee on Internal Revenue Taxation identifying the critical assumptions and the source of data underlying that estimate.

This rule is a good starting point for implementing dynamic analysis but it could be improved. In particular, I offer the following guidelines for implementing dynamic analysis into the policy process.

- While examining the aggregate macroeconomic effects of various proposals is of interest, this approach ignores much of the additional information that could be gleaned from dynamic analyses. Thus, dynamic analysis should focus on comparing the macroeconomic effects of competing provisions as well as presenting information on the aggregate effects of all the provisions. Obviously, analyzing every provision separately would be impossible and counterproductive,

as this would consume far too many staff resources. However, it is important to ensure that the choice of provisions to be analyzed is not politically driven, as this would undermine the integrity of the process. A balance must be struck on this issue.

- Dynamic analysis should also be applied to spending proposals, as the dynamic implications of expenditure policies may be as important as those of tax policies.
- Debt service costs are generally included in dynamic analysis but are not included in conventional cost or revenue estimates. To be consistent, the debt servicing costs of conventionally scored policies should also be considered in the policymaking decision. Otherwise, the budget process may be biased towards proposals with negligible or negative long run effects relative to proposals that are associated with positive long run effects.
- Macroeconomic aggregates are not the only information that should be provided to policymakers. Some measure of economic well being should also be provided in addition to the macroeconomic aggregates. This is important because positive macroeconomic effects can be associated with negative welfare effects.
- Distributional analyses should also be conducted both within income groups and across generations for certain policies. For example, the President's Advisory Panel on Federal Tax Reform in the United States decided against recommending a true consumption-based tax, and instead, proposed a consumption-based system supplemented with an "add-on" capital income tax at the individual level (the "Growth and Investment Tax" or GIT). Given that the report showed that the economic gains were larger under the consumption-based tax relative to the GIT and that the transitional effects of the two proposals were different, it would be interesting to compare how the plans differed from a distributional perspective, both during the transition and in the long run.
- The extent of the uncertainty contained in a dynamic analysis should be well noted. For example, this would include discussing the sensitivity of the results to various assumptions about parameter values, the assumptions underlying the economic model, whether the policy was financed by changes in government spending (and the effects of such spending on welfare), taxes, or government debt, and assumptions about the reactions of other entities such as the Federal Reserve, state governments, and foreign countries.
- Dynamic analysis should be timely so that it can be used effectively in the formulation of policy. The current House rule (XIII.3.(h)(2)) requires an analysis of the macroeconomic effects before the bill can be considered on the floor. This is somewhat late in the political process, as many of the major details of a bill are typically established at this point. It is important to note that there are possible logistical constraints on this issue, given the current state of macroeconomic modeling.

- Public disclosure is imperative. As much information as possible should be released to the public. At a minimum, enough information should be released so that outside entities could replicate the work. This will ensure that the process is seen as fair and open and will serve as a check on those who provide the estimates.

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