

**BRIEF ANALYSIS**

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*For immediate release:**Tuesday, January 31, 1995***Dynamic Scoring: A Primer**

Changes in tax rates affect how hard and long people work and how much they save and invest. But the official revenue-estimating arms of government ignore this fact in making their calculations. They assume that earning and saving behaviors will stay exactly the same, regardless of the tax rate.

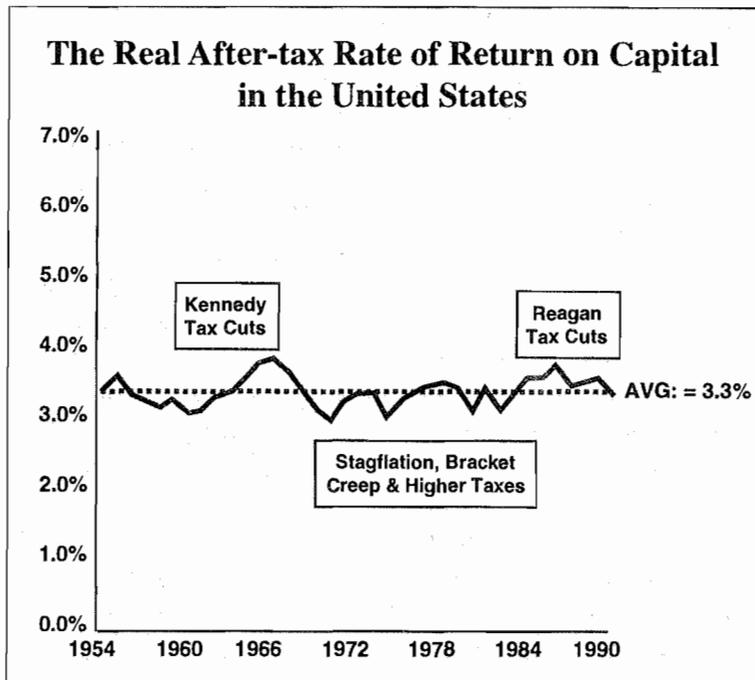
Because of this assumption, the government's revenue estimates usually overstate both the amount of revenue a tax increase will raise and the amount a tax reduction will lose.

Perhaps the most ridiculous example of what this can lead to occurred when Senator Bob Packwood (R-OR) asked the Joint Committee on Taxation (JCT) to forecast the revenue increase from raising the top tax rate to 100 percent on all income over \$200,000 in 1989. The answer: tax revenue would increase by \$204 billion in 1990 and by \$299 billion in 1993. Even if all income over \$200,000 were confiscated, the JCT assumed, people would work and save as before!

**Static vs. Dynamic Scoring.** The JCT used what is known as "static" scoring in making its estimate. Whether revenue estimators should employ "static" or "dynamic" methods — that is, methods that take into account behavioral reaction to tax changes — is at the heart of a major debate in Washington. Many leaders of the Republican Congress believe that the government's use of static methods and its failure to take into account taxpayer behavior have created a bias in favor of tax

increases and against tax cuts. They want to incorporate dynamic effects in the estimates. The Clinton administration opposes such a change as potentially undermining budget discipline.

This argument is important because the budget laws are very restrictive. Under current law, any tax cut brought up for consideration in Congress must be "paid for" with spending cuts or tax increases. On the other hand, tax increases do not require any offsetting tax cuts or spending increases. The result is that it is almost impossible to cut taxes. Deficit reduction efforts must rely heavily on tax increases, rather than spending cuts.



**Static Scoring Errors.** Static scoring has led the revenue-estimating agencies into huge forecasting errors. Take the Congressional Budget Office (CBO), for example:

■ When the capital gains tax rate was raised from 20 to 28 percent in 1986, the CBO forecast that taxable capital gains would rise to \$225 billion by 1989. The actual figure was \$150 billion — an error of \$75 billion or 50 percent. (The CBO failed

to tell members of Congress or the news media about this error until Rep. Dick Armey, an economist, asked.)

■ Between 1988 and 1991, taxable capital gains fell below the 1985 level in every single year. By 1991 they were just half of what they were in 1985 (after adjusting for inflation) and lower than in any year since 1978. Still, as late as 1988 the CBO claimed that its computer simulations showed "a net revenue increase from the 1986 Act."

■ In January 1990, the CBO estimated that Americans would realize capital gains of \$269 billion for 1991. They missed the mark by about 150 percent, as capital gains realizations reached \$108 billion.

■ The CBO forecast that the 1986 tax rate increase would raise corporate tax revenue from \$89 billion to \$101 billion the following year. Instead, corporations shifted from equity financing to debt financing to reduce taxes, and corporate revenue *fell* to \$84 billion.

**How Static Scoring Damaged Bush.** In 1989, President Bush's plan to cut the capital gains tax was blocked, in part because the revenue estimators said it would lose too much revenue. A year later, the president was encouraged to abrogate his solemn campaign promise not to raise taxes, in part because these same estimators said it was the best way to cut the deficit.

Many economists now believe that the 1990-91 recession and the general economic malaise of the 1990s can be traced directly to the failure to cut the capital gains tax in 1989 and to the 1990 tax increase. Flawed revenue-estimating methods led to these policy errors. Had the estimators taken into account past experiences with cutting the capital gains tax in 1978 and 1981 — both of which *raised* government revenue — they might predicted a similar response to President Bush's proposal and aided its passage. And had they considered the negative effects of numerous tax increases in recent years, they might have encouraged the president and Congress to rely more on spending cuts and less on tax increases in 1990. As it turned out, the tax increases of 1990 raised far less revenue than estimated and, for that reason, several were ultimately repealed.

For 12 years, the Reagan and Bush administrations failed to force the Treasury Department's career bureaucrats to change their estimating methods, despite strong evidence that the methods are flawed. The administrations faced media criticism for introducing the methods that opponents decried "voodoo economics." Yet, such methods are not new or untried — except in government. Private businesses use them daily.

**Why Static Scoring Is Wrong.** Static scoring operates from the principle that no tax increase will reduce net investment and no tax reduction will increase it. In this view, since tax policy cannot change investment in the U. S. economy, tax policy cannot increase output or create jobs. Both logic and research reject this argument.

If investors did not change their behavior in response to tax changes, then a tax increase on investment income would permanently lower the aftertax rate of return investors receive. Conversely, a tax reduction would permanently increase the rate of return. In fact, NCPA Senior Fellows Gary Robbins and Aldona Robbins have shown investors to be highly and consistently sensitive to tax changes — so much so that the real aftertax rate of return on capital tends to stay constant over time. As the figure shows:

- Over the past 37 years, the real rate of return on capital has tended to be remarkably stable — averaging about 3.3 percent per year.
- This stability has persisted despite radical changes in the structure of the economy, significant changes in technology and substantial changes in the taxation of income from capital.
- Events that change the rate of return on capital (such as changes in the tax law) rarely cause variations of more than 1 percentage point above or below the long-term average.
- A return to the rate of 3.3 percent usually occurs within five years following a significant deflection, and 60 percent of the adjustment occurs within two years.

**Time to Change.** Republican control of Congress presents another opportunity to introduce dynamic revenue estimating methods. Republicans now control the JCT and the CBO, the two congressional forecasting agencies. They should move quickly to institute new estimating procedures that will accurately reflect the disincentive effects of tax increases and the stimulative effect of tax cuts. Failure to do so could lead to policy errors such as those made by President Bush.

*This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett and NCPA President John C. Goodman.*