THE WASHINGTON POST

Wednesday, April 30, 2003; Page A23

Accounting for Taxpayer Behavior

By Martin Feldstein

After years of resisting, the Congressional Budget Office finally made a first stab at dynamic tax analysis -- a new way of assessing how much tax cuts will affect the deficit -- in its review of the president's 2004 budget. But this initial step, while laudable, didn't get it quite right. So when congressional negotiators sit down to draft specific tax legislation, they will still be using estimates that overstate the loss of tax revenue from President Bush's proposal. Given the continued uncertainty in the economic outlook, the congressional budget committees should adjust for this overestimate and agree on a tax cut that is closer to the House proposal than to the Senate's lower limit.

Common sense and studies based on past experience conclude that cutting taxes stimulates economic activity in both the short run and the longer term. These behavioral changes raise taxable incomes, and that in turn reduces the revenue cost of lowering tax rates. While any tax rate cut that could completely pay for itself would be unusual, studies of past tax reforms show that taxpayer behavior can offset a substantial portion of estimated revenue loss.

It's good news that the CBO has initiated dynamic scoring of tax changes. Traditional "static" estimates are based on the assumption that taxes don't affect the economy. In dynamic scoring, forecasts take into account revenue gained from changes in labor supply, investment and spending induced by tax changes.

A good feature of the CBO analysis is that it distinguishes the short-term "demand-side" effects of the president's plan from the longer-term "supply-side" effects. This distinction is important, because the ability of any tax cut to raise GDP in the short term by stimulating demand depends on the Federal Reserve's response to the tax cut. There are times when the Fed responds by raising interest rates to prevent an increase in demand because it fears the resulting rise in inflation. But the Fed is now eager to see stronger growth and would not take any such offsetting action.

Unfortunately, the CBO analysis fails to recognize the Fed's current stance. Instead, it assumes that much of the favorable short-term effect on the economy would be offset by higher interest rates. The CBO calculations therefore imply less stimulus and greater short-term revenue loss than would occur with a more realistic picture of the Federal Reserve's behavior.

There are other analytic shortcomings, particularly in reflecting the longer-term supply-side effects of tax reforms on individual behavior. Although the CBO links lower marginal tax rates to increased working hours, it does not reflect their more important impact on the incentive to work harder and in more remunerative occupations, to get more education and job training, and to take compensation in taxable form rather than as fringe benefits.

The president's proposal would raise saving rates by eliminating the double taxation of dividends and expanding personal saving accounts. This would raise economic growth and therefore taxable income, something that the CBO seeks to capture. But its current preliminary version does not give adequate attention to the resulting increase in corporate tax revenue, a feature that can substantially reduce the revenue costs of the president's plan.

With such good intentions but weak implementation, it's not surprising that the new estimates of the revenue cost of the president's budget are similar to the traditional static calculations. Critics have seized upon this to argue that dynamic scoring is irrelevant and that the economy's response to tax incentives does not reduce revenue cost. This is wrong for three reasons.

First, a more accurate analysis would show substantially larger differences between static and dynamic estimates. Moreover, the difference between static and dynamic estimates would be much greater for some tax changes (such as, lowering marginal tax rates) than for others (such as the child tax credit). And third, the CBO analysis also muddies the results of dynamic scoring by combining the effects of tax cuts and spending proposals. Dynamic estimation reduces the cost of tax cuts but increases the cost of spending proposals that weaken incentives.

Despite all these shortcomings, the CBO's new dynamic analysis establishes the principle that estimates of major tax changes should take behavioral effects into account. Future improvements will make this an important tool for congressional tax policy. But in its current form, it fails to convey the extent to which lower tax rates and savings incentives generate revenue that reduces the net cost. Congress should take that into account when it sets the budget limits on the tax cuts and when it legislates specific tax changes.

The writer, an economics professor at Harvard, was chairman of the Council of Economic Advisers under President Reagan.