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Spooked by the obvious

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If you suddenly learned the government had reduced taxes on interest, dividends and capital gains, would you save and invest more or less? Most people would say more, because saving and investing would be more profitable with lower tax rates. As obvious as this seems, much of the Washington establishment is shocked the deficit is falling rapidly due to surging tax revenues, despite the "massive" Bush tax cuts.

The Washington establishment was shocked back in the late 1970s when, as a result of the capital-gains rate tax cut, tax revenues went up rather than down. They were shocked again in the mid-1980s when revenues surged despite the "massive" Reagan tax rate cuts. They were again shocked in the early 1990s when new tax revenues did not pour in after the Bush 41 tax rate increase. In the mid-1990s, they were also shocked when the Republican Congress forced President Clinton to cut the capital-gains tax rate, and revenues soared, leading to an unanticipated budget surplus.

Many in the political and bureaucratic class, not only in Washington, but in most world governments, are rather simple-minded on economics. They tend to think if they just increase tax rates they will get more money to spend. They rarely think about the behavioral responses of people and companies to changes in tax rates, and how the sum of these individual behavioral responses will affect the whole economy.

The issue of correctly forecasting changes in tax revenue receipts as a result of changes in tax rates and policies will become critically important again at the end of next month when the President's Tax Reform Commission is due to give its report. The commission was charged with recommending "revenue neutral" tax changes. In simple language, that means any new or revised tax system they devise should produce the same revenue as the current system.

This may sound simple but, in fact, no one knows how much revenue the current tax system will produce in future years, let alone some new system. Long-range forecasts are notoriously unreliable because they require knowing future rates of economic growth and inflation and understanding how people will alter behaviors because of any tax system changes.

To illustrate, let's start with a simple, true proposition: Normally, the higher something is priced, the less it will be demanded. Thus, if we wish to cut gasoline demand, we should

raise the price -- now occurring because of market forces rather than tax increases on gasoline (the effect is the same).

But the full price increase effect takes time. People have established driving and commuting patterns and are slow to change them or find alternatives. They do not immediately sell their existing gas guzzler and buy a more fuel efficient automobile. It takes years to adjust the auto stock.

With every individual and business tax, there are similar behavioral affects. Given enough time, both individuals and businesses will go to great lengths to avoid paying a tax. Taxes affect the willingness of people to work, save and invest which ultimately determines the growth of the economy and the number and quality of jobs produced.

The government's tax revenue estimating agencies, primarily the Joint Tax Committee of the Congress and the Office of Tax Analysis in Treasury, have poor records of tax revenue forecasting, particularly long-run, because of inadequate behavioral and macroeconomic analysis. These forecasts drive congressional and administration decisions about how much to increase or decrease tax rates and other major tax policy issues. Bad numbers lead to bad policy, which hurts everyone.

There is no way the Tax Reform Commission can develop highly credible, revenue neutral, tax proposals, because the necessary expertise does not exist in the U.S. government to give us good long-run numbers to compare.

Thus, a very valuable commission contribution would be to recommend reform and strengthen tax estimating. Specifically, it should recommend analyzing each proposed tax change both for short- and long-run complete behavioral effects, and that the sum of these effects be incorporated into strong macroeconomic models (capable of adequately evaluating both the supply-side and "rest of the world" effects of policy changes). Finally, the revenue estimating needs to be much more transparent by requiring the revenue forecasters to publish their models and subject them to peer reviews.

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