The Washington Times
www.washingtontimes.com

Destructive Miscalculations

By Richard W. Rahn
Published November 1, 2007

What would you think about a boater who enters a navigation contest each year, but always finishes south of the destination marker, even though he is told to consider the environmental factors? He claims that he does pay attention to the wind speed and direction, but his colleagues note that he always ignores the strength and direction of the water current.

Think of our boater as the Joint Tax Committee (JTC) of the U.S. Congress, which forecasts tax revenue. Year after year, it is wrong in very predictable directions. These errors are important because they often translate into bad tax policy, which makes most Americans poorer and gives them fewer job opportunities.

Normally, I do not use my column to respond to letters. But because of the importance of the issue of tax revenue forecasts by the JTC, it is worth responding to Edward Kleinbard, Chief of Staff of the JTC, who, in an Oct. 14 letter to the editor titled "False Allegations on Tax Reform," took exception to my statements that the JTC does not use "dynamic scoring." Mr. Kleinbard claims that all JTC revenue estimates are "dynamic," in that it makes adjustments for changes in taxpayer behavior to tax changes. Those of us who have been critics of the JTC argue that making some behavioral adjustments is insufficient, because it is also necessary to look at the effect of tax changes on productivity growth, job creation, and real economic growth, among other things.

UNDERESTIMATES OF FEDERAL TAX REVENUEBY THE JTC 2004-2007 (percentage error)	
	Predictions Made for the Year

Predictions Made in the Year	2004	2005	2006	2007
2004	-3.48	-5.12	-6.68	-7.67
2005		-4.71	-8.80	-8.95
2006			-4.10	-4.35

If you look at the adjoining table, you will see that those at the JTC consistently underestimated the growth in tax revenues after President Bush's tax rate cuts in 2003. Even when the JTC forecasters saw they were wrong, they still did not make the necessary adjustments to their model. The fact is that for decades they have consistently missed the macroeconomic growth stemming from tax rate reductions and have often overestimated tax revenues stemming from a rate increase. JTC's three-year projections of capital gains tax receipts have often been off by more than 50 percent, and at times in the past they have even had the direction of their sign wrong (i.e., lower capital gains rates led to more revenues). When most errors tend to be in the same direction, it is telling you that you are missing things – *but JTC still does not get it!* Like our boater in the initial illustration, if you leave out key variables, your forecast will be wrong because you have not done what professionals consider to be a full "dynamic" forecast.

In part, because of the failure of the JTC to correctly forecast the increase in tax revenues after the 2003 rate cut (they missed over $200 billion in actual revenue), a number of members of Congress and all the Democrat presidential candidates have recommended repealing the Bush tax rate cuts. Stephen J. Entin, President of the Institute for Research on the Economics of Taxation (IRET) and a former senior economist at the U.S. Treasury, has just estimated – using real dynamic models – that letting the Bush tax cuts expire will cause an eventual real drop in GDP of 5-6 percent, and the loss of income and output ($700 to $800 billion) will result in a net tax loss of $25 billion, not counting the considerable loss in state and local tax revenue.

The JTC now has itself in a political bind, because it has left the Democrat candidates out on a limb. Over the next year, the JTC will be asked to "score" the tax proposals from the presidential candidates. If it uses true dynamic scoring and measures the effect of letting the Bush tax cuts expire, the JTC is likely to get numbers pretty close to that of Mr. Entin's, which will be unacceptable to its political masters (the congressional Democrats), so the JTC will probably continue to punt and pretend that a big tax increase will have little negative effect. Then, when the economy tanks and JTC's forecasts are seen to wrong once again, the JTC will blame it on other factors.

If the JTC were confident and serious about its forecasts, it would provide its methodology, the assumptions it has made, the basis for the assumptions, and the actual calculations, so that independent researchers could check the forecast. A scholar publishing a forecast in an academic journal would have to give such detail. The JTC does publish some general material about its methodology, but not the necessary detail about each specific forecast to show it was done accurately and without ideological bias. Given that tax policy is often driven by revenue forecasts and that taxes affect the economic well being of everyone, policymakers should not agree to accept the forecasts of only one non-transparent group.

Richard W. Rahn is chairman of the Institute for Global Economic Growth.

http://www.washingtontimes.com/article/20071101/COMMENTARY/111010090