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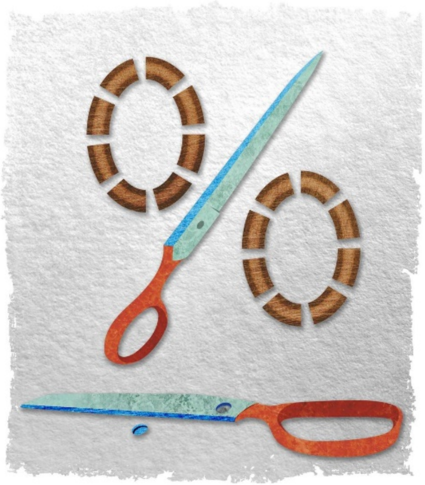

Tax Reform for the Real World

by Richard W. Rahn

GOVERNMENT REVENUE FORECASTS FAIL TO ACCOUNT FOR HUMAN BEHAVIOR

There is an old adage that entrepreneurs often find to be true, and that is that things take three times as long and cost three times as you much as you thought. The Republicans claim they are going to get tax reform done this year — but this is not going to happen unless they do two necessary things. First is to extend their number of work days, and the second is to ignore the Congressional Budget Office (CBO) revenue forecasts from the proposed tax changes.

The only way to get tax reform passed by the fall is to make sure that the pain of not getting it done by a date certain is so great that they will make the necessary compromises with each other to get it passed. Congress has scheduled a July 4 holiday and an August recess. Members' spouses have already made plans for August — trips to faraway places or to see relatives — and promised fun events for the kids. Many commentators and others have said that it would be irresponsible to take the August vacation if the promised work is not done. And yes, that puts a certain pressure on Congress, but nothing like the pressure that spouses and kids put on them to go on vacation. Speaker Paul Ryan and Senate Majority Leader Mitch McConnell are smart enough to know that without a tax cut this year, their control of Congress after next year's election is only going to be a memory. Real leaders understand that making the troops unhappy in the short run is at times necessary to achieve victory in the long run. So they need to announce that no more vacations (or "district work periods") until tax reform is finished. That is, the time to get the work done comes first, and the time left over can be used for vacation.

This may sound radical — but most kids know there is no TV until the homework is done. First responders, like policemen and firemen, do what they need to do before going home. Businesses with deadlines don't stop at 5 o'clock. The long established principle of overtime pay, or time off, is merely a way of compensating people for doing what has to be done at a given time. We don't give Congress members overtime pay, but we can fire them (by voting for their opponents) if they don't fulfill their promises in a timely matter. Don't feel sorry for them — they were the ones who made the promises to get rid of Obamacare and to pass tax reform by Labor Day.

The tax cuts need to be put in place in sufficient time to have a positive effect on the economy, well before Election Day 2018 — or it will be political suicide. Some will be tempted to not pass tax reform until next year and then make the tax cuts retroactive. This will have no behavioral effect and will only waste money without having a positive effect on the economy or an incumbent's political prospects.

When deciding on how big a tax cut "we can afford," Congress relies on the CBO to provide the numbers. Assume you were running a business, and your sales forecast department always overestimated the increase in revenues every time you increased prices and overestimated the revenue losses each time you cut prices. In fact, you found that because people had choices, sometimes a price increase resulted in less revenue and sometimes a price cut resulted in more revenue — we call this the real world.

Washington is not the real world, and both elected officials and government bureaucrats like to pretend that prices do not affect behavior and ignore the fact that a tax is a price. Thus, the government tax revenue forecasts almost always overstate the additional money from a tax rate increase and overstate the tax loss from a tax rate cut.

It is almost impossible for "tax reform" to take place unless there are more winners than losers, which means that "reform" has to be accompanied by a real tax cut to obtain the necessary number of winners. But if the revenue forecasters overstate the amount of loss from a tax rate cut, and Congress wants to claim that the bill is revenue neutral as to not increase the deficit over the long run, they have put themselves into a very tight political box.

The proper way to approach the problem is to ask nongovernment tax revenue forecasters who have true dynamic behavioral tax revenue models to give Congress an estimate as to both the shape and size of a tax cut that would increase GDP and job growth by a certain percent per year. And then, require that spending growth be cut to meet the tax revenue expectations — unlike doing it in the usual, backward manner of assuming tax revenues will rise to meet spending wishes.

Richard W. Rahn is chairman of Improbable Success Productions and on the board of the American Council for Capital Formation

http://www.washingtontimes.com/news/2017/jun/26/tax-reform-requires-looking-at-government-revenues/