

# Written Testimony of John L Buckley

## Joint Economic Committee

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### INTRODUCTION

Chairman Coats, Ranking Member Maloney, I want to thank you and the other Members of the Committee for the opportunity to appear before you today.

I doubt that any Member of this Committee would disagree with the proposition that expanding economic opportunities in this country should be one of our most important priorities. An expanding economy would make our long-term budgetary challenges less daunting. It also could reverse the loss of employment opportunities and wage stagnation that threaten the well-being of many American families. Therefore, there is no question that an analysis of the macroeconomic effects of major Federal legislation should occur. I believe that such analysis should cover all types of major legislation. You cannot have a modern economy without adequate transportation or other infrastructure. Investments in basic research are required for this country to remain competitive in the world economy. Information about the macroeconomic benefits of those government investments should be part of the legislative process.

In summary, I believe that macroeconomic analysis should play an important role in the design of legislation, but should not affect the official measure of its budgetary impact. But more importantly, the macroeconomic analysis, however used, should be reality based. All of the macroeconomic models used by the Congressional Budget Office (CBO) or staff of the Joint Committee on Taxation (JCT) are extraordinarily complex mathematical formulae. However, it is not possible to accurately reflect our complex economy and the vagaries of human behavior in a mathematical formula no matter how complex it is. Therefore, the models make simplifying assumptions that are often speculative or counterfactual in the sense that they are inconsistent with

observable facts. Since those assumptions, not the complex reality of our economy, determine the results produced by the model, they may not accurately predict the real-world impacts of legislation.

In addition to being based on those counterfactual or speculative assumptions, I believe that the economic principles underlying all of the macroeconomic models developed by the CBO or JCT are increasingly divorced from the reality of a world where companies, responding to market forces, are moving production offshore where there is a virtually unlimited supply of labor and capital. In such a world, I believe that enhancing the competitiveness of US businesses and workers through public and private investments in physical and intellectual capital is the key to long-term growth.

In simple terms, the question is whether the largest economic challenge faced by this country is the lack of jobs that can support a middle-class family or too few people looking for work. I believe most would agree that it is the lack of job opportunities. Yet, the macroeconomic models discussed today assume that expanding the number of people looking for work (labor supply) will result in increased economic growth. Most handle the problem of unemployment by simply assuming it does not exist.

## **DYNAMIC SCORING NOT APPROPRIATE FOR OFFICIAL SCOREKEEPING.**

### **Budget Numbers Could Lose Credibility.**

Dynamic scoring starts with the conventional estimate of the cost of the legislation and then reduces that cost by estimates of the increased revenue that could result from the legislation's impact on the economy. Reducing the reported cost of a policy change or expenditure by the potential benefits of the policy change or expenditure is a luxury not available to corporations. Corporations are not permitted to reduce the cost of their investments by the anticipated future benefits no matter how certain those future benefits appear to be. Even with the scrutiny of independent auditors, the risk of harm to

investors relying on overly optimistic projections is too great. That logic is even more compelling in the case of dynamic scoring for legislation.

First, there is little question that the dynamic scoring estimates are more uncertain than conventional cost estimates. They require judgment calls by the staff on factors like the elasticity of labor supply where there is little empirical evidence to guide the choice from a wide range of possibilities. In the case of tax legislation, they require predictions about future actions by the Federal Reserve. Some models, including some used by the CBO and JCT, require assumptions concerning future actions by the Congress. The CBO in its report on the budgetary and economic effects of repealing the Affordable Care Act (CBO report on repeal of the ACA) acknowledged that the “estimates of the macroeconomic effects and their consequences for the federal budget are highly uncertain.”

Second, there is no consensus in the economic community on a single model and there are many opinions on basic assumptions used in the models. That lack of consensus is reflected in the fact that the CBO and JCT use different models and sets of assumptions. The fact that the official Congressional scorekeepers do not have a common approach could result in confusing and inconsistent budget numbers.

Third, dynamic scoring requires a single cost estimate even though the CBO and JCT have consistently stated that no one model can adequately explore the implications of major changes in fiscal policy. Even Professor Diamond in his report for the Business Roundtable on the implications of the Camp tax reform plan, stated that the results of any one model are “at best suggestive”.

Fourth, the results of dynamic scoring vary dramatically depending on choice of model and assumptions and there is little objective evidence to guide CBO or JCT in deciding on a single model or set of assumptions. The JCT macroeconomic analysis of the tax reform plan of former Ways and Means Chairman Camp showed a wide range of possible outcomes. Depending on the model and set of assumptions, the predicted increase in real GDP after 10 years was as little as 0.1% and as large as 1.6%.

Finally, the perception, if not the reality, of political interference in budget scorekeeping may be inevitable. Since there is little objective evidence justifying choice of method or assumptions, it might be difficult for the staff to

justify their approach when confronted by a Member not happy with their conclusion. In 1995 Congressional testimony, former Federal Reserve Chair Alan Greenspan cautioned that the use of controversial scoring procedures like dynamic scoring could cause financial markets to lose confidence in the integrity of budget scoring. If that happened, "the rise in inflation premiums and interest rates could more than offset any statistical difference between so-called static and more dynamic scoring."

### **Implications of Federal Budget Constraint.**

Many models, so called forward-looking models, simply do not work when the federal budget is on an unsustainable path as is the case today. Those models typically produce the largest growth projections. In the past, the models used by the CBO were subject to that constraint. The JCT has used one model with that constraint and one without. Professor Diamond's model is subject to that constraint.

To avoid that constraint, the analysts simply assume that the Congress has or will enact deficit reduction legislation. In some models, there is the assumption of a detailed deficit reduction plan. Other models assume a less detailed plan. The details of the deficit reduction plan can affect the projections.

I would hope that we can all agree that no official budget estimate for any legislation should dependent on an assumption of future Congressional action. In addition, Congressional staff should not be placed in the position of making predictions of how the Congress will respond to the deficit issue.

## **MODELS POOR POLICY GUIDES**

### **Counterfactual Assumption of Economic Equilibrium Critical to Results.**

All of the dynamic scoring models used by the CBO or JCT are based on growth models that contain two basic assumptions. First, they assume that the long-term constraint on economic growth is supply of labor and capital. An

increase in those factors of production will result in an increase in potential economic activity.

Second, they assume that the supply and demand for labor and capital are in equilibrium. As a result, they assume that there is no such thing as involuntary unemployment; individuals without jobs are assumed to have voluntarily left the workforce. Based on that assumption, the high rate of unemployment in the recent recession was due to the collective decision of millions of Americans to take an unpaid vacation. Some models, like one of the JCT models, do allow for temporary periods of unemployment, but they assumes that prices will adjust (that is, wage rates will fall) to bring supply and demand for labor into balance.

The assumption that the economy is in equilibrium is critical to the projections of increased growth from increases in the factors of production. For example, the CBO report on repeal of the ACA assumes a large increase in labor supply due to the fact that 24 million individuals would lose health insurance as a result of that repeal. Those individuals may seek employment to gain access to employer-provided health insurance or may work harder to pay health care expenses no longer covered by insurance. That increase in labor supply is largely responsible for the report's projection of increased growth. An increase in labor supply can result in greater economic growth only in an economy without unemployment.

The question is how you can assume that there will be jobs for the additional number of individuals seeking work. The answer is one that few wish to acknowledge. Unless there are other provisions increasing the productivity of the labor force, the models assume that price adjustments (again wage reductions) will bring the supply and demand for labor back into balance.

For example, the JCT report on the macroeconomic effects of the Camp tax reform plan concluded that the net effect of its rate reductions and repeals of domestic investment incentives would increase the cost of capital for domestic firms and result in lower levels of business investment than those projected under current law. The reduction in business investment would reduce the productivity of the economy. Since there was a negative effect on productivity, the president of the Tax Foundation (a conservative organization focusing on tax issues) stated in testimony before a subcommittee of the House Ways and Means Committee that the Camp tax

reform plan would increase economic growth because it would result in more individuals working for lower wages.

The assumption of an economy in equilibrium also permits the models to ignore the potential disruptive effects of the legislation. For example, the CBO report on repeal of the ACA projects that repeal would result in 28 million individuals losing health insurance. One can only assume that 28 million individuals losing health insurance would cause some disruption and reduction of employment by health care providers and insurers. I believe that, in the case of any serious legislative consideration of such repeal, the potential disruption would be an important issue. But, that issue is not even mentioned in the CBO report because the assumption of equilibrium means that workers losing jobs in the health care industry are assumed to seamlessly move to jobs in other sectors.

Similarly, in 2006, the JCT did a macroeconomic analysis of a tax reform plan that, among other things, repealed all existing benefits for owner-occupied housing. The repeal of housing benefits was assumed to increase economic growth by reducing investment in owner-occupied housing, thus increasing funds for other more productive investments. The JCT acknowledged that the proposal would reduce housing prices, with potential consequences not accounted for in the macroeconomic models. This is another example where major macroeconomic consequences are ignored by these models.

### **Time to Examine Underlying Principles**

An article in 2011 by Sandile Hlatshwayo and Nobel Laureate economist Michael Spence<sup>1</sup> suggests that the economic theories which are the basis of models used in dynamic scoring have little relevance now when “the global economy has an abundance of human resources and they are becoming more accessible as time goes on.” Those resources are becoming more accessible because multinationals have become adept at creating and managing global supply chains and they are getting better all the time.

The Spence article looks at employment growth in the US between 1990 and 2008 in the tradable sector of the economy (the sector subject to cross-border

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<sup>1</sup> The Evolving Structure of the American Economy and the Employment Challenge, Council on Foreign Relations.

competition) and the non-tradable sector. Not surprisingly, virtually all of the domestic employment growth during that period (97.7%) occurred in the non-tradable sector, with employment in government, healthcare and retail accounting for most of that growth. The article concludes that there is “a long-term structural challenge with respect to the quantity and quality of employment opportunities in the United States” since continued large employment growth in those non-tradable sectors is unlikely.

In the opinion of the authors, the domestic employment challenge is not the result of market failures. Multinational enterprises moving jobs overseas are doing exactly what the market is telling them to do. A tax reform plan or other legislation based on the primacy of market outcomes will not reverse the declines in domestic manufacturing employment. Indeed, a tax reform plan like the Camp plan could worsen domestic employment challenges by repealing broad-based incentives for domestic investment under the guise of economic neutrality while liberalizing tax rules for the overseas operations of US multinationals. Those provisions would create a playing field that tilts in favor of investments overseas.

The Spence article suggests that we may have employment challenges that call into question all of the equilibrium assumptions that are part of the dynamic scoring models.

### **Counterfactual Assumptions Concerning Human Behavior.**

Increasingly, there are differences among economists on how to model human behavior. Until recently, the prevailing view has been that individuals act rationally to optimize their economic well-being. This theory generally is part of the models being discussed today. Forward looking models take an additional step. They assume that individuals have the benefit of being able to accurately predict future economic conditions and future legislation or other governmental actions.

Those assumptions are critical for predictions of increases in labor supply or savings from tax rate reductions or savings incentives. Unless people always act to optimize their economic well-being and plan ahead for a long time horizon, rate reductions or savings incentives may have limited effect.

The question is whether these assumptions have any basis in fact. There is a growing school of economics (behavioral economics) that insists that we should analyze economic issues based on the actual behavior of individuals, not the assumed optimizer. They can point to many examples, large and small, where individuals for many reasons do not act as assumed in these models. For example, most individuals have far too little in retirement savings, notwithstanding the broad expansion of retirement savings incentives over the last 35 years. If the assumptions were an accurate reflection of human behavior, the financial crash of 2007-2008 could not have happened.

## **CONCLUSION**

Most of the tax legislation enacted after 1980 and before 2009 was based on the supply side theories and notions of economic efficiency that are the foundation of the dynamic scoring models. Essentially, we conducted a 30 year experiment in the real-world validity of those theories. The results of that experiment are quite clear; projections based on those theories consistently have overstated the real-world impact of tax legislation.

The 1981 Reagan tax cut was accompanied by projections that it would increase economic growth by encouraging greater savings and labor supply. Those predictions did not come true. The personal savings rate declined after the 1981 tax legislation. A report by Martin Feldstein, the chair of President Reagan's Council of Economic Advisors, concluded that there was no support for the proposition that the recovery in the 1980's reflected an increase in labor supply induced by the reduction in tax rates. Instead, he credited expansionary monetary policy as the primary cause of the expansion.

Many economists predicted that the Tax Reform Act of 1986, with its dramatic rate reductions, would increase economic efficiency and contribute to increased economic growth. Those predictions seemed especially warranted since the rate reductions were financed to a significant extent by eliminating clearly distortive, nonproductive, tax-shelter activity.



The University of Michigan commissioned a study of the economic impact of the 1986 reforms by a group of prominent economists, which included both proponents and opponents of the 1986 reforms. Their almost unanimous conclusion was that the real world effects of the 1986 reform were substantially less than predicted.

Contrary to predictions of negative economic consequences, the 1993 tax increases were followed by one of the strongest periods of economic growth in recent history.

The performance of our economy during the recent Bush presidency was quite inconsistent with the positive economic predictions that were used to support enactment of the 2001 and 2003 tax reductions.

None of this should be surprising. Models based on faulty assumptions that do not reflect the realities of our complex economy will tend to produce faulty predictions. Unless we are willing to compete as a low wage economy, relying on market forces and an expanding workforce is not sufficient for this country to be competitive in the world economy.

I would like to thank the Committee, once again, for inviting me to testify today and would be happy to answer any questions you may have.