JOINT ECONOMIC COMMITTEE

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ECONOMIC POLICY RESEARCH

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UNDERSTANDING THE CBO'S DYNAMIC ANALYSIS

Last week the Congressional Budget Office (CBO) released a dynamic analysis of the president's budget.[1] Using a variety of economic models, the CBO evaluated how the president's tax and spending proposals, *taken together*, would affect the economy and, thereby, government spending and tax revenues. Initial reactions to the study reveal much confusion about its results and methodology. This update answers key questions about the analysis.

What did the CBO find?

The CBO concluded that the tax and spending proposals in the president's budget, taken together, would have relatively small impacts on overall economic activity in the long run; these impacts could be either positive or negative. The CBO's "dynamic" projections of the fiscal impact of the president's budget thus differ relatively little (roughly ±15 percent) from its usual "static" projections.[2]

The CBO also found that the president's budget would provide a significant boost to the economy in the next few years. The two business cycle models used by the CBO indicate that the budget proposals would increase real gross domestic product by 1.3 percent in 2004.

Does that mean the growth package won't boost the economy in the long run?

No. The president's budget consists of several different components: enacting the economic growth package, extending the 2001 tax relief, providing additional tax relief (e.g., by strengthening incentives for saving and charitable giving), and increasing spending. The CBO analyzed all of these proposals together; it did not analyze them separately. CBO's conclusions thus apply to the entire budget, not to its individual components.

Although CBO does not report separate results for the growth package, we can infer from its findings that the president's growth package is likely to provide a significant boost to long run growth. However, that boost is substantially offset by the economic drag of spending increases (which alone comprise more than a third of the president's budget proposal[3]) and the mixed macroeconomic impact of other tax reductions.

What would happen if the growth package were made smaller?

Economic growth would be lower. Without support from the growth package, the rest of the president's budget proposals, taken together, would provide little macroeconomic boost and might actually weaken economic growth in the long run.

Why might the other budget proposals weaken the economy in the long run?

Holding other things constant, an increase in government spending leads to a larger government deficit and greater federal borrowing. The increase in borrowing reduces national saving; private

investment thus declines or must be financed by international sources of capital. Either way, domestic economic growth is reduced. The CBO assumes that such "crowding out" of private investment is substantial. Government spending may be justified on other policy grounds, but it frequently reduces the long run potential of the U.S. economy.[4]

Do tax cuts have similar "crowding out" effects?

Only if they don't provide a sufficient boost to economic growth. The CBO analysis presumes that tax cuts have two offsetting effects:

- Supply side effects. Many tax cuts encourage people to work, save, invest, and undertake entrepreneurial pursuits. These tax cuts expand the economy's capacity to supply goods and services (hence the description "supply side") and increase long run economic growth.

- Effects on national saving. Holding other things constant (i.e., ignoring supply side effects), tax reductions affect national saving the same way that spending increases do: increased federal borrowing reduces national saving (unless people save the entire tax reduction) and private investment gets "crowded out." The magnitude of this "crowding out" of private saving is a matter of ongoing dispute. The CBO assumes a fairly high degree of crowding out; other analyses show substantially smaller effects.[5]

The net effect of tax cuts on the economy depends on the relative magnitude of these two effects. If the potential for crowding out is substantial (as the CBO assumes), some tax cuts may hamper the economy if they don't sufficiently improve incentives to work, save, and invest. Well-designed supply side tax cuts will still increase economic growth, however, as the supply side benefits offset any reduction in growth due to lower national saving.

Does the president's budget include tax reductions that would increase economic growth?

Yes. The president's budget includes several important supply side tax cuts: ending the double taxation of dividends, increasing expensing of small business investment, and accelerating and making permanent reductions in marginal tax rates. These tax reductions encourage work, saving, investment, and entrepreneurial effort, so they increase the economy's capacity in the long run.

What does the CBO report conclude about the budget impacts of taxes and spending?

The CBO's dynamic analysis indicates that spending programs are more expensive than traditional static budget scores have indicated. Increased government spending typically weakens the economy, leading to lower tax revenues and higher spending elsewhere in the budget. Tax reductions, on the other hand, may be either more or less expensive than traditional static scores have indicated. Tax reductions that provide a sufficient boost to economic growth are less expensive, while tax reductions that do little to spark growth are more expensive.

What does the CBO report teach us about the potential for dynamic budget analysis?

The report demonstrates that dynamic budget analysis is possible. The CBO should be commended for producing such a professional and detailed analysis in such a short time.

Given the many uncertainties and unsettled research questions identified in the report, further work is required before we can move to full-fledged dynamic scoring (i.e., using dynamic

estimates as part of the federal budget process). Dynamic analyses are valuable for informing Congress about the potential economic impacts of policy proposals, but the techniques are not yet sufficiently refined to incorporate in official budget mechanisms. With the help of outside researchers, CBO should work to resolve key uncertainties and winnow down the broad range of models that were required for this inaugural effort.

CBO should also consider whether and how to report results for individual components of budget proposals. Congress would clearly benefit from more disaggregated information about how tax and spending proposals affect the economy.

Finally, the report also raises important questions about budget analysis responsibilities and the transparency of the budget process. CBO has traditionally held responsibility for economic analyses and the scoring of spending proposals, while the Joint Committee on Taxation (JCT) has been responsible for scoring tax proposals. As dynamic analysis matures into dynamic scoring, CBO and JCT may have to refine the ways that they coordinate their activities. Both organizations should also examine, with input from other Congressional offices, how to make their analyses sufficiently transparent and accessible. The CBO report takes an excellent step in this direction with its clear documentation of many modeling assumptions.

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[1] *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, Congressional Budget Office, March 2003. The dynamic analysis begins at page 16 of the final report.

[2] A "static" budget analysis assumes that the overall economy would not be affected by the adoption of a particular budget proposal; a "dynamic" budget analysis attempts to measure how the economy would respond and how those responses would, in turn, affect tax revenues and spending.

[3] On a static basis, the budget includes $1.5 trillion in tax relief, $725 billion in new spending , and $530 billion in increased interest payments over the 2004-2013 budget horizon (relative to the CBO baseline). Allocating the increased interest, the static impacts are $1.8 trillion from tax relief and $910 billion from spending increases.

[4] Some spending might boost the economy in the long run (e.g., spending on research or some infrastructure projects). The CBO did not believe such spending to be significant in the president's budget, so it did not estimate such effects.

[5] See, for example, John Seater, "Ricardian Equivalence," *Journal of Economic Literature*, March 1993.

Other recent JEC publications include:

- “Recent Economic Developments,” April 1, 2003.
- “10 Facts About Oil Prices,” March 26, 2003.
- “Understanding the Size of the Economic Growth Package,” March 12, 2003.
- “Who Benefits from Ending Double Taxation of Dividends?,” February, 2003.
- “The President’s Budget and the Federal Debt,” February 11, 2003.

The above publications and other information can be found at jec.senate.gov.