THOUGHTS ON DYNAMIC SCORING OF FISCAL POLICIES

Donald B. Marron

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This brief was first published as a comment on Douglas W. Elemendorf's contribution to the Fall 2015 *Brookings Papers on Economic Activity*.

Donald Marron is director of economic policy initiatives and Institute fellow at the Urban Institute.

In his recent paper, Douglas Elmendorf (2015) lays out a compelling case that the Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation (JCT) should account for macroeconomic feedback when scoring proposed legislation. I agree. The two agencies have been developing and refining their macroeconomic modeling techniques for more than a decade. They have successfully applied those techniques in a host of analyses. The next step in this gradual evolution is to incorporate them in official scoring.

Concerns about dynamic scoring are understandable in light of highly politicized fiscal policy debates and the way claims about dynamic effects often align with ideological views. But CBO and JCT have a strong track record of navigating such shoals and delivering nonpartisan analysis to Congress. I expect the same will be true with dynamic scoring, which will not fully live up to the hopes of its proponents nor "live down" to the fears of its detractors. Instead, it will modestly improve the budget estimates that inform policymakers and the public.

Seven points in Elmendorf's paper deserve particular emphasis:

First, including macroeconomic effects can improve budget estimates. The budget process requires year-by-year estimates of the revenue and spending implications of proposed legislation. CBO's and JCT's missions are to make those estimates as accurate as possible, given the constraints under which they operate. Fiscal policies can change how people work, save, invest, and spend and thus can raise or lower macroeconomic activity. Including such effects in official scores will improve budget deliberations as long as there is a sufficient evidentiary base for estimating them and as long as doing so is consonant with other constraints the agencies face (such as timeliness, resource limits, and transparency requirements).

Second, including macroeconomic effects can improve policy comparisons. Policy debates often distill macroeconomic effects to the level of tweets and bumper stickers: "Tax cuts boost growth"; "Spending stimulates the economy." The extent to which such claims are true, however, depends on policy specifics. Marginal tax cuts likely do more for long-run economic growth than do inframarginal ones, for example, and spending in recessions likely boosts the economy more than at times of full employment (CBO 2014).

CBO and JCT have traditionally quantified those differences in supplementary analyses undertaken outside of official budget scoring. Including them in official scores would make them more politically salient. Tax cuts that weaken long-run growth, for example, will get worse budget scores than under conventional estimating, while cuts that encourage growth will get better scores. Differing scores will give lawmakers more reason to consider seriously the macroeconomic effects of competing policy proposals.

Third, dynamic scoring should apply to both taxes and spending. Most of the public debate about dynamic scoring has focused on tax policies, but spending programs have the same potential for macroeconomic effects. Investments in infrastructure and education can boost long-run economic potential; so can private investment induced by tax policy changes. The phase-out of benefits in social insurance programs can discourage labor supply; so can taxes on wages. Spending can soften recessions; so can tax cuts. Spending financed by deficits can crowd out private investment; so can tax cuts financed by deficits. Treating spending and taxes equally in dynamic scoring thus makes perfect sense. This is straightforward for taxes and mandatory spending, but it is more challenging for the discretionary spending that Congress handles through its annual appropriation process. Whether and how to apply dynamic scoring to discretionary spending therefore deserves further attention in budget process discussions.

Fourth, dynamic scoring should be applied only to major pieces of legislation. Dynamic scoring is logistically challenging. It takes time and talented staff. As a result, there are practical limits to how many dynamic scores CBO and JCT can produce. It makes sense to focus solely on the largest bills, while allowing legislators to require dynamic scoring in other cases where macroeconomic effects may be important. If CBO and JCT develop ways to make macroeconomic analysis easier in the future, lawmakers can expand the scope of required dynamic scoring.

Fifth, the authority to require dynamic scoring should be shared by the two parties. Under current congressional procedures, only the chairs of the House and Senate budget committees can request dynamic scoring of particular bills. As Elmendorf recommends, however, that power should also be given to the ranking members of those committees. Sharing this power would reduce the risk of the majority's using dynamic scoring strategically and would maintain more consistency in the scoring's application.

Sixth, the adoption of dynamic scoring at the start of 2015, as important as it is, is not as big a break with past practice as it first appears. CBO and JCT have been publishing dynamic analyses for more than a decade, including analyses of major tax reforms (JCT 2014a, 2014b), stimulus proposals (CBO 2009), and presidential budgets (CBO 2015). The techniques used in those analyses have been refined through experience and external review.

Immigration reform proposals in 2006, 2007, and 2013 provided special opportunity for the agencies and Congress to prepare and consider scores that included some macroeconomic effects. When CBO and JCT did this in 2006—at a time when I served as CBO's acting director—we expected controversy, but there was none; lawmakers and outside analysts understood that it made sense for CBO and JCT to consider the effects of an increased labor force when evaluating immigration reform despite the convention of not including any macroeconomic effects for other bills (Marron 2013).

In addition, the agencies incorporate the macroeconomic effects of fiscal policy when constructing their twice-yearly budget baselines. In August 2012, for example, CBO had to project the budget outlook in the face of the then-looming "fiscal cliff," a panoply of scheduled tax increases and spending cuts. Those provisions would have amounted to $500 billion in fiscal tightening in 2013. As a result, CBO (2012) projected that the economy would be pushed into recession. That projection provided important context for fiscal cliff deliberations.

Dynamic analysis, immigration reform, and baseline projections have thus paved the way for the agencies to include macroeconomic feedbacks in official scores.

Seventh, the strongest concerns about dynamic scoring—uncertainty and the risk of bias—are understandable but manageable. Macroeconomic impacts are uncertain, and experts disagree on how best to model them. How myopic or forward-looking are individuals when making work, saving, and consumption decisions? How will the Federal Reserve respond to changes in fiscal policy? What are the feedbacks between the U.S. economy and the rest of the world? How much do deficits crowd out private investment? Can fiscal policy reduce hysteresis effects in the aftermath of a deep recession?

In principle, such uncertainties could create opportunities for the agencies to put a thumb on the scale to favor results preferred by their political masters. In reality, the cultures and staffing of CBO and JCT are fundamentally nonpartisan. The two agencies' directors are chosen by the congressional majority, and they certainly hear from congressional leaders about important bills, but they have done an admirable job maintaining their non-partisan credibility.

Moreover, concerns about uncertainty and potential bias apply equally to many estimates the agencies have traditionally produced. Future economic conditions and behavioral responses are highly uncertain. What will be the take-up rate of a never-before-seen benefit program? How will state governors and legislatures respond to new flexibility in a federal program? What are the probability and magnitudes of potential terrorist attacks in the United States? What will oil prices be in 2025? What will electromagnetic spectrum sell for in 2022? What new medicines will come to market in the next decade? At what price and usage? How will the Supreme Court respond to a possibly unconstitutional piece of legislation?

The strong nonpartisan culture of the agencies has allowed them to make objective calls on such questions in the past and will allow them to do so with dynamic scoring in the future. That culture also implies that the effects of dynamic scoring will be less rosy than some proponents claim and less dire than some opponents fear. President Harry S. Truman once asked for a one-armed economist. He would not find any at CBO and JCT. Instead, the agencies will provide classic many-handed analyses that include offsetting effects.

In analyzing macroeconomic feedback from tax cuts, for example, the agencies will consider how they might encourage working, saving, and investing. But they will also consider how tax cuts may increase after-tax income and thus reduce work and how any resulting deficits may eventually reduce private investment. To use the jargon, CBO and JCT will consider the income effects and the crowding-out effects of tax cuts, not just the substitution effects that proponents emphasize. That three-handed approach tempers the potential macroeconomic effects of tax cuts. Indeed, it reveals that some tax cuts reduce economic growth and thus have a larger budget cost than conventionally estimated (CBO 2010).

The same is true of the dynamic scoring of spending provisions, stimulus efforts, and other policies that often have the opposite political valence. Proponents of stimulus often emphasize the potential boost from putting money in peoples' pockets and the multiplier effects that this may set in motion. But CBO and JCT also consider whether and how much Federal Reserve policy may offset such effects and what long-term drag will result from accompanying deficits and accumulated debt (CBO 2014).

The reality of dynamic scoring is thus unlikely to live up to the hype. Instead, dynamic scoring will modestly improve the budget projections that inform fiscal policy deliberations.

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